UNCLEAN HANDS: RESIDENTIAL REAL ESTATE LOAN MODIFICATIONS IN SOUTH CAROLINA AND THE UNAUTHORIZED PRACTICE OF LAW

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I. Introduction

Most states allow either title companies or escrow agents to perform real estate closings without the supervision of an attorney.[1] South Carolina, though, is one of only ten states which require that attorneys manage the entire closing process.[2] This requirement has provided a substantial amount of work for South Carolina attorneys, as there were 46,762 real estate closings in 2011 alone.[3] The recent economic climate though has brought about record rates of home foreclosures,[4] and as such there has been an increased focus on real estate transactions. Most recently, loan modifications have become a focus of controversy. In *Carolina Federal Savings Bank v. Campbell*, a question arose as to whether or not attorneys must supervise loan modifications, just as attorneys are presently required to supervise real estate closings.[5] If attorneys are indeed required to supervise loan modifications, unsupervised loan modifications will be considered the unauthorized practice of law in South Carolina and thus constitute unclean hands. Unclean hands is an equitable defense derived from the equitable maxim that "a party seeking equity must come into courts with unclean hands."[6] The unclean hands defense "bars

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[1] Who Handles Closings in My State?, http://www.closing.com/search/ClosingAttorney.
[2] *Id.*
[3] See 2011 Premium South Carolina Realtors Year End Market Report: The Skinny, http://www.youtube.com/watch?v=hBTZ1eZ5oNw.
[4] South Carolina Foreclosures, http://www.realtytrac.com/mapsearch/south-carolina-foreclosures.html (There have been 22,618 foreclosures in South Carolina since January 1st, 2012).
[5] *Carolina Fed. Sav. Bank v. Campbell*, Case No.: 08-CP-10-2241, Court of Common Pleas, Charleston County, pg. 14 (Aug. 12, 2011)
[6] Randolph R. Lowell, Robert L. Reibold, & Shealy Boland Reibold, *South Carolina Equity: A Practitioner's Guide*, 178 (2010).

relief to those guilty of improper conduct in the matter as to which they seek relief" and "protect[s] the integrity of the court."[7]

Judge Scarborough, the presiding Master in Equity in *Campbell*, ultimately decided that attorneys are not required to be involved in loan modifications.[8] He reasoned that given the struggling status of the real estate market, requiring attorneys to be involved in loan modifications "could significantly dampen lenders' willingness to enter into such modifications going forward" and stagnate the process of recovering from the recession.[9] Judge Scarborough's decision was the first to address this question in South Carolina, and as such it begs the question as to how the South Carolina Supreme Court may one day decide this issue.

This paper will posit an answer to that question by first analyzing the case law which requires attorneys to supervise residential real estate closings, refinancing, and home equity loans. Within that framework, the rationale behind the attorney supervision requirement will be discussed. Next, the *Campbell* decision will be examined, and this paper will subsequently address whether attorney supervision is indeed necessary for loan modifications. Finally, this paper will conclude with a prediction as to how the South Carolina Supreme Court would rule in light of the aforementioned analysis.

II. Attorney Supervision of Residential Real Estate Closings, Refinancing, and Home Equity Loans in South Carolina

A. Buyer's Service

State v. Buyer's Service Co.[10] is the seminal case concerning attorney supervision of real estate closings in South Carolina. In this case, the State brought action to enjoin a title company, Buyer's Service, from engaging in what the State considered to be the "unauthorized practice of

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[7] *Id.*
[8] *Campbell,* 08-CP-10-2241 at 26-27.
[9] *Id.*
[10] 357 S.E.2d 15 (1987).

law."[11] Buyer's Service had prepared loan documents and title abstracts, performed closings, and filed recording documents with the court, all without the supervision of an attorney.[12] The Supreme Court held that each one of these activities did in fact require attorney supervision.[13]

As indicated above, South Carolina attorneys certainly do benefit economically from this requirement. However, the *Buyer's Service* Court stated:

> The reason preparation of instruments by lay persons must be held to constitute the unauthorized practice of law is not for the economic protection of the legal profession. Rather, it is for the protection of the public from the potentially severe economic and emotional consequences which may flow from erroneous advice given by persons untrained in the law.[14]

The court used this same public protection rationale in determining that title searches and loan closings must be supervised by an attorney as well.[15] Further, while filing court documents in and of itself is not considered the unauthorized practice of law, when it is done in relation to a real estate closing, "[i]t is an act of conveyancing and affects legal rights."[16] Therefore, recording loan documents requires attorney supervision.[17]

In summary, the *Buyer's Service* Court found attorney supervision of the entire real estate closing to be a critical requirement because it protects the public from erroneous legal advice and assistance.[18] While title search companies certainly do not agree with this result, the Court's decision can be further justified by the fact that purchasing real estate is one of the biggest

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[11] *Id.*
[12] *Id.*
[13] *Id.* at 18-19.
[14] *Id.* at 18.
[15] *Id.* at 19:

> The examination of titles requires expert legal knowledge and skill. For the protection of the public such activities, if conducted by lay persons, must be under the supervision of a licensed attorney... One handling a closing might easily be tempted to offer a few words of explanation, however innocent, rather than risk losing a fee for his or her employer. We are convinced that real estate and mortgage loan closings should be conducted only under the supervision of attorneys, who have the ability to furnish their clients legal advice should the need arise and fall under the regulatory rules of this court. Again, protection of the public is of paramount concern.

[16] *Id.* Further, "[t]he appropriate sequence of recording is critical in order to protect a purchaser's title to property."
[17] *Id.*
[18] *Id.* at 18-19.

financial events to take place in the lives of most purchasers.[19] With that consideration in mind, it makes sense for the law to require attorney supervision of the entire real estate closing process to ensure purchasers' interests are protected.[20]

B. The *Doe* Cases

Doe v. McMaster[21] and *Doe Law Firm v. Richardson*[22] have affirmed *Buyer's Service* and extended it, respectively. In *Doe v. McMaster* the Court had to decide whether or not refinancing existing mortgages requires the same level of attorney supervision as real estate closings do.[23] While the attorney in that case argued the two processes are different, the Court said that the same four steps required in real estate closings take place in refinancing, and as such the requirement for attorney supervision are the same.[24] Therefore, *McMaster* stands for the fact that both real estate closings and mortgage refinancing in South Carolina require the supervision of an attorney.[25]

In *Doe Law Firm v. Richardson* the Court was presented with the question as to whether the disbursement of funds in residential real estate transactions, without attorney supervision, constitutes the unauthorized practice of law.[26] While the question was a novel one, the court noted that "several attorney disciplinary cases have implied, but not decided, that disbursement is the practice of law when performed in connection with a residential real estate loan closing."[27] The Court went on to hold that disbursement in this context is considered the practice of law, and

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[19] Lecture by Professor Stephen A. Spitz, Real Estate Transactions, Fall 2011.
[20] *Id.*
[21] 585 S.E.2d 773 (2003).
[22] 636 S.E.2d 866 (2006).
[23] 585 S.E.2d at 776.
[24] *Id.* at 776, 778.
[25] *Id.*
[26] 636 S.E.2d at 868.
[27] *Id.*

as such, attorney supervision is required.[28] The Court, though, stated that attorneys do not have to perform disbursements personally (nor must funds pass through attorney trust accounts), but rather attorneys must only supervise the process.[29]

C. The *Matrix* Cases and *Wachovia*

Matrix Financial Services Corporation v. Frazer[30] involved competing lien holders attempting to collect on a homeowner's debts. The Appellant in the actions, Matthew Kundinger (Kundinger) filed a lawsuit against Louis and Linda Frazer (the Frazers) in California in 1998.[31] After a move to South Carolina in 2000, the Frazers defaulted in the California lawsuit.[32] The Frazers purchased a home in South Carolina in January 2001, and that mortgage was assigned to Matrix Financial Services Corporation (Matrix) in June 2001.[33] In September of the same year, "Matrix and the Frazers entered into a loan commitment to refinance the January 2001 mortgage."[34]

On September 4, 2001, Kundinger "obtained a default judgment against the Frazers in California."[35] Shortly thereafter, on September 18, 2001, Matrix conducted a title search on the property.[36] Kundinger enrolled the judgment from the California lawsuit in Greenville County on October 31, 2001.[37] Matrix and the Frazers closed on the refinanced mortgage on November 26, 2001, "but the new mortgage was not recorded until April 3, 2002."[38]

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[28] *Id.*
[29] *Id.*
[30] 394 S.C. 134 (2011) (*Matrix II*).
[31] *Id.* at 136.
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*

The suit arose when the Frazers filed for bankruptcy, and Matrix "sought to foreclose its November 2001 refinance mortgage."[39] Kundinger "counterclaimed, alleging his judgment had priority over Matrix's mortgage because it had been recorded first."[40] At this point, in order to regain the primary position, Matrix "sought to have the refinance mortgage equitably subrogated to the rights of the January 2001 mortgage."[41]

The Court ultimately decided that Matrix was not entitled to equitable subrogation, justifying this decision in part by stating that Matrix was "not entitled to an equitable remedy because it closed the refinance loan unlawfully, thus has unclean hands."[42] Prior precedent, the court noted, instructs that "[r]eal estate and mortgage closings, including refinance loans, must be supervised by an attorney."[43]

The Court also relied on *Wachovia Bank v. Coffey*[44] in reaching its conclusion. In *Wachovia*, the lender "closed a home equity loan without the supervision of an attorney and later instituted foreclosure proceedings."[45] Because of the lack of attorney supervision, the court held that Wachovia "came to the court with unclean hands and thus was barred from seeking equitable relief."[46] As a result, the *Matrix* Court said that "even if Matrix were able to satisfy the requirements for equitable subrogation, Matrix would not be entitled to that equitable remedy because it has unclean hands."[47]

The Court re-filed its opinion nearly a year later, in *Matrix II*, and stated, "[w]e take this opportunity to definitively state that a lender may not enjoy the benefit of equitable remedies

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[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.* at 138.
[43] *Matrix Fin. Servs. Corp. v. Frazer*, 2010 S.C. Lexis 289, *4 (Aug. 16, 2010) (*Matrix I*).
[44] 389 S.C. 68 (Ct. App. 2010).
[45] *Matrix I*, 2010 S.C. Lexis 289 at *5 (citing *Wachovia Bank v. Coffey*).
[46] *Id.*
[47] *Id.* at *6.

when that lender failed to have attorney supervision during the loan process as required by our law."[48] As such, while the *Matrix* cases deal with equitable subrogation in South Carolina, they also stand for the premise that home loan refinancing requires attorney supervision throughout the entire refinancing process to protect the public and prevent lenders from operating with unclean hands.

III. Loan Modifications

A. *Campbell*

Carolina Federal Savings Bank v. Campbell is a recent case decided by the Master-in-Equity of Charleston County, and it dealt with mortgage foreclosures for commercial and residential real estate.[49] The original mortgages were closed using an attorney, and some of these mortgages were modified to adjust the maturity date and interest rates. The defendant debtors asserted numerous defenses, including unclean hands, which Judge Scarborough allowed after *Matrix I*.[50] After failing to make their required mortgage payments, the debtors alleged that the plaintiff lenders engaged in the unauthorized practice of law because there was no attorney present for their mortgage modifications.[51] Judge Scarborough considered *Matrix II* and *Wachovia*, but he concluded these cases were distinguishable from *Campbell*. First, *Matrix* involved a refinancing lender, while this case involved "loan modifications affecting only the amounts or terms of the notes."[52] Second, *Wachovia* did not involve an attorney at any stage, but the original closings here "were closed and the mortgages recorded by the [defendants'] own attorney."[53]

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[48] *Matrix II, 394 S.C.* at 140.
[49] *See Carolina Fed. Sav. Bank v. Campbell*, Case No.: 08-CP-10-2241, Court of Common Pleas, Charleston County (Aug. 12, 2011).
[50] *Id.* at 14.
[51] *Id.*
[52] *Id.* at 18.
[53] *Id.*

Before issuing his holdings, Judge Scarborough issued a disclaimer in stating "it is questionable whether I have jurisdiction to determine the heretofore undecided questions of whether the preparation and recordation of note and mortgage modification agreements constitute the unauthorized practice of law."[54] He further stated that "[i]f I do not, then any ruling I make on these questions is nugatory."[55] Notwithstanding the disclaimer, Judge Scarborough analyzed the case because he felt "the[re] [were] important issues that need[ed] to be decided in light of the public policy in favor of mortgage modifications."[56] He did note that only the Supreme Court of South Carolina has jurisdictional grounds to rule on the unauthorized practice of law.[57]

Judge Scarborough said that the case law in South Carolina requires attorney supervision only where there is some kind of transfer or conveyance of property.[58] As such, because there was no conveyance, Judge Scarborough ruled that the preparation of the loan modification documents and the document recording did not constitute the unauthorized practice of law.

Judge Scarborough found that the "Plaintiff acted as nothing more than a scrivener in... prepar[ing] the modifications and did not engage in the unauthorized practice of law."[59] Since there was no real estate closing, the "recordation did not constitute the unauthorized practice of law."[60] He went on to say that additional disbursements of funds would not constitute the unauthorized practice of law in this situation because there was no real estate closing.[61]

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[54] *Id.* at 19.
[55] *Id.*
[56] *Id.*
[57] *Id.; see also Doe Law Firm v. Richardson,* 371 S.C. 14 (2006); *Hambrick v. GMAC Mort. Corp.,* 370 S.C. 118 (Ct. App. 2006).
[58] *Id.* at 20-21.
[59] *Id.* at 22.
[60] *Id.* at 23.
[61] *Id.*

Judge Scarborough also pointed out that there was no evidence the Plaintiff gave any legal advice to the Defendants during the loan modifications.[62] Further, as indicated above, given the struggling status of the real estate market, Judge Scarborough said that requiring attorneys to be involved in loan modifications "could significantly dampen lenders' willingness to enter into such modifications going forward" and stagnate the process of recovering from the recession.[63]

B. Prediction of the South Carolina Supreme Court's Ruling on Loan Modifications

Even though *Campbell* says that attorney supervision is not required for loan modifications, prior case law suggests that the South Carolina Supreme Court may decide the opposite. While Judge Scarborough's decision took account of the present financial crisis, the main premise of the South Carolina Supreme Court's decisions requiring attorney supervision has consistently been the protection of the public, likely an overriding consideration.[64] The Court has ruled that the same public protection considerations of residential home closings are present in both residential home loan refinancing and home equity loans.[65] For instance, both of these situations are ripe with the potential of the public receiving erroneous legal advice, and that was one of the main reasons the Court extended the attorney supervision requirement to those situations.[66]

Applying that rationale, the very nature of loan modifications would require attorney supervision more so than loan refinancing. This is because while refinancing generally affects only the pricing terms of a loan, loan modifications may alter both pricing and other substantive

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[62] *Id.* at 22.
[63] *Id.* at 26.
[64] *See, Buyer's Service*, 357 S.E.2d at 19 (1987).
[65] *Id.* at 18.
[66] *Id.*

terms. Without attorney supervision, real estate owners may unknowingly rely on faulty advice and grant lenders security interests in personal assets while also agreeing to acceleration clauses they otherwise would not. This is the very type of protection the Court was concerned with in *Buyers Service* and its progeny.

Further, contrary to Judge Scarborough's rationale in *Campbell*, the Court has required attorney supervision in situations other than real estate transfers and closings, specifically in the context of loan refinancing and home equity loans. Also, since the Court required attorney supervision for the disbursement of funds in real estate closings, it is a logical conclusion that the Court will find attorney supervision necessary in loan modifications where there is more opportunity for the public to receive erroneous advice.

IV. Conclusion

While the Court has extended *Buyers Service* to loan refinancing, home equity loans, and disbursements in real estate closings, it would be no stretch for the Court to make the same extension to loan modifications. The same public protection considerations in residential home closings are found in loan modifications. Should the Court extend *Buyers Service* to loan modifications, lenders who attempt to foreclose on loans modified without attorney supervision may find themselves subject to the equitable defense of unclean hands as a result of engaging in the unauthorized practice of law. As such lenders may be unable to collect on those loans. While *Campbell* was not appealed, it seems to be only a matter of time until the South Carolina Supreme Court rules on this issue, and when it does, lenders beware.