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United States District Court
For the Northern District of California

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

ARMANDO PLASCENCIA and MELANIA
PLASCENCIA, individually and on
behalf of all others similarly
situated,

No. C 07-4485 CW

Plaintiffs,

ORDER GRANTING IN
PART EMC MORTGAGE
CORP.'S MOTION TO
DISMISS

v.

LENDING 1ST MORTGAGE; LENDING 1ST
MORTGAGE, LLC; and EMC MORTGAGE
CORPORATION,

Defendants.

_____ /

Plaintiffs Armando and Melania Plascencia charge Defendants Lending 1st Mortgage, Lending 1st Mortgage, LLC and EMC Mortgage Corp. with violating the Truth in Lending Act and California statutory and common law in connection with the sale of certain residential mortgage products. EMC moves to dismiss the claims against it. Plaintiffs oppose the motion. The matter was heard on September 25, 2008. Having considered oral argument and all of the papers submitted by the parties, the Court grants EMC's motion in part and denies it in part.

BACKGROUND

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2 According to the complaint, Lending 1st sells a variety of
3 home loans, including option adjustable rate mortgages (OARMs).
4 EMC is in the business of purchasing, packaging, and securitizing
5 some or all of Lending 1st's OARMs. In May, 2006, Plaintiffs
6 purchased an OARM in the amount of \$395,000 from Lending 1st to
7 refinance their primary residence in San Leandro, California. The
8 terms of their mortgage are complex and are set out in extensive
9 detail in an Adjustable Rate Note (the Note), which is attached to
10 the complaint.¹

11 As with all adjustable rate loans, the interest rate on
12 Plaintiffs' loan was pegged to a variable index and thus changed
13 over time. One unusual feature of Plaintiffs' loan, however, was a
14 low initial interest rate of one percent. This "teaser" rate
15 resulted in an initial minimum monthly payment of \$1,270, which is
16 equal to the monthly payment on a fully amortized thirty-year loan
17 with a one-percent interest rate. On July 1, 2006 -- the date of
18 Plaintiffs' first loan payment -- the interest rate on their
19 mortgage increased substantially from the teaser rate of one
20 percent. As of that date, the loan began accruing interest at a
21 variable rate that changed each month and was calculated by adding
22 3.375% to an Index equal to the twelve month average of the annual
23 yields on actively traded U.S. Treasury Securities adjusted to a

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25 ¹On this motion, the Court may properly consider the contents
26 of the exhibits to the complaint. See United States v. Ritchie,
27 342 F.3d 903, 908 (9th Cir. 2003) (a court may consider, among
28 other things, documents attached to the complaint without
converting a motion to dismiss into a motion for summary judgment).

1 constant maturity of one year.²

2 Although Plaintiffs' interest rate rose almost immediately,
3 their minimum monthly payment did not. This is because the Note
4 limited to once a year the frequency of initial increases to the
5 minimum monthly payment. Because of this limit, Plaintiffs'
6 minimum monthly payment did not increase until July, 2007. In
7 addition, the Note imposed a "payment cap" on the amount of each
8 initial increase to the minimum monthly payment. Under this cap,
9 the minimum monthly payment could only increase by 7.5% for each of
10 the first four years. However, subsequent increases were not
11 limited by the payment cap. Instead, with the fifth increase, the
12 payment would reset so that the remaining principal would be paid
13 off with equal monthly payments over the remaining term of the
14 loan.

15 Because Plaintiffs' initial minimum monthly payment was based
16 on a one-percent interest rate and did not go up along with the
17 almost immediate increase in their interest rate, their mortgage
18 began accruing more interest each month than the entire amount of
19 their payment. The interest that was left unpaid at the end of
20 each month was added to the outstanding principal and began
21 accumulating interest itself. As a result, Plaintiffs' principal
22 debt grew even while they made the minimum payment each month.
23 This process is known as negative amortization. Assuming the value
24 of the property subject to a mortgage remains constant, the effect

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26 ²As a point of reference, the annual yield on such securities
27 was 5.22% in July, 2006. See [http://www.federalreserve.gov/
releases/h15/data/Monthly/H15_TCMNOM_Y1.txt](http://www.federalreserve.gov/releases/h15/data/Monthly/H15_TCMNOM_Y1.txt) (last accessed on
28 September 16, 2008).

1 of negative amortization is to reduce the borrower's equity in the
2 property.

3 The Note limited the amount of negative amortization that
4 could occur on Plaintiffs' loan such that the principal could never
5 rise to more than 115% of its original amount. Once the principal
6 rose to this level, Plaintiffs' minimum monthly payment would be
7 reset so that the principal would be paid off with equal monthly
8 payments over the remaining term of the loan. This provision
9 overrode the ordinary rule that the minimum monthly payment could
10 rise only once a year and could increase by only 7.5% for each of
11 the first four years.

12 In addition to the Note, Plaintiffs also attached to the
13 complaint a Federal Truth-in-Lending Disclosure Statement (the
14 Statement) that they were given before finalizing their mortgage.
15 The Statement specified that the annual percentage rate (APR) on
16 the mortgage was 7.68%. The Statement also included a schedule of
17 estimated payments based on the initial one-percent interest rate
18 and the subsequent interest rate increase described above.³ The
19 schedule listed an initial minimum payment of \$1,270 that increased
20 by 7.5% on July 1 of each year until September 1, 2010. On that
21 date, which is just over four years into the repayment term, the
22 minimum monthly payment was shown to increase from \$1,697 to
23 \$3,314. It was set to remain at this level until the loan was paid
24 off in 2036. The dramatic increase is apparently attributable to
25 the projection that the principal would reach 115% of its original

26
27 ³The APR presumably was calculated using the value of the
Index at the time the Statement was issued.

1 amount in or about August, 2010, due to negative amortization. The
2 schedule assumed that Plaintiffs would make no more than the
3 minimum monthly payment at any time.

4 Plaintiffs claim they were unaware that their loan was subject
5 to negative amortization. They claim they were told that, "if they
6 made payments based on the promised low interest rate, which were
7 the payments reflected in the written payment schedule provided to
8 them by Defendants, [] the loan would be a no negative amortization
9 home loan and that Plaintiffs' payments would be applied to both
10 principal and interest." TAC ¶ 26. Plaintiffs assert that the
11 disclosures they were provided were inadequate to inform them that,
12 although the minimum monthly payment would remain low for several
13 years, the interest rate would increase almost immediately, causing
14 negative amortization and a consequent loss of equity.

15 Plaintiffs allege that Lending 1st sold their mortgage to EMC
16 at an unspecified time, but apparently shortly after the mortgage
17 was issued. According to documents submitted by EMC, in May, 2007,
18 Plaintiffs refinanced their home again with a new mortgage.⁴ In
19 doing so, they repaid in full the OARM that Lending 1st had issued
20 them. Plaintiffs do not dispute this fact.

21 Plaintiffs brought this action on behalf of themselves and
22 similarly situated individuals who purchased OARMS from Defendants.
23 Plaintiffs have identified two classes of these individuals: a
24 "California Class" consisting of all individuals who have purchased
25 an OARM from Defendants in connection with a primary residence in

26
27 ⁴The Court grants EMC's request for judicial notice of these
documents (Exhibits B and C to the request).

1 California; and a "National Class" consisting of all individuals
2 who have purchased an OARM from Defendants in connection with a
3 primary residence elsewhere in the United States.

4 Plaintiffs claim that Defendants violated the Truth in Lending
5 Act (TILA), 15 U.S.C. § 1601 et seq., because they did not clearly
6 and conspicuously disclose: 1) the actual interest rate on
7 Plaintiffs' mortgage; 2) the fact that the one-percent interest
8 rate was a discounted rate; and 3) the fact that negative
9 amortization was certain to occur. The Court previously denied
10 Lending 1st's motion to dismiss these claims. Plaintiffs also
11 assert a new TILA claim in the third amended complaint for
12 Defendants' failure to disclose that the payment schedule in the
13 Statement is "not based on the APR" identified in the same
14 document. This claim appears to be a restatement of their former
15 claims for Defendants' failure to disclose in the Statement
16 Plaintiffs' "true legal obligation" and the "composite" interest
17 rate. The Court previously dismissed these claims with prejudice,
18 and to the extent the new claim is based on the same allegations as
19 the old ones, it is not properly asserted. Plaintiffs also charge
20 Defendants with violating the California Unfair Competition Law
21 (UCL), Cal. Bus. & Prof. Code § 17200 et seq., by committing
22 unlawful, unfair and fraudulent business practices. Finally,
23 Plaintiffs charge Defendants with common law fraud, breach of
24 contract and breach of the covenant of good faith and fair dealing.

25 EMC moves to dismiss Plaintiffs' TILA claim for rescission on
26 the ground that it was mooted by Plaintiffs' 2007 refinance, and to
27 dismiss Plaintiffs' TILA claim for damages on the ground that it is

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1 barred by the statute of limitations. EMC also moves to dismiss
2 Plaintiffs' UCL claims on the grounds that the claims are preempted
3 and that EMC cannot be held vicariously liable for Lending 1st's
4 conduct. EMC further moves to dismiss the claims for fraud, breach
5 of contract and breach of the covenant of good faith and fair
6 dealing on the basis that the complaint fails to state substantive
7 claims for relief.

8 LEGAL STANDARD

9 A complaint must contain a "short and plain statement of the
10 claim showing that the pleader is entitled to relief." Fed. R.
11 Civ. P. 8(a). On a motion under Rule 12(b)(6) for failure to state
12 a claim, dismissal is appropriate only when the complaint does not
13 give the defendant fair notice of a legally cognizable claim and
14 the grounds on which it rests. See Bell Atl. Corp. v. Twombly,
15 __ U.S. __, 127 S. Ct. 1955, 1964 (2007).

16 In considering whether the complaint is sufficient to state a
17 claim, the court will take all material allegations as true and
18 construe them in the light most favorable to the plaintiff. NL
19 Indus., Inc. v. Kaplan, 792 F.2d 896, 898 (9th Cir. 1986).

20 Although the court is generally confined to consideration of the
21 allegations in the pleadings, when the complaint is accompanied by
22 attached documents, such documents are deemed part of the complaint
23 and may be considered in evaluating the merits of a Rule 12(b)(6)
24 motion. Durning v. First Boston Corp., 815 F.2d 1265, 1267 (9th
25 Cir. 1987).

26 When granting a motion to dismiss, the court is generally
27 required to grant the plaintiff leave to amend, even if no request
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1 to amend the pleading was made, unless amendment would be futile.
2 Cook, Perkiss & Liehe, Inc. v. N. Cal. Collection Serv. Inc., 911
3 F.2d 242, 246-47 (9th Cir. 1990). In determining whether amendment
4 would be futile, the court examines whether the complaint could be
5 amended to cure the defect requiring dismissal "without
6 contradicting any of the allegations of [the] original complaint."
7 Reddy v. Litton Indus., Inc., 912 F.2d 291, 296 (9th Cir. 1990).

8 DISCUSSION

9 I. TILA Claims

10 A. Effect of Plaintiffs' Refinance on the Availability of
11 Rescission

12 If a lender fails to make the material disclosures required by
13 TILA, the borrower has the right to rescind the mortgage agreement
14 within three years after the date on which the transaction is
15 consummated. See 15 U.S.C. § 1635. EMC argues that rescission is
16 unavailable because Plaintiffs have refinanced their loan. In
17 support of this position, EMC cites King v. California, 784 F.2d
18 910 (9th Cir. 1986). In King, as here, the plaintiff sought
19 rescission of a mortgage on the basis that the lender had not
20 provided the required TILA disclosures. Although the Ninth Circuit
21 did not address the issue of rescission in depth, it stated, "The
22 loan of March 1981 cannot be rescinded, because there is nothing to
23 rescind. King refinanced that loan in November 1981, and the deed
24 of trust underlying the March 1981 loan has been superseded." Id.
25 at 913. This statement was not dictum, in that it disposed of the
26 plaintiff's TILA claim for rescission. And although other circuits
27 have offered a more thorough analysis of the issue and have reached

1 a different result than King, see Handy v. Anchor Mortgage Corp.,
2 464 F.3d 760 (7th Cir. 2006); Barrett v. JP Morgan Chase Bank,
3 N.A., 445 F.3d 874 (6th Cir. 2006), the Court is not free to
4 disregard Ninth Circuit precedent.

5 Plaintiffs argue that King was superseded by the 1995
6 amendments to TILA. But those amendments did not alter § 1635(f),
7 the subsection that relates to the three-year right of rescission
8 for failure to provide material disclosures, let alone alter the
9 statute to specify a right to rescind following a refinance. See
10 Truth in Lending Act Amendments of 1995, Pub. L. 104-29, 109 Stat.
11 271 (1995). Plaintiffs state that the legislative history of the
12 1995 amendments "shows that Congress carefully considered the
13 rescission provisions of § 1653(f) [and] made a well-informed
14 decision not to include a provision which would cut off the
15 statute's rescission remedy if the homeowner refinanced." Pls.'
16 Opp. at 4. But the only legislative history actually cited by
17 Plaintiffs is a floor statement by Senator Sarbanes stating that,
18 under a previous version of the bill that was not passed,
19 "consumers would have lost the right of rescission for a whole
20 class of loans even if the most egregious violations of the Truth
21 in Lending Act were committed." 141 Cong. Rec. S14566-03, S14567
22 (1995). The statement does not, however, identify the class of
23 loans to which the Senator was referring. In any event, Congress'
24 failure pass a particular legislative provision would not be
25 conclusive under the circumstances. See Pension Benefit Guar.
26 Corp. v. LTV Corp., 496 U.S. 633, 650 (1990) ("Congressional
27 inaction lacks persuasive significance because several equally
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1 tenable inferences may be drawn from such inaction, including the
2 inference that the existing legislation already incorporated the
3 offered change."). If Congress had wished to supersede King, it
4 could easily have done so by amending TILA to specify explicitly
5 that a right to rescission exists even following a refinance.

6 Plaintiffs also claim that their claim for rescission is not
7 based simply on § 1635, but also on Regulation Z, which provides in
8 relevant part, "If the required notice or material disclosures are
9 not delivered, the right to rescind shall expire 3 years after
10 consummation, upon transfer of all of the consumer's interest in
11 the property, or upon sale of the property, whichever occurs
12 first." 12 C.F.R. § 226.23(a)(3). Nonetheless, the Federal
13 Reserve's authority to promulgate this portion of Regulation Z
14 apparently derives from 15 U.S.C. § 1635(f) -- Plaintiffs do not
15 suggest otherwise -- and thus the Ninth Circuit's interpretation of
16 the statute must also guide the Court's interpretation of the
17 regulation. The regulation therefore does not support Plaintiffs'
18 claim for rescission.

19 B. Timeliness of Plaintiffs' Claim for Damages

20 Unlike TILA claims for rescission, which may be brought within
21 three years, a TILA claim for damages must be brought within "one
22 year from the date of the occurrence of the violation." 15 U.S.C.
23 § 1640(e). "[T]he limitations period in Section 1640(e) runs from
24 the date of consummation of the transaction but [] the doctrine of
25 equitable tolling may, in the appropriate circumstances, suspend
26 the limitations period until the borrower discovers or had
27 reasonable opportunity to discover the fraud or nondisclosures that

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1 form the basis of the TILA action." King, 784 F.2d at 915.

2 EMC argues that Plaintiffs' TILA claim for damages is barred
3 by the statute of limitations. A statute of limitations defense
4 may be raised in a motion to dismiss, but only where "the running
5 of the statute is apparent from the face of the complaint," and the
6 motion should be granted "only if the assertions of the complaint,
7 read with the required liberality, would not permit the plaintiff
8 to prove that the statute was tolled." Durning v. First Boston
9 Corp., 815 F.2d 1265, 1278 (9th Cir. 1987). The issue of equitable
10 tolling must be considered when "the complaint, liberally construed
11 in light of our 'notice pleading' system, adequately alleges facts
12 showing the potential applicability of the equitable tolling
13 doctrine." Cervantes v. City of San Diego, 5 F.3d 1273, 1277 (9th
14 Cir. 1993) (emphasis added).

15 Plaintiffs' loan transaction was consummated in May, 2006, but
16 they did not file this action until August 29, 2007. Accordingly,
17 the TILA claim for damages would be timely if they did not
18 discover, or have a reasonable opportunity to discover, Defendants'
19 alleged TILA violations until August 29, 2006. Plaintiffs assert
20 in their opposition to EMC's motion that they did not, and could
21 not, discover the violations until they began receiving their
22 statements and realized that the amount of their principal was
23 increasing over time. This accords with the complaint's allegation
24 that Defendants did not adequately disclose the terms of
25 Plaintiffs' loan. EMC's assertion that the Note and the Statement
26 demonstrate that Plaintiffs had sufficient information to know of
27 their claim at the outset is contrary to the Court's decision on
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1 the first motion to dismiss. In denying that motion in part, the
2 Court found that, while the Note and the Statement are literally
3 accurate, Plaintiffs may be able to show that Defendants obscured
4 crucial terms of the mortgage -- in particular, the fact that the
5 initial minimum monthly payments were not sufficient to pay the
6 monthly interest that was accruing.

7 Although the facts surrounding Plaintiffs' discovery of the
8 objectionable loan terms must be developed through discovery, the
9 complaint does not foreclose the possibility that equitable tolling
10 may apply to their TILA claim for damages. Accordingly, dismissal
11 at this stage would be inappropriate. See Huynh v. Chase Manhattan
12 Bank, 465 F.3d 992, 1003-04 (9th Cir. 2006) ("Generally, the
13 applicability of equitable tolling depends on matters outside the
14 pleadings, so it is rarely appropriate to grant a Rule 12(b)(6)
15 motion to dismiss (where review is limited to the complaint) if
16 equitable tolling is at issue.").

17 II. UCL Claims

18 California's Unfair Competition Law prohibits any "unlawful,
19 unfair or fraudulent business act or practice." Cal. Bus. & Prof.
20 Code § 17200. The UCL incorporates other laws and treats
21 violations of those laws as unlawful business practices
22 independently actionable under state law. Chabner v. United Omaha
23 Life Ins. Co., 225 F.3d 1042, 1048 (9th Cir. 2000). Violation of
24 almost any federal, state, or local law may serve as the basis for
25 a UCL claim. Saunders v. Superior Ct., 27 Cal. App. 4th 832, 838-
26 39 (1994). In addition, a business practice may be "unfair or
27 fraudulent in violation of the UCL even if the practice does not
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1 violate any law." Olszewski v. Scripps Health, 30 Cal. 4th 798,
2 827 (2003).

3 A. EMC's Potential Liability Under the UCL

4 EMC argues that it cannot be held liable under the UCL because
5 the statute does not impose vicarious liability. See People v.
6 Toomey, 157 Cal. App. 3d 1, 14 (1984). It is true that the UCL
7 imposes liability only for a party's "personal participation in the
8 unlawful practices." Id. However, it is sufficient that the
9 defendant aided and abetted the principal violator. Id. at 15.
10 Under the common law definition, a person "aids and abets the
11 commission of an intentional tort if the person . . . knows the
12 other's conduct constitutes a breach of duty and gives substantial
13 assistance or encouragement to the other to so act." Fiol v.
14 Doellstedt, 50 Cal. App. 4th 1318, 1325 (1996) (quoting Saunders v.
15 Superior Court, 27 Cal. App. 4th 832, 846 (1994)).

16 The complaint alleges that EMC routinely purchased and
17 securitized OARMs that Lending 1st issued in violation of TILA. It
18 also alleges that all Defendants are "engaged in the business of
19 promoting, marketing, distributing, selling, servicing, owning, or
20 are and were the assignees of the Option ARM loans that are the
21 subject of this Complaint." TAC ¶ 8. By showing that EMC
22 purchased Lending 1st's OARMs with knowledge of Lending 1st's TILA
23 violations, Plaintiffs may be able to establish that EMC gave
24 Lending 1st a financial incentive to continue to commit those
25 violations, and therefore may be subjected to liability for aiding
26 and abetting violations of the UCL. Moreover, EMC's profiting from
27 loans featuring oppressive terms that were not fully disclosed in
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1 compliance with TILA could itself be an unfair business practice
2 under the UCL. EMC may therefore be liable for UCL violations in
3 its own right. Accordingly, the UCL claim will not be dismissed.

4 B. Preemption of UCL Claims by TILA

5 TILA contains a preemption provision that states:

6 Except as provided in subsection (e) of this section,
7 this part and parts B and C of this subchapter do not
8 annul, alter, or affect the laws of any State relating to
9 the disclosure of information in connection with credit
10 transactions, except to the extent that those laws are
11 inconsistent with the provisions of this subchapter and
12 then only to the extent of the inconsistency. Upon its
13 own motion or upon the request of any creditor, State or
14 other interested party which is submitted in accordance
15 with procedures prescribed in regulations of the Board,
16 the Board shall determine whether any such inconsistency
17 exists. If the Board determines that a State-required
18 disclosure is inconsistent, creditors located in that
19 State may not make disclosures using the inconsistent
20 term or form, and shall incur no liability under the law
21 of that State for failure to use such term or form,
22 notwithstanding that such determination is subsequently
23 amended, rescinded, or determined by judicial or other
24 authority to be invalid for any reason.

15 U.S.C. § 1610(a)(1) (emphasis added).

17 California law provides a four-year limitations period for UCL
18 claims. Cortez v. Purolator Air Filtration Prods. Co., 23 Cal. 4th
19 163, 178-79 (2000). This contrasts with the one- and three-year
20 limitations periods applicable to TILA claims for damages and
21 rescission, respectively. In addition, restitution and injunctive
22 relief are available as remedies for UCL violations. Cal. Bus. &
23 Prof. Code § 17203. EMC argues that these aspects of the UCL
24 render it "inconsistent" with TILA, and thus Plaintiffs' UCL claims
25 are preempted.

26 EMC's argument finds no support in the text of TILA's
27 preemption provision. That provision applies only to laws

1 "relating to the disclosure of information in connection with
2 credit transactions," and preempts those laws only to the extent
3 that the "terms and forms" mandated by the state are "inconsistent"
4 with those required by TILA. The preemption provision thus applies
5 only to inconsistencies in the substance of state disclosure
6 requirements.

7 The UCL does not, on its face, relate to the disclosure of
8 information in connection with credit transactions, let alone
9 impose disclosure requirements that are different than TILA's in
10 any way. To the extent EMC's argument is premised on the
11 contention that the UCL would impose liability for aiding and
12 abetting TILA violations where TILA itself would not, EMC has not
13 established that its alleged conduct would not subject it to
14 liability under TILA. And in any event, § 1610(a)(1) explicitly
15 provides that states may impose requirements beyond what is
16 required under TILA, so long as the states do not mandate the use
17 of "terms or forms" that are inconsistent with those required by
18 TILA.

19 Similarly, the fact that the UCL allows a claim to be brought
20 within four years or may provide remedies not available under TILA
21 (and it is not clear that it does) simply provides an additional
22 level of protection for consumers. The UCL does not mandate
23 additional disclosures that are substantively inconsistent with
24 TILA's, and therefore does not bring the UCL within the scope of
25 TILA's preemption provision. See In re First Alliance Mortgage
26 Co., 280 B.R. 246, 250-51 (C.D. Cal. 2002) ("Additional penalties
27 are not inconsistent with TILA, but merely provide greater
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1 protection to consumers. Section 17200 does not provide
2 inconsistent disclosure requirements."); Black v. Financial Freedom
3 Senior Funding Corp., 92 Cal. App. 4th 917, 936 (2001) ("[A]n
4 inconsistency or contradiction with federal law does not exist
5 merely because the state requires disclosures in addition to those
6 required by and under TILA.")

7 III. Fraud Claim

8 Under California law, "[t]he elements of fraud, which gives
9 rise to the tort action for deceit, are (a) misrepresentation
10 (false representation, concealment, or nondisclosure);
11 (b) knowledge of falsity (or 'scienter'); (c) intent to defraud,
12 i.e., to induce reliance; (d) justifiable reliance; and
13 (e) resulting damage." Small v. Fritz Cos., Inc., 30 Cal. 4th 167,
14 173 (2003) (quoting Lazar v. Superior Court, 12 Cal. 4th 631, 638
15 (1996)).

16 Plaintiffs have alleged that EMC bought OARMs, including
17 theirs, from Lending 1st and securitized them. Although the
18 complaint does not allege that EMC made a misrepresentation or an
19 omission of material fact directly to Plaintiffs, it alleges that
20 EMC was engaged in a fraudulent scheme with Lending 1st pursuant to
21 which loans with unfavorable terms were sold to consumers without
22 those terms being properly disclosed. EMC then bought, serviced
23 and securitized those loans. In In re First Alliance Mortgage Co.,
24 471 F.3d 977, 994-95 (9th Cir. 2006), the Ninth Circuit upheld a
25 jury verdict finding a secondary lender liable for fraud based on
26 the "substantial assistance" it provided to a fraudulent scheme by
27 virtue of its role in the securitization of loans that were

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1 originated fraudulently. Although EMC's liability for fraud will
2 ultimately turn on the exact nature of its involvement in the
3 allegedly unlawful lending practices, the allegations in the
4 complaint are sufficient to withstand dismissal at this early stage
5 of the proceedings.

6 In addition, the complaint contains sufficient allegations to
7 meet the heightened pleading requirements of Rule 9(b) of the
8 Federal Rules of Civil Procedure. Pursuant to this rule, "a party
9 must state with particularity the circumstances constituting
10 fraud." However, the rule requires only that the allegations be
11 "specific enough to give defendants notice of the particular
12 misconduct which is alleged to constitute the fraud charged so that
13 they can defend against the charge and not just deny that they have
14 done anything wrong." Semegen v. Weidner, 780 F.2d 727, 731 (9th
15 Cir. 1985). Plaintiffs have alleged specific non-disclosures
16 concerning the interest rate on their loan, the insufficiency of
17 their monthly payments to cover the accrued interest and the
18 consequent negative amortization that was certain to occur if they
19 made only the minimum monthly payments. They have also alleged
20 that EMC purchased and serviced their loan, and that it was in the
21 business of securitizing OARMS it similarly purchased from Lending
22 1st. The allegations in the complaint are sufficiently specific to
23 enable EMC to articulate a defense, and thus the requirements of
24 Rule 9(b) are satisfied.

25 EMC argues that it cannot be held liable for fraud because,
26 "to establish fraud through nondisclosure or concealment of facts,
27 it is necessary to show the defendant was under a legal duty to
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1 disclose them." OCM Principal Opportunities Fund v. CIBC World
2 Mkts. Corp., 157 Cal. App. 4th 835, 845 (2007) (internal quotation
3 marks omitted). But Defendants owe Plaintiffs a legal duty
4 pursuant to TILA. Although EMC argues that this duty cannot serve
5 as the basis of a common law fraud claim because such a claim would
6 be preempted, the Court has already rejected this theory of
7 preemption. In addition, independent of any duty imposed by TILA,
8 the mortgage transaction gave rise to a legal relationship between
9 the parties capable of serving as the basis for a fraud claim. See
10 LiMandri v. Judkins, 52 Cal. App. 4th 326, 337 (1997) ("[A] duty to
11 disclose may arise from the relationship between . . . parties
12 entering into any kind of contractual agreement."). It does not
13 matter that the original transaction was not between Plaintiffs and
14 EMC, because by purchasing the loan, EMC subjected itself to
15 potential liability for its role in the alleged fraudulent scheme.

16 IV. Contract Claims

17 A. Breach of Contract

18 EMC argues that Plaintiffs have not stated a claim for breach
19 of contract. Plaintiffs counter that EMC, as the assignee of
20 Lending 1st's rights and obligations under the Agreement, violated
21 its alleged promise to apply each of Plaintiffs' monthly payments
22 to both "principal and interest." They interpret the Agreement's
23 references to monthly payments of "principal and interest" as
24 implying such a promise. See TAC Ex. 1 at § 3(A) ("I will pay
25 principal and interest by making a payment every month.")

26 Although the Court has held that Plaintiffs may be able to
27 show that, considered as a whole, the disclosures provide confusing
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1 and seemingly contradictory information concerning the terms of the
2 loan, the disclosures nonetheless accurately describe the
3 relationship between the minimum monthly payment and the accrued
4 interest. The Agreement states that each monthly payment "will be
5 applied to interest before Principal." Id. It states elsewhere
6 that the "monthly payment could be less than or greater than the
7 amount of interest each month." Id. § 5(C).

8 The Agreement thus contains no promise, express or implied,
9 that Plaintiffs' payment would always be applied to both principal
10 and interest. Whether the payment would be applied to principal
11 depended on whether it was large enough to cover the entire amount
12 of interest that had accrued during the preceding month. Because
13 Plaintiffs could choose to pay more than the minimum payment, they
14 had the option of making payments large enough to reduce their
15 principal each month. Plaintiffs do not allege that they actually
16 made payments that were greater than the amount of accrued
17 interest, and that EMC nonetheless failed to apply the payments to
18 principal. If this were the case, they would have stated a breach
19 of contract claim. As the complaint stands now, they have not.
20 Accordingly, the breach of contract claim is dismissed.

21 B. Breach of the Covenant of Good Faith and Fair Dealing

22 Under California law, "every contract . . . 'imposes upon each
23 party a duty of good faith and fair dealing in its performance and
24 its enforcement.'" McClain v. Octagon Plaza, LLC, 159 Cal. App.
25 4th 784, 798 (2008) (quoting Carma Developers (Cal.), Inc. v.
26 Marathon Dev. Cal., Inc., 2 Cal. 4th 342, 371-72 (1992)). The
27 implied covenant "prevent[s] a contracting party from engaging in
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1 conduct which (while not technically transgressing the express
2 covenants) frustrates the other party's rights to the benefits of
3 the contract." Id. at 806 (quoting Racine & Laramie, Ltd. v. Dep't
4 of Parks & Recreation, 11 Cal. App. 4th 1026, 1031-32 (1992)).
5 "[I]t imposes 'not only . . . upon each contracting party the duty
6 to refrain from doing anything which would render performance of
7 the contract impossible by any act of his own, but also the duty to
8 do everything that the contract presupposes that he will do to
9 accomplish its purpose.'" Id. (quoting Pasadena Live v. City of
10 Pasadena, 114 Cal. App. 4th 1089, 1093 (2004)) (omission in
11 McClain).

12 Plaintiffs have not alleged any conduct on EMC's part that
13 deprived them of the benefit of the Agreement -- namely, to receive
14 the sum of \$395,000, subject to repayment according to the terms of
15 the Agreement. Nor is EMC alleged to have done anything to render
16 Plaintiffs' performance of the contract impossible. Plaintiffs'
17 claim appears to be based largely on EMC's failure to apply
18 Plaintiffs' monthly payments to both principal and interest. In
19 this sense, it is identical to their non-viable breach of contract
20 claim and must be dismissed. To the extent the claim is based on
21 EMC's participation in the allegedly misleading marketing of OARMS,
22 the claim similarly must be dismissed, because "the implied
23 covenant is a supplement to an existing contract, and thus it does
24 not require parties to negotiate in good faith prior to any
25 agreement." McClain, 159 Cal. App. 4th at 799.

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United States District Court
For the Northern District of California

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CONCLUSION

For the foregoing reasons, EMC's motion to dismiss (Docket No. 73) is GRANTED IN PART and DENIED IN PART. Plaintiffs' TILA claim is dismissed to the extent it seeks rescission.⁵ This dismissal is with prejudice because the refinancing of Plaintiffs' loan makes such relief unavailable as a matter of law. Plaintiffs' claims for breach of contract and breach of the covenant of good faith and fair dealing are also dismissed. Because these claims are premised on a promise that is not contained in the contract, they are dismissed with prejudice as well.⁶

EMC must file an answer to the third amended complaint within twenty days of the date of this order.

IT IS SO ORDERED.

Dated: 9/30/08



CLAUDIA WILKEN
United States District Judge

⁵The complaint does not contain separate TILA claims for rescission and damages; both rescission and damages are remedies sought in connection with the first cause of action.

⁶At oral argument, Plaintiffs' counsel stated that, if Plaintiffs were granted leave to amend the breach of contract claim, he would attempt to demonstrate with greater specificity that the Agreement contains a promise to apply Plaintiffs' payments to both principal and interest. Because the Court has reviewed the entire Agreement and finds no such promise, Plaintiffs' proposed amendment would be futile.