ETHICS ALERT

Legal Services to Distressed Homeowners and Foreclosure Consultants on Loan Modifications

Committee on Professional Responsibility and Conduct
(February 2, 2009)

You have all read and heard about the residential mortgage crisis in California. In 2007, roughly 84,000 California homeowners lost their homes in foreclosure.[1] Through the first three quarters of 2008 alone, that number increased to over 190,000. During that same period, lenders recorded nearly 330,000 notices of default on California home mortgages. Recording a notice of default is the first step of a non-judicial foreclosure or trustee sale, the most common process in California, which typically takes four to six months or more. In other words, the crisis seems far from over.

Seeing a business opportunity in this crisis, "foreclosure consultants" purport to offer distressed homeowners assistance in assessing their options and/or negotiating loan modifications with their lenders.[2] According to the California Legislature,

> These foreclosure consultants, however, often charge high fees, the payment of which is often secured by a deed of trust on the residence to be saved, and perform no service or essentially a worthless service. Homeowners, relying on the foreclosure consultants' promises of help, take no other action, are diverted from lawful businesses which could render beneficial services, and often lose their homes, sometimes to the foreclosure consultants who purchase homes at a fraction of their value before the sale.
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> Vulnerable homeowners are increasingly relying on the services of foreclosure consultants who advise the homeowner that the foreclosure consultant can obtain the remaining funds from the foreclosure sale if the homeowner executes an assignment of the surplus, a deed, or a power of attorney in favor of the foreclosure consultant. This results in the homeowner paying an exorbitant fee for a service when the homeowner could have obtained the remaining funds from a trustee's sale from the trustee directly for minimal cost if the homeowner had

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[1] See Reports on California Foreclosure Activity issued by DataQuick Information Systems, available at http://www.dqnews.com/News/California/CA-Foreclosures/RRFor080422.aspx, http://www.dqnews.com/News/California/CA-Foreclosures/RRFor080722.aspx, and http://www.dqnews.com/News/California/CA-Foreclosures/RRFor081023.aspx.

[2] Civil Code section 2945(a) defines "foreclosure consultant" as any person who performs for compensation certain services for a homeowner or makes any solicitation, representation, or offer to do so. The services include, for example, stopping or postponing a foreclosure sale, obtaining forbearance from any beneficiary or mortgagee, obtaining reinstatement of a loan obligation, obtaining an extension for reinstating a loan obligation, obtaining a waiver of an acceleration clause, assisting the owner in getting a loan, and saving the owner's residence from foreclosure. Civ. Code § 2945.1(a)(1)-(6) & (8). Section 2945.1(b) excludes from the definition of "foreclosure consultant" certain types of people, including generally lawyers licensed in California. See Civ. Code § 2945.1(b)(1)).

> consulted legal counsel or had sufficient time to receive notices from the trustee [ ] regarding how and where to make a claim for excess proceeds.[3]

To protect distressed homeowners, the Legislature has imposed numerous restrictions on foreclosure consultants.[4] For example, agreements with foreclosure consultants must be in writing and contain specific disclosures.[5] Also, foreclosure consultants are prohibited from collecting a fee for any services until after the services have been fully performed.[6] In addition, distressed homeowners have a right in certain circumstances to rescind foreclosure consultant agreements.[7] These protections cannot be waived.[8] The State Bar of California has posted a news release that includes a link to consumer information on loan modification and foreclosures.[9]

There is evidence that some foreclosure consultants may be attempting to avoid the statutory prohibition on collecting a fee before any services have been rendered by having a lawyer work with them in foreclosure consultations. Many of the proposed relationships between these foreclosure consultants and lawyers violate the Rules of Professional Conduct and other ethical rules and, therefore, could result in lawyer discipline.

The purpose of this Ethics Alert is to remind California lawyers of several ethics rules that may apply in the event a foreclosure consultant or another non-lawyer requests assistance from a lawyer and/or refers potential distressed homeowner clients to the lawyer.

- **A California lawyer may not pay a referral or marketing fee to a foreclosure consultant or other person for referring distressed homeowners to the lawyer.[10]**

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[3] Civ. Code § 2945(a) (citation to another Civil Code provision omitted).

[4] See, e.g., Civ. Code § 2945.4.

[5] Civ. Code § 2945.3.

[6] Civ. Code § 2945.4(a).

[7] See Civ. Code § 2945.2.

[8] Civ. Code § 2945.5.

[9] To find the release, go to the State Bar's home page at http://calbar.ca.gov. Look down the right hand column of the home page for the links under "News." Click on "News Releases." Then click on "News Releases 2008." Finally, click on the link for the News Release dated October 8, 2008 entitled "State Bar and Public Interest Clearinghouse Offer Foreclosure Help for Consumers." Among other things, this release identifies, and includes a link to, www.ForeclosureInfoCA.org, a site that offers general information for consumers on mortgages and loans, such as how to avoid losing a home and where to go for assistance when foreclosure is a possibility.

[10] E.g., Cal. Rules of Prof. Conduct rule 1-320(B) ("A member shall not compensate, give, or promise anything of value to any person or entity for the purpose of recommending or securing employment of the member or member's law firm by a client …"); see also Bus. & Prof. Code §§ 6151 & 6152 (prohibiting running and capping); Bus. & Prof. Code § 6155 ("[N]o lawyer shall accept a referral of such potential clients" from any type of referral service unless certain conditions are met, including registration of the referral service with the State Bar.). California lawyers should be particularly mindful of the rules prohibiting the payment of referral fees if and when they are approached by a foreclosure consultant. A foreclosure consultant may be tempted to propose that a lawyer pay the consultant a fee in exchange for referring a homeowner client to circumvent Civil Code section 2945.4(a), which prohibits a foreclosure consultant from collecting a fee from a distressed homeowner until the consultant's services have been completed. As noted above, a lawyer may not compensate another for a client referral.

- **A California lawyer may not directly or indirectly split any attorney's fees that the lawyer earns from a distressed homeowner client with the foreclosure consultant or any other non-lawyer.**[11]

- **A California lawyer may not aid a foreclosure consultant or anyone else in the unauthorized practice of law. A lawyer may not form a partnership or joint venture with a foreclosure consultant or other non-lawyer if any of the activities of the business would involve providing legal services. A lawyer may not, under the guise of serving as in-house counsel for a foreclosure consultancy business, perform legal services for a distressed homeowner.**[12]

- **A California lawyer may not contact in person or by telephone a distressed homeowner referred to the lawyer by a foreclosure consultant or someone else unless the lawyer has a family or prior professional relationship with the homeowner. Nor may a lawyer direct another to do so on the lawyer's behalf. A lawyer, however, may write to a distressed homeowner who is a prospective client.**[13]

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[11] See, e.g., Cal. Rules of Prof. Conduct rule 1-320(A) ("Neither a member nor a law firm shall directly or indirectly share legal fees with a person who is not a lawyer…"); *In the Matter of Francis E. Jones, III* (Review Dept. 1993) 2 Cal. State Bar Ct. Rptr. 411 (lawyer suspended and placed on probation, *inter alia*, for paying to insurance agent one quarter of client fees); *In the Matter of Robert B. Scapa and Michael S. Brown* (Review Dept. 1993) 2 Cal. State Bar Ct. Rptr. 635 (lawyers suspended and placed on probation, *inter alia*, for paying ex-salesman, ex-police officer and other non-lawyers a portion of fees generated from settlements for clients identified by them); *In the Matter of Lawrence Crawford Bragg,* (Review Dept. 1997) 3 Cal. State Bar Ct. Rptr. 615 (lawyer aided insurance adjuster, who evaluated whether to accept clients for lawyer, negotiated and settled pre-litigation claims with insurers, and occasionally filed lawsuits in lawyer's name, in unauthorized practice of law); compare Cal. State Bar Formal Opn. No. 1987-91 (insurance company's "captive" law firm not engaged in fee splitting because no legal fees paid by insureds); Cal. Rules of Prof. Conduct rule 2-200(A) & (B) (permitting lawyer, under certain circumstances, to split fees with another lawyer).

[12] See, e.g., Cal. Rules of Prof. Conduct rule 1-300(A) ("A member shall not aid any person or entity in the unauthorized practice of law."); Cal. Rules of Prof. Conduct rule 1-310 ("A member shall not form a partnership with a person who is not a lawyer if any of the activities of that partnership consist of the practice of law."); see also L.A. County Bar Ass'n Formal Opn. No. 510 (fee sharing with financial planning company); *In re Carlos* (Bankr. C.D. Cal. 1998) 227 B.R. 535, 538-39 (paralegal engaged in unauthorized practice of law by negotiating reaffirmation agreements); *In the Matter of Francis E. Jones, III, supra*, 2 Cal. State Bar Ct. Rptr. 411 (lawyer suspended and placed on probation, *inter alia*, for engaging in legal business with insurance agent); *In the Matter of Robert B. Scapa and Michael S. Brown*, supra,) 2 Cal. State Bar Ct. Rptr. 635 (lawyers suspended and placed on probation, *inter alia*, for opening office staffed solely by non-lawyers who explained retainer agreements and fee arrangements to prospective clients); *In the Matter of Lawrence Crawford Bragg, supra*, 3 Cal. State Bar Ct. Rptr. 615 (lawyer aided insurance adjuster, who evaluated whether to accept clients for lawyer, negotiated and settled pre-litigation claims with insurers, and occasionally filed lawsuits in lawyer's name, in unauthorized practice of law); compare Cal. State Bar Formal Opn. No. 1987-91 (insurance company's "captive" law firm not aiding unauthorized practice of law because "captive" law firm was independent); *Gafcon, Inc. v. Ponsor & Associates* (2002) 98 Cal.App.4th 1388 [120 Cal.Rptr.2d 392] (same). Thus, although a foreclosure consultant business, as any business, may hire in-house counsel to provide legal services for the business, such in-house counsel could not ethically provide legal services for distressed homeowners (the business's clients) either directly or through the guise of approving loan modification documentation for the business.

[13] See, e.g., Cal. Rules of Prof. Conduct rule 1-400(C) ("A solicitation shall not be made by or on behalf of a member or law firm to a prospective client with whom the member or law firm has no family or prior professional relationship…"); Cal. Rules of Prof. Conduct rule 1-400(B) ("For purposes of this rule, a 'solicitation' means any

- **A California lawyer may not without good cause file a lawsuit or motions in a lawsuit that are simply intended to delay or impede a foreclosure sale.**[14]

- **A lawyer may not intentionally or recklessly fail to perform legal services with competence.**[15]

- **A lawyer should be wary of accepting fees for little or no work.**[16]

Distressed homeowners may need legal assistance. California lawyers should be wary, however, of non-lawyers – such as foreclosure consultants – who, seeking to capitalize on the vulnerability of distressed homeowners, offer to provide distressed homeowners assistance in renegotiating their loans and/or assessing and protecting their legal rights. These non-lawyers may propose arrangements that would violate one or more of a lawyer's ethical obligations. They may attempt to loop California lawyers into their businesses with promises of large numbers of referrals and/or "easy money," that is, fees for the lawyer for little or no work. They may request that a lawyer pay them a referral or marketing fee. They may propose an agreement to split legal fees obtained from the distressed homeowners. They may request that the lawyer enter into a joint venture with them and a distressed homeowner. They may request that a lawyer approve loan modification documentation. They may request that a lawyer serve as the general counsel to their business in order to provide legal advice to homeowners. They may ask that the lawyer file a frivolous lawsuit on behalf of a homeowner with whom the lawyer has had little or

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communications: (1) Concerning the availability for professional employment of a member or a law firm…; and (2) Which is; (a) delivered in person or by telephone …"). Thus, a lawyer generally may not call or show up at the doorstep of a potential client with whom the lawyer does not already have a prior relationship. The lawyer may, however, write, fax or e-mail such a potential client. Rule 1-400 of the Rules of Professional Conduct imposes various restrictions on the form and content of lawyer communications and solicitations. See, e.g., Cal. Rules of Prof. Conduct rule 1-400(D)(1), (2) & (3) (prohibiting lawyer communications or solicitations that contain untrue facts or mislead); Cal. Rules of Prof. Conduct rule 1-400, standard 5 (setting forth requirements for law firm brochures, newsletters, recent legal development advisories, and similar materials that are mailed); see also *Shapero v. Kentucky Bar Assoc.* (1988) 486 U.S. 466 [108 S.Ct. 1916] (unconstitutional for state to ban lawyer from soliciting legal business through truthful and non-deceptive mailing directed to homeowners facing foreclosure, but such communications could be subject to state regulation); see also Cal. State Bar Formal Opn. No. 1995-142 (ethical restrictions on direct mail marketing of legal services).

[14] See, e.g., Cal. Rules of Prof. Conduct rule 3-200 ("A member shall not seek, accept, or continue employment if the member knows or should know that the objective of such employment is (A) To bring an action … without probable cause and for the purpose of harassing … any person; or (B) To present a claim or defense in litigation that is not warranted …); Bus. & Prof. Code § 6068(c), (d), (g) (duty of lawyer to assert legal and just causes only, not to mislead court, and not to encourage commencement or continuance of action "from any corrupt motive of passion or interest").

[15] See, e.g., Cal. Rules of Prof. Conduct rule 3-110(A) ("A member shall not intentionally, recklessly, or repeatedly fail to perform legal services with competence."); see also Bus. & Prof. Code § 6450 (permissible and prohibited activities of paralegals); *In re Ivan O. B. Morse* (1995) 11 Cal.4th 184 [44 Cal.Rptr.2d 620] (lawyer suspended for, *inter alia*, incompetence in connection with mass mailing offering homeowners assistance in filing homestead declarations); *In the Matter of Robert B. Scapa and Michael S. Brown, supra*, 2 Cal. State Bar Ct. Rptr. 635 (lawyers suspended and placed on probation for opening office staffed solely by secretaries and paralegals).

[16] See, e.g., Cal. Rules of Prof. Conduct rule 4-200(A) ("A member shall not enter into an agreement for, charge, or collect an illegal or unconscionable fee."). The unconscionability of a fee is determined by multiple factors, including the amount of the fee in proportion to the value of the services performed (Cal. Rules of Prof. Conduct rule 4-200(B)(1)), and the time and labor required (Cal. Rules of Prof. Conduct rule 4-200(B)(10)).

no contact in order to buy time so that the foreclosure consultant will have more time to negotiate a loan modification directly with a homeowner's lender. As noted above, much of this conduct – accepting referral fees, fee splitting, forming a business with a non-lawyer that performs legal services, helping a non-lawyer engage in the unauthorized practice of law, filing frivolous lawsuits – violates the Rules of Professional Conduct and/or ethics rules set forth in the Business and Professions Code. A California lawyer should consider carefully the applicable ethical rules before agreeing to participate in any such venture involving people acting as foreclosure consultants or in a similar capacity. Failure to do so may result in lawyer discipline.[17]

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[17] See, e.g., *Cincinnati Bar Ass'n v. Mullaney* (2008) 119 Ohio St.3d 412 [894 N.E.2d 1210] (lawyers disciplined for accepting customers of Foreclosure Solutions, L.L.C.); see also Cal. State Bar Formal Opn. No. 1997-148 (ethical issues, including whether lawyer-client relationship is created, that lawyer should consider when non-lawyer generates prospective clients for lawyer by marketing living trust packages); and Cal. State Bar Formal Opn. No. 1995-143 (ethical issues that lawyer should consider when "medical liaison" generates prospective clients for lawyer by giving presentation to physicians).