New Wrinkle in Loan Modifications

In a previous column, we looked at some of the troublesome ethical issues confronting lawyers who accept referrals from foreclosure-prevention services.[1] Now, from Florida, comes news of a new way that lawyers are finding to make money in the home-foreclosure crisis when they are successful in defending against the lender's right to foreclose. Foreclosure defense is a new legal specialty, but the methods by which lawyers get paid for their services in these kinds of cases are not yet settled.

A careful lawyer who is considering a swim in what might ultimately be treacherous waters will comply with the ethical requirements.

Variously and alternatively described as "innovative," "creepy" and "crass," the fee agreement involves the lawyer's client agreeing to pay a contingent fee to the lawyer based on a percentage of the amount by which the lawyer is able to reduce the client's mortgage, secured by a second mortgage on the client's property. For instance, if the client's mortgage was $500,000 and, through the lawyer's efforts, is reduced by the lender to $200,000, the client would owe the lawyer 40 percent of $300,000, or $120,000, which is then carried by the lawyer, at interest, and secured by a second mortgage on the client's property.

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There are a number of ethical issues here.

Let's start by recognizing that in Arizona, it is proper for a lawyer to secure her fees by a lien on her client's property.[2] But that simple proposition can be deceptive. Originally articulated in a case where the issue was whether taking a deed of trust on a client's property constituted the acquisition of a proprietary interest in the subject matter of the litigation in violation of what is now ER 1.8(i), the case did not decide what could be a more troublesome issue—whether the arrangement is a "business transaction with a client" subject to the provisions of ER 1.8(a).

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The facts in the Florida cases are more in the nature of a business transaction than was the case where a firm simply asked that its fee in a collection case be secured by a deed of trust on the client's property. In the loan modification/foreclosure scenario, we are presented with vulnerable, desperate clients who can't afford to pay a lawyer by the hour, who are in fear of losing their homes, and who are being asked to encumber their property for almost half of what their lawyers just "saved" them.

A careful lawyer who is considering a swim in what might ultimately be treacherous waters will comply with the ethical requirements of ER 1.8(a) before even suggesting a similar arrangement to the potential client. ER 1.8(a) requires (1) that the transaction and its terms be fair and reasonable to the client and fully disclosed and given to the client in terms the client can understand; (2) the client be advised in writing of the wisdom in seeking the advice of independent counsel, and then be given sufficient time to do so; and (3) that the client give informed consent (a defined term),[3] in writing signed by the client, to the essential terms of the transaction and the lawyer's role in it, including whether the lawyer is representing the client in the transaction.

Remember that just because a lawyer jumps through the hoops of ER 1.8(a) doesn't mean he's home-free. ER 1.7(b) still requires the lawyer's reasonable belief that he can provide competent and diligent representation of the client, including after the case is over and during the life of the secured "loan."[4]

From what little there is to read about these transactions presently,[5] the lawyers involved haven't paid much attention to this aspect of the ethics rules. And just how a potential client is going to react to the admonition about hiring another lawyer to give him advice about the lawyer sitting in front of him and the deal he is being offered is open to question. Beyond that, any lawyer choosing a transaction of this nature must assume that he will end up having to foreclose his lien, which will require him to end up suing his own client, with all the risks that this entails.

endnotes

1. *Loan Modification Services*, ARIZ. ATT'Y (January 2010), at 12.
2. ER 1.8(i)(1), Arizona Rules of Professional Conduct, Rule 42, ARIZ.R.S.CT.; *Skarecky, Horenstein, P.A. v. 3605 North 36th Street Co.*, 825 P.2d 949 (Ariz. 1991); and *see* Dodge, *Enforcing Your Right To Get Paid*, ARIZ. ATT'Y (October 2005), at 26.
3. ER 1.0(e) defines "informed consent" as the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct.
4. *See* Comment [3] to ER 1.8.
5. *See Foreclosure Lawyers Put Second Mortgages on Client's Homes*, N.Y. TIMES, Business Section, Nov. 7, 2010, at www.nytimes.com/2010/11/07/business/07lawyers.