

NOS. CAAP-12-0000365 and CAAP-12-0000527

IN THE INTERMEDIATE COURT OF APPEALS

OF THE STATE OF HAWAII

FIRST UNITED FUNDING, LLC, Plaintiff-Appellee,
v.
NAUPAKA INVESTMENTS, L.L.C.; LAURI L. LANE, as Personal
Representative of the Estate of D. Grant Lane;
LAURI L. LANE, Defendants-Appellants,
and
NAUPAKA PLACE AT WAIKOLOA BEACH RESORT OWNERS ASSOCIATION;
JOHN DOES 1-50 and DOE ENTITIES 1-50, Defendants-Appellees.

APPEAL FROM THE CIRCUIT COURT OF THE THIRD CIRCUIT
(CIVIL NO. 10-1-82K)

MEMORANDUM OPINION

(By: Fujise, Presiding Judge, Reifurth and Ginoza, JJ.)

This case involves a borrower's challenge to the amount determined to be owed on a loan in the course of a judicial foreclosure action. Defendants-Appellants Naupaka Investments, L.L.C. (Naupaka),¹ Lauri L. Lane, as personal representative of the Estate of D. Grant Lane (Grant), and Lauri L. Lane (Lauri),² (collectively, the Defendants), appeal from a Judgment entered

¹ Naupaka is an Arizona limited liability company doing business in Hawaii'i.

² The Lanes were a married couple, both named individually as parties to this action. Grant passed away during the pendency of this litigation, and Lauri, as Personal Representative of the Estate of Grant, was substituted as a party.

Additionally, Naupaka Place at Waikoloa Beach Resort Owners Association was named as a defendant in this case, but it takes no part in this appeal.

April 30, 2012, in the Circuit Court of the Third Circuit (circuit court),³ in favor of Plaintiff-Appellee First United Funding, LLC (First United).⁴ Judgment was entered pursuant to two orders which together granted First United's Motion for Confirmation of Sale, for Deficiency Judgment, for Writ of Possession and Cancellation of Notice of Pendency of Action.

The circuit court entered two orders because, upon confirming the sale of the subject property, the court deferred ruling on the amount owed to First United because the parties disagreed whether a Second Loan Modification between the parties was valid. In the end, after a further hearing and then various submissions by the parties, the circuit court treated the Second Loan Modification as void after First United indicated, via a post-hearing letter sent to the court, that if the circuit court believed there was a genuine issue of material fact related to that agreement, First United would withdraw its reliance on the Second Loan Modification and agree to treat that agreement as void.

On appeal, the Defendants assert that the circuit court erred by (1) granting the deferred portion of First United's motion related to amounts owed to First United despite genuine issues of material fact regarding the Defendants' defenses as to the amounts owed; (2) improperly limiting Defendants' defenses to the existence of the Second Loan Modification and voiding the Second Loan Modification without legal basis; (3) holding that the Defendants' defenses were moot because they depended on the continued existence of the Second Loan Modification; (4) entering certain additional orders and findings based on the prior alleged errors; and (5) granting First United's motion for attorneys' fees.

³ The Honorable Elizabeth A. Strance presided.

⁴ First United is a Minnesota limited liability company doing business in Hawai'i.

After appellate briefing was completed in this case, we granted First United's motion for temporary remand to allow the circuit court to correct clerical mistakes in the Judgment and the March 5, 2012 "Order Granting Deferred Portion of Plaintiff's Motion for Confirmation of Sale, for Deficiency Judgment, for Writ of Possession and Cancellation of Notice of Pendency of Action" (March 5 Order). During the temporary remand, the circuit court made corrections *inter alia* to its calculation of additional per diem interest. On March 19, 2013, the circuit court entered an Amended Judgment and an amended order (March 19 Order).

For the reasons discussed below, we hold that the circuit court erred in concluding that the Defendants' defenses regarding the amount owed to First United were moot. We vacate the Amended Judgment and remand.

I. Background

On August 23, 2007, First United loaned \$6,650,000 to Naupaka for the purchase of two vacant residential lots on the Island of Hawai'i (Subject Property). Naupaka executed a promissory note for the loan amount in favor of First United (Note). The Note provided *inter alia* that at no time shall the interest rate be less than 6% per annum and established a maturity date of August 15, 2008, at which time the entire remaining principal balance, plus any unpaid accrued interest, was due. Naupaka also executed a mortgage in favor of First United (Mortgage). Under the loan documents, First United reserved the right to pursue foreclosure on the Property in the event of default on the terms of the various loan documents. The Lanes jointly and severally guaranteed payment of the Note pursuant to a Guaranty (Guaranty).

Effective August 15, 2008, Grant, on behalf of Naupaka, and Corey Johnston (Johnston), as president of First United, executed a loan modification agreement (First Loan Modification) which extended the maturity date of the Note to February 15, 2009.

Effective October 15, 2008, Grant and Johnston executed a Second Loan Modification Agreement (Second Loan Modification) which *inter alia* extended the loan maturity date to August 15, 2009; increased the interest due on the outstanding principal to a fixed rate of 7% per annum commencing on January 1, 2009; and required Naupaka to make a principal reduction payment of \$1.19 million to First United by March 30, 2009. The Second Loan Modification also provided that

9. Borrower shall deliver to Lender's legal counsel, to hold in escrow consistent with this Second Loan Modification Agreement an original general warranty deed in favor of Lender for the Hawaii Real Property free and clear of all liens, encumbrances and security interests, except those in favor of Lender and other liens, encumbrances and security interests existing as of the date hereof (the "Warranty Deed"). If Borrower or Borrower's realtor identifies a potential buyer for the Hawaii Real Property, Lender will negotiate in good faith for the entering into a purchase and sale agreement with such potential buyer. If the principal reduction payment described above is received by Lender by March 30, 2009, the unrecorded original Warranty Deed shall be returned immediately to Borrower. If the principal reduction payment described above is not received by Lender by March 30, 2009, then (a) Lender may record the original Warranty Deed, and (b) Borrower (but not the Guarantors) shall be deemed released from the indebtedness evidenced by the Loan Documents, but neither Borrower nor any Guarantor will be released from any other liens, encumbrances, assessments and/or claims recorded against the Hawaii Real Property except real estate taxes, levied assessments and homeowner's association fees. If Lender records the original Warranty Deed, Lender shall immediately undertake to sell the Hawaii Real Property in a commercially reasonable manner and, upon such sale, all net sales proceeds shall be applied toward the obligations then due under the Loan Documents, and Lender shall pay to Borrower all net sales proceeds, if any, that are in excess of the obligations then due under the Loan Documents.

(Emphases added.) The Defendants assert that Grant agreed to the Second Loan Modification because of representations by Johnston that Johnston would provide the funds needed by Naupaka to make the \$1.19 million principal reduction payment.

It appears undisputed that Naupaka fulfilled its duty under section 9 of the Second Loan Modification to deliver original warranty deeds in favor of First United on the Subject Property. In a letter dated September 14, 2009, First United's counsel, Mark Gleeman (Gleeman), stated that "[t]his letter will

confirm that, pursuant to the Loan documents, as amended, a principal reduction payment of \$1,190,000 must be received by the Lender by September 30, 2009. Otherwise, Lender reserves the right to record the warrant[y] deed for the Hawaii Real Property" ⁵

Johnston did not provide Naupaka with funding for the \$1.19 million principal reduction payment, and Naupaka failed to make the principal reduction payment required by the Second Loan Modification or to repay all sums due on the maturity date. Despite Naupaka's failure to make the principal reduction payment, First United did not exercise its option to record the deeds.

Subsequently, pursuant to orders entered on October 23, 2009, and February 5, 2010, in a case before the District Court of Dakota County, Minnesota, Community First Bank v. First United Funding, LLC, et al., No. 19HA-CV-09-6282, Lighthouse Management Group, Inc. (Lighthouse) was appointed as receiver for First United with authority to liquidate the assets of First United. The Minnesota district court found that First United had "oversold participation interests" in various loans, including the instant loan to Naupaka, and had failed to account for payments received from borrowers. ⁶

On March 8, 2010, Lighthouse filed the instant lawsuit against the Defendants in First United's name. On December 1, 2010, a judgment pursuant to Rule 54(b) of the Hawai'i Rules of

⁵ The record is unclear as to when or why the deadline for the \$1.19 million payment was moved from March 30, 2009 to September 30, 2009.

⁶ Based on the Minnesota court's orders, it appears that First United loaned money to various borrowers, including Naupaka, and that First United then sold interests in the notes to other parties pursuant to "participation agreements." For example, the "Naupaka note" is subject to a participation agreement between First United and Community First Bank, pursuant to which Community First Bank purchased \$1 million of the Naupaka note, equating to "a participation percentage of Fifteen Percent (15%)." The Minnesota court orders indicate that under the various participation agreements, First United was responsible for *inter alia* administering the notes for the benefit of the participants and acting prudently, but that First United had failed to account for application of the payments it had received from the borrowers on the notes.

Civil Procedure was entered, authorizing a foreclosure sale of the Subject Property. There was no appeal as to that judgment.

On March 7, 2011, a public auction was held at which First United purchased the property for \$5,100,000. First United filed a motion on May 13, 2011, requesting confirmation of the sale, a deficiency judgment, a writ of possession, and cancellation of a notice of pendency of action. As part of its motion, First United asserted a right to 7% interest pursuant to the Second Loan Modification. On August 3, 2011, the circuit court issued an order granting in part and deferring in part First United's motion. The circuit court confirmed the sale of the property, but deferred issues related to the amounts owed to First United because the Second Loan Modification had been brought to the court's attention for the first time in support of First United's motion to confirm, and the application of the Second Loan Modification was in dispute.

The Defendants and First United then submitted memoranda regarding their positions on the amount owed to First United and the applicability of the Second Loan Modification. A key part of the dispute regarding the amounts owed was the Defendants' assertions that Grant was fraudulently induced by Johnston to enter the Second Loan Modification, and that First United failed to take reasonable steps to mitigate its damages. Based on the foregoing, the Defendants argued *inter alia* that the Second Loan Modification was voidable and that the amount owed to First United should be limited to amounts owed at the time First United could have recorded the deeds. At a September 19, 2011 hearing on the deferred portion of the motion, the circuit court took the issues under advisement, and directed the parties to submit their proposed orders.

After the parties had submitted their respective proposed orders and Defendants had objected to First United's proposed order, First United sent a letter to the court dated October 13, 2011, stating that, "to the extent that this Court believes that a genuine issue of material fact exists with

respect to fraudulent intent, [First United], in the interest of avoiding any further delay and expense, withdraws its reliance on the Second Loan Modification and is willing to treat it as having been voided for the purposes of this Motion." In the letter, First United contended that such action rendered all of the Defendants' defenses moot because the defenses were based on the existence of the Second Loan Modification.

On March 5, 2012, without a further hearing,⁷ the circuit court issued an order granting the deferred portion of First United's motion. The circuit court noted that First United had agreed to treat the Second Loan Modification as having been voided. The court then determined that the Defendants' defenses regarding the amounts owed to First United were moot because the defenses depended on the existence of the Second Loan Modification. In short, the court viewed the defenses as aimed only at voiding the Second Loan Modification. Subsequently, the circuit court entered the Judgment in favor of First United.

II. Standard of Review

The Defendants contend that the circuit court erred because there are genuine issues of material fact regarding their asserted defenses that precluded the award of amounts owed to First United.

The circuit court ruled on the amounts owed to First United without an evidentiary hearing.⁸ We therefore review the circuit court's rulings on the deferred issues under a summary judgment standard.

⁷ We note that Defendants did not submit anything addressing First United's October 13, 2011 letter. At the September 19, 2011 hearing, the circuit court had simply instructed the parties to submit proposed orders. Both parties appear to have exceeded the circuit court's instructions.

⁸ At the beginning of the September 19, 2011 hearing on the deferred issues, the circuit court stated that "I think my primary question, based upon the submissions, is whether all of the facts are before the Court, or whether there are matters of credibility or things like that regarding fraud that would require the Court to hold an evidentiary hearing." First United argued against an evidentiary hearing and the court ultimately ruled based on the parties' written submissions.

We review the circuit court's grant or denial of summary judgment *de novo*. The standard for granting a motion for summary judgment is settled:

[S]ummary judgment is appropriate if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. A fact is material if proof of that fact would have the effect of establishing or refuting one of the essential elements of a cause of action or defense asserted by the parties. The evidence must be viewed in the light most favorable to the non-moving party. In other words, we must view all of the evidence and the inferences drawn therefrom in the light most favorable to the party opposing the motion.

Stanford Carr Dev. Corp. v. Unity House Inc., 111 Hawai'i 286, 295, 141 P.3d 459, 468 (2006) (citations omitted).

III. Discussion

The procedural history of this case presents somewhat unusual circumstances. First United asserted, among other things, that the amounts owed to it included the higher interest rate of 7% set out in the Second Loan Modification. In response, the Defendants asserted that the Second Loan Modification was voidable because Grant entered the agreement in reliance on misrepresentations made by Johnston, and that the amounts owed to First United should be reduced because First United failed to take steps to mitigate its damages. Defendants also generally argued that, due to the fraudulent misrepresentation and failure to mitigate damages, First United possessed unclean hands and were being unjustly enriched. Thus, the Defendants' defenses appear to have been aimed at two goals: voiding the Second Loan Modification and its 7% interest rate; and generally, a reduction of the amounts owed to First United.

The Defendants presented evidence in an effort to support its asserted defenses, including the declaration of Jay M. Allen (Allen), Naupaka's attorney involved in the loan transaction, and various exhibits. After the parties had submitted extensive arguments on the validity of the Second Loan Modification and its effect on the amount owed, after the hearing

on the deferred issues, and after the submission of proposed orders, First United then retracted its reliance on the Second Loan Modification when the parties had been simply instructed to submit proposed orders. As previously noted, via a letter to the court, First United informed the court that it would be willing to withdraw its reliance on the Second Loan Modification and treat it as void, *to the extent that* the court believed there were genuine issues of material fact as to fraudulent inducement. The circuit court did not call for further briefing or a hearing to address this development before accepting First United's concession and its claimed effect on the defenses asserted by Defendants. The circuit court held that all of the Defendants' defenses depended on the continued existence of the Second Loan Modification, and therefore those defenses were deemed moot.

First United's change of position regarding the Second Loan Modification via its post-hearing letter at the peak of the circuit court's decision-making process was highly unusual and appears to have prejudiced the Defendants' efforts to have their asserted defenses considered.

Moreover, regardless of whether the Second Loan Modification was voidable, there are genuine issues of material fact as to the amount properly owed to First United. In this regard, we focus on the mitigation of damages defense because it is most directly related to amounts owed to First United. "In contract or in tort, the plaintiff has a duty to make every reasonable effort to mitigate his damages. The burden, however, is upon the defendant to prove that mitigation is possible, and that the injured party has failed to take reasonable steps to mitigate his damages." Malani v. Clapp, 56 Haw. 507, 517, 542 P.2d 1265, 1271 (1975) (citation omitted). Here, because the circuit court deemed the Defendants' defenses were moot, it did not consider the mitigation of damages defense.

As previously noted, the Defendants submitted the declaration of Allen, who was familiar with the loan negotiations and the documentary evidence related to the negotiation process.

Defendants also submitted various loan documents and correspondence, and the record further contains documents submitted by First United.

The evidence shows that, under the original loan agreement, the principal balance and any unpaid accrued interest would be due and payable by August 15, 2008, and the interest would never be less than 6%. As the maturity date neared, the parties agreed to the First Loan Modification, effective on August 15, 2008, which extended the maturity date to February 15, 2009. The First Loan Modification also required Naupaka to *inter alia* pay a non-refundable extension fee of \$66,500, and noted that Naupaka had paid in full all interest through August 15, 2008, but the entirety of the principal remained unpaid. Shortly thereafter, the parties began to negotiate the Second Loan Modification. Allen attests that Johnston represented to Grant that Johnston would make available to Naupaka sufficient money to pay the \$1.19 million principal reduction payment described in the Second Loan Modification and that Grant relied on that representation.⁹ In turn, the Second Loan Modification required Naupaka to execute and deliver to First United's counsel original warranty deeds on the Subject Property, which First United reserved the right to record if Naupaka failed to pay the \$1.19 million by March 30, 2009. Naupaka was also required to pay a non-refundable extension fee of \$33,250, and the Second Loan Modification noted that accrued interest was paid in full through October 15, 2008, the effective date of the Second Loan Modification.

It is undisputed that Naupaka delivered to First United's counsel, Gleeman, deeds to the Subject Property. Allen attests that he sent the deeds in January 2009. Gleeman acknowledged receipt of the deeds in a letter dated September 14, 2009, in which he also stated that if the principal reduction payment was not received by September 30, 2009, First United

⁹ First United does not challenge admissibility of Allen's declaration.

reserved the right to record the warranty deeds. There is no indication in the letter or in the record why the deadline to pay the \$1.19 million was extended to September 2009.

This evidence raises a genuine issue of material fact as to whether mitigation was possible, and whether First United failed to take reasonable steps to mitigate its damages. At the time of Naupaka's failure to make the \$1.19 million principal reduction payment, there was no challenge to the validity of the Second Loan Modification, which allowed First United to record the deeds, take immediate ownership of the property, and to conduct a sale of the Subject Property. First United's subsequent willingness during litigation to treat the agreement as void does not alter its rights at the time of the default and does not render the Defendants' defenses moot. Further, regardless of whether the Defendants have proven the market value of the Subject Property when the deeds could have been recorded, there are, at a minimum, genuine issues of material fact whether damages could have reasonably been mitigated. In this regard, First United would have recouped at least some of the principal earlier on, and the interest under the loan agreement would not have accrued over an extended length of time against the Defendants or be based on the entirety of the unpaid principal.

In regards to the reasonableness of First United's actions, "[a]s a general principle . . . the question of whether one has acted reasonably under the circumstances is for the trier of fact to determine." Richardson v. Sport Shinko (Waikiki Corp.), 76 Hawai'i 494, 503, 880 P.2d 169, 178 (1994). Where reasonable minds might differ as to the reasonableness of conduct, summary judgment is inappropriate. See Matsuura v. E.I. du Pont de Nemours & Co., 102 Hawai'i 149, 163, 73 P.3d 687, 701 (2003). Given the evidence in this case, reasonable minds can differ as to whether First United acted unreasonably given the circumstances by failing to record the deeds and instead initiating this foreclosure action the following year, which added to the accruing interest.

First United argues that the loan documents gave it the option of *either* recording the deeds or pursuing foreclosure, and that requiring First United to pursue one of its contractually bargained-for options at the expense of the other would amount to re-writing the contract. However, given the allegations of fraud and the questionable conduct of Johnston in this case, we cannot conclude as a matter of law that mitigation of damages should not be considered. Indeed, there is enough evidence in the record to create a genuine issue of material fact whether First United sought to draw out the transaction in an effort to further accumulate fees and interest.

As an overriding matter, the record establishes that First United was placed into receivership because it had "oversold participation interests" in various loans, including the loans to Naupaka, and failed to account for application of payments it had received. The Defendants' evidence further shows that Johnston was the President and sole member of First United, that First United made the loans to Naupaka, but that Johnston made the unfulfilled representation that he would provide funding for Naupaka to pay the \$1.19 million principal reduction payment owed to First United.

Further, the evidence indicates that each extension of the loan maturity date resulted in more interest and fees owed and paid by Naupaka to First United. At the time each loan modification agreement was executed, the parties agreed that Naupaka had only made payments on accrued interest, which were paid in full, leaving the entirety of the principal outstanding. Each time the parties reached a loan modification agreement, First United also charged Naupaka a substantial non-refundable extension fee. Also, despite Allen's undisputed declaration that he provided the deeds to First United in January 2009 as required under the Second Loan Modification, Gleeman did not acknowledge receipt until September 2009, almost six months after the apparent deadline for receipt of the \$1.19 million payment. Then, after Naupaka's default on the loan and failure to make the

principal reduction payment, First United did not immediately take ownership of the property by simply recording the deeds, as allowed under the Second Loan Modification. Rather, recovery on the loans was sought by filing the instant foreclosure lawsuit on March 8, 2010, about a year after the Second Loan Modification mandated receipt of the \$1.19 million payment, and six months after the maturity date provided in the agreement.

Therefore, there is ample evidence, when viewed in a light most favorable to the Defendants, raising a genuine issue of material fact whether First United sought to continually accrue interest and fees on unpaid principal, and thus, reasonable minds could differ as to whether First United acted reasonably in mitigating its damages.

The Defendants also claimed that the amounts owed should be reduced based on First United's unclean hands and unjust enrichment, apparently due in part to First United's failure to mitigate damages. For similar reasons that we conclude that the circuit court erred in regards to the mitigation of damages defense, we conclude that these other defenses should not have been deemed moot as a matter of law.

Given the above, on *de novo* review, we hold that the circuit court erred in entering the March 5, 2012 order on the deferred issues.

The Defendants also assert that the circuit court committed plain error by basing the per diem interest rate on the voided Second Loan Modification and the circuit court compounded the error by failing to recalculate the per diem interest rate to reflect First United's purchase of the properties at the foreclosure auction. Because we vacate the Amended Judgment and remand the deferred issues to the circuit court, we need not address this issue.

The Defendants further assert that the circuit court erred by granting First United's motion for attorneys' fees. Because we vacate the Amended Judgment, we also vacate the circuit court's award of fees and costs.

IV. Conclusion

For the foregoing reasons, we vacate the Amended Judgment and remand to the Circuit Court of the Third Circuit for proceedings consistent with this opinion.

DATED: Honolulu, Hawai'i, June 30, 2015.

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