

## Creative Financing

There has been a lot of press recently about suits being brought against mortgage brokers, appraisers, real estate agents, title insurance companies and home buyers and sellers for allegedly fraudulent home purchases in the Phoenix area.<sup>1</sup> The stories are about homes purchased with borrowed money and, with the seller's acquiescence, for more than the original asking price. The seller gets his asking price, and the difference between that and the amount of the new purchase price is then returned to the buyer in the form of cash.

This practice is known as "cash-back" and has been condemned as inflating the real value of the property in question. That in turn gets the attention of banking regulators and the holders of the mortgage paper when the buyer defaults, abandons the property and leaves the holder of the mortgage or deed of trust with less than full security.<sup>2</sup>

Although the original participants in the scheme (with the exception of the sometimes unsuspecting lender) do not take any risks in the deal, the effects of the practice compromise the integrity of loan underwriting. It ultimately can harm those investors who are issued mortgage-backed securities from associations such as Fannie Mae (the Federal National Mortgage Association); those investors receive their returns from the payments made by the original home buyers.

These are the people who have no way to protect themselves from the sales practices now being challenged.

The only professionals who are not consistently mentioned in the news stories are lawyers, and it probably won't be long before they start getting dragged into the fray. Cash-back deals require the participation of both buyer and seller, an appraiser and a mortgage lender, parties who frequently interact with or use the services of lawyers.

Lawyers who represent any of the knowing participants in these arrangements have potential civil and criminal liabilities<sup>3</sup> and an additional problem, as well: There are three ethical rules that can be implicated, making such schemes potential disciplinary cases.


A recent New Jersey ethics opinion shows that the cash-back schemes are not peculiar to Arizona.<sup>4</sup>

There, the cash returned to the buyer is referred to as a "seller's concession" or "seller's payment of purchaser's closing costs." The New Jersey ethics committee deemed the practice deceptive because the money given to the buyer is not justified by any extra property rights allocated to the buyer or by any extra costs allocated to the seller.

The opinion also says that lawyers who assist clients in these schemes violate ER 1.2(d),<sup>5</sup> which prohibits a lawyer from counseling or assisting a client in conduct the lawyer knows is illegal, criminal or fraudulent. Those lawyers also violate ER 4.1, which prohibits them from knowingly making false statements of material fact or law to a third person or from failing to disclose a material fact to a third person when necessary to avoid assisting a criminal or fraudulent act. The New Jersey ethics committee found that the cash-back practice indisputably involves a material fact because the increase in the agreed sale price would not be made unless the parties expected the lender to increase the amount the buyer borrowed to buy the property.

Finally, the opinion states that assisting in cash-back schemes involves a deceitful intent that the mortgage lender will rely on the parties' misrepresentations, supported by an inflated appraisal, in determining the size of the mortgage loan. Thus, lawyers who take part in these practices also violate ER 8.4(c), which prohibits conduct involving dishonesty, fraud, deceit or misrepresentation.

Lawyers should consider the New Jersey case of *In re Labendz*,<sup>6</sup> in which a lawyer was suspended from practice for participating in a mortgage loan application that overstated the sale price so that the lender's loan limitations could be avoided. And they might also revisit the lessons many lawyers learned during the savings and loan crisis of the early 1990s, where assisting clients who were less than honest with financial institutions resulted in often severe civil liabilities.<sup>7</sup>

Under the Model Rules of Professional Conduct, adopted in both New Jersey and Arizona, the duties of candor and honesty may require disclosures that sometimes may not be agreeable to the client. As the New Jersey ethics committee concludes, it is the lawyer's duty to see that the true terms of a real estate transaction are disclosed by their clients to the lender and to prevent false and misleading information from becoming available to persons who may ultimately be injured as a result. 

### endnotes

1. See, e.g., Catherine Reagor, *Lawsuits Targeting Mortgage Schemes*, ARIZ. REP. (special report), Mar. 4, 2007, at 1.
2. Holders of purchase money obligations are subject to the provisions of Arizona's anti-deficiency statutes, A.R.S. § 33-814 (for deeds of trust) and A.R.S. § 33-729 (for mortgages).
3. See, e.g., the Federal Bank Fraud statute, 18 U.S.C. § 1344, making it a criminal offense to defraud a "financial institution," a very broadly defined term. 18 U.S.C. § 20.
4. N.J. Supreme Court Advisory Committee on Professional Ethics, Op. 710 (Dec. 26, 2006).
5. Rule 42, ARIZ.R.S.Ct.
6. 471 A.2d 21 (N.J. 1984).
7. *In re American Continental Corporation/Lincoln Savings and Loan Securities Litigation*, 794 F. Supp. 1424 (D. Ariz. 1992) (cause of action stated against bank's lawyers for violations of conduct governed by ER 1.16 [Declining or Terminating Representation], court stating that lawyers must withdraw from representation when their services are being used to deceive others. Court held that lawyer had obligation to actively discuss and discourage violative conduct with client, urge cessation of the activity, and withdraw if client continues the conduct).

**"Bar Counsel Insider" is on p. 55.**

**Ethics Opinions and the Rules of Professional Conduct are available at [www.myazbar.org/Ethics](http://www.myazbar.org/Ethics)**



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