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Seller's Concession – Danger to the Legal Profession?

January 7, 2008

In 2006 a New Jersey Ethics Opinion disciplined the Buyer's and Seller's attorneys for participating in a real estate transaction which had a "Seller's Concession" built into the purchase price. Despite the fact that full disclosure was made to the originating bank, the NJ Committee on Professional Ethics held that a lender acquiring the loan in the secondary market could be deceived. See N.J. Opinion 710.

New York has now (11-2-07) issued a similar opinion. See Opinion 817. "Participation in residential real estate transactions that include a "seller's concession" and "grossed up" sales price is prohibited unless the transaction is entirely lawful, the gross-up is disclosed in the transaction documents, and no parties are misled to their detriment." NY Opinion 817.

There is much room for interpretation in the opinion. What is meant by transaction documents? Must the deed contain a recital concerning the concession so that there is record notice? Would a bank relying on an appraisal, which, in turn, relied on a grossed-up purchase price of an adjoining property, be considered as a party misled to their detriment? What has always been a slippery slope is now a sheet of ice. In a market looking for solutions this could be a serious roadblock. See following pages to read entire opinion.

NEW YORK STATE BAR ASSOCIATION

COMMITTEE ON PROFESSIONAL ETHICS

Opinion 817 – 11/2/07

Topic: Lawyer's participation in residential real estate purchase and sale closing that includes a "seller's concession" and "grossed up" sale price.

Digest: Participation in residential real estate transaction that includes a "seller's concession" and "grossed up" sale price is prohibited unless the transaction is entirely lawful, the gross-up is disclosed in the transaction documents and no parties are misled to their detriment.

Code: DR 1-102(A)(3), (4), (5); DR 7-102(A)(7).

QUESTION

1. Following written agreement between buyer and seller of real estate as to terms, the purchaser requests that the agreed actual sale price be increased by 3% to cover the purchaser's anticipated closing costs, and that the seller grant purchaser a "seller's concession" in an equal amount. The buyer thereby obtains a mortgage loan based upon an increased amount, the actual purchase price plus the buyer's closing costs.

2. Seller's counsel is advised by the lender that this type of seller's concession is "done all the time" by lenders, and it is apparently authorized in the lender's underwriting manual.[1] Moreover, the lender advises seller's counsel that the practice is also acceptable to the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corp. ("Freddie Mac"), who are among the major purchasers of residential mortgage loans.

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[1] According to the inquirer, the manual appears to approve of seller's contributions up to a maximum of 6% of the selling price (where there is a 10% deposit; if the deposit is less than 10%, the maximum seller's concession allowed is 3%). The lender has also provided seller's counsel with a redacted HUD-1 Settlement Statement from a transaction the bank recently closed, showing the grossed-up contract price on Lines 101 and 401, and the "Seller's Concession" as reductions on Lines 215 and 515.

8. Still more closely on point, in Opinion 710 (2006),[4] the New Jersey Supreme Court Advisory Committee on Professional Ethics considered facts like those presented here. In that opinion, the practice was described as follows:

> A contract for the sale of residential property has been prepared by a realtor and signed by both seller and buyer for a set purchase price with a mortgage contingency. Either during attorney review or thereafter, the lawyers for the seller and the buyer are required to amend the contract by increasing the purchase price and the mortgage contingency amount in like amounts. In addition, the attorneys are asked to amend the contract to provide that the seller give a credit to the purchaser at closing in the same amount, calling it a "seller's concession" or "seller's payment of purchaser's closing costs." The inquirer states that the amendments are calculated to increase the size of the purchaser's mortgage loan and "is a fraudulent practice perpetrated on the ultimate investor."
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> The Committee notes that in recent years residential mortgage lending has, through the secondary market, become a major category of finance in this country. As a result of federal programs, those who originate loans may earn financing fees at the closing and then convey those loans to entities such as the Government National Mortgage Association (known as Ginnie Mae), the Federal National Mortgage Association (known as Fannie Mae) and the Federal Home Loan Mortgage Association (known as Freddie Mac). These programs, in turn, after buying the mortgages from the originators, then issue "mortgage-backed bonds" to investors, who receive the periodic payments of principal and interest from the borrowers.
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> This secondary market enables the originating lender to sell the loan, and to originate more loans and financing fees with the sales proceeds. In addition, the secondary market has created an investment market for low risk mortgage based securities, and attracts investment dollars into the residential mortgage business.
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> On the facts set forth in the inquiry, it appears that the sales contract as amended is submitted to the original mortgage lender, or broker, with the sale price increase and corresponding credit expressly stated, but without any assurance that assignees in the secondary market would be aware of the device employed to increase the size of the mortgage loan.

9. Based upon this description, New Jersey Op. 710 determined that the practice violated the prohibitions contained in New Jersey's Rules of Professional Conduct against counseling or assisting a client in conduct that the lawyer knows is illegal, criminal or fraudulent, and engaging in conduct involving dishonesty, fraud, deceit or misrepresentation:

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[4] 2006 WL 3891474.

> By manipulating the sales price in the manner described by the inquirer, either the originating lender or the secondary investors may be deceived as to the true market price of the house. The deception is the credit to the buyer given by the seller to offset the increase in purchase price. The credit is not justified by any additional property or rights to be sold to purchaser, or by a legitimate charge against the seller on account of any actual costs assumed by it and otherwise payable by the buyer.
>
> . . . .
>
> In the present inquiry, it would seem that the originating lender would have the opportunity to uncover the ruse upon a close reading of the contract and the loan application, and to protect itself before completing the transaction, but it is less clear that persons investing in the secondary market would have the same opportunity, or would have recourse against the assignor in the event a later default occurs and a loss is suffered as a result of the enhanced sales price.

The opinion concludes that a lawyer's participation in the increase in the purchase price and offsetting credit was improper because it "involves a deceit, intending that the mortgage loan investor will rely on the misrepresentations in the contract in determining the size of the mortgage loan." The advisory committee also said that the conduct "compromises the integrity of the underwriting of the loan because it exposes the lender and those who purchase the resulting loan to a greater risk of loss than is knowingly accepted."

10. New Jersey Op. 710 provoked requests for clarification from the Mortgage Bankers Association of New Jersey and the North Central Jersey Association of Realtors.[5] They asserted that New Jersey Op. 710 was based on a misunderstanding of mortgage lending practices and was leading New Jersey attorneys to refuse to work on mortgage loans containing seller's concessions of any kind. The mortgage bankers association said that seller's concessions made to permit financing of closing costs serve a salutary purpose because low-income and first-time buyers often do not realize at the time of contract that they will not have sufficient cash to cover the closing costs.[6] The realtor association asked whether the opinion covered, for example, closing credits for repairs to resolve problems uncovered by the home inspection process.[7]

11. A week after the original issuance, the New Jersey committee clarified that New Jersey Op. 710 "address[ed] fictional and deceptive increases in purchase prices unrelated to the actual circumstances or costs of closing, and contrary to the expectations of the lender or the ultimate holder of the mortgage." The clarification

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[5] Mary Pat Gallagher, Ethics Ban on Seller's Concessions at Closings Limited, 187 N.J.L.J. 1 (Jan. 1, 2007).

[6] *Id.*

[7] *Id.*

stated that the opinion was meant to bar only those seller's concessions not premised on "a legitimate charge against the seller on account of any actual costs assumed by it and otherwise payable by the buyer," and did "not implicate a contract of sale that explicitly states that the seller shall provide the buyer with a credit against legal and legitimate costs or expenses related to the sale, which would otherwise be absorbed by the buyer, such as actual closing costs."[8]

12. The clarification thus addressed, and found permissible, some shifting of costs otherwise borne by buyers, but continued to find impermissible an increase in the purchase price and an offsetting credit to permit the buyer to finance closing costs.[9]

13. This Committee is neither a legislative, nor a judicial body. Just as we cannot opine on matters of law nor can we "find facts." Thus, while we recognize the evidence that the practice of grossing up the price post-contract has become common, we find the concerns expressed in North Carolina Op. 12 and New Jersey Op. 710 of considerable weight.[10]

14. The issue is whether the lawyer's participation in such a transaction facilitates deception or misrepresentation. It seems obvious that there is potential deception implicit in the transactions, but we cannot determine whether or in what circumstances actual deception will occur. Thus we hold that a lawyer may not ethically participate in such a "gross up" of the actual purchase price and concomitant seller's concession unless there is neither deception nor misrepresentation at work in the transaction and its predictable consequences. At a minimum this means that the gross-up (and not merely the grossed-up purchase price) must be disclosed in the transaction documents. We are persuaded that merely reporting "a seller's concession" may imply either that the seller has agreed to reduce the purchase price he or she would otherwise have obtained or that the reported sales price is the actual price of the property, less certain costs the seller has agreed to pay. If neither of these is the case, then reporting a concession, without more, is misleading under DR 1-102.

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[8] Notice to the Bar, Clarification of Advisory Committee on Professional Ethics Opinion 710 (Dec. 22, 2006).

[9] While New Jersey Op. 710 was thereafter approvingly cited as supporting the imposition of civil liability and professional discipline against attorneys participating in transactions that include seller's concessions, *see* Dodge, *Creative Financing*, 43 Arizona Attorney 8 (June 2007), it has also been strenuously criticized in some quarters, *see* Schonberger, *Real Estate Attorneys Miscast as Mortgage-Market Watchdog*, 187 N.J.L.J. 1123 (March 26, 2007) ("[T]he advisory committee failed to understand that the secondary mortgage investor is not unknowingly buying risk . . . . Perhaps more important is the existence, and actions, of professionals [such as appraisers] between the mortgagor and ultimate secondary market buyer.").

[10] This Committee has long recognized that the lawyer's obligation under DR 1-102(A)(4) not to engage in conduct involving deception extends to deception of both clients and non-clients. *See* N.Y. State 626 (1992) (holding that the lawyer must provide non-client borrower with information to judge whether the lawyer's fee is or is not excessive); N.Y. State 796 ¶ 6 (2006) (noting that statements made to third parties "can become a matter of ethical concern" under DR 7-102(A)(5), which bars a lawyer from "[k]nowingly mak[ing] a false statement of law or fact").

CONCLUSION

15. On the facts presented here, and for the reasons above, we conclude that participation in such transactions is unethical unless there is no unlawful conduct, and there is full disclosure in the transaction documents of the substance and effect of the transaction.

(11-07)

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3. Seller's counsel is unaware whether the lender's underwriting guidelines, or those of Fannie Mae and Freddie Mac, discuss a price "gross up" and is concerned that there is no assurance that the "ultimate purchaser of the loan" would be aware of the selling price "gross up" used to offset the seller's concession. Moreover, counsel is concerned that the reporting of a "grossed up" selling price on the purchaser's mortgage application and the HUD-1 Settlement Statement may violate federal law, and in particular 18 U.S.C. §§ 1001, 1010, and 1012 (which criminalize fraud in certain transactions concerning the federal government).

4. Counsel asks whether participation in this transaction, as seller's attorney, will violate New York's Code of Professional Responsibility.

OPINION

5. It is clear that DR 1-102(A)(3) prohibits an attorney from engaging in "illegal" conduct; and DR 7-102(A) provides that "[i]n the representation of a client, a lawyer shall not . . . (7) counsel or assist the client in conduct the attorney knows to be illegal or fraudulent." Therefore, if the conduct at issue is unlawful or fraudulent, it is *per se* unethical. We do not opine on issues of law, however, so we cannot determine whether it is criminal or fraudulent.

6. This Committee does construe the Code, however. DR 1-102(A)(4) prohibits "conduct involving dishonesty . . . deceit, or misrepresentation." While we have not previously addressed the specific question raised here,[2] two other state ethics opinions have considered closely related questions.

7. First, in North Carolina Formal Ethics Opinion 12 (2001),[3] a developer sold a lot for a certain purchase price, giving an early buyer a credit at closing. The developer, hoping to maintain the price of future sales, wanted the lawyer to obtain deed tax stamps based upon the higher price recited in the purchase agreement. The ethics committee of the North Carolina Bar, applying provisions substantially the same as the applicable New York Code provisions, determined that such conduct would be barred as involving dishonesty and misrepresentation, at least in part because the deed recordation concealed (and was intended to hide) from subsequent purchasers of nearby lots, the fact that the credit had been given.

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[2] In N.Y. State 545 (1982) we hold that it was improper for a lawyer to execute a Real Property Transfer Report that set forth a purchase price that excluded the cost of a number of "extras." The Committee presumed that the conduct violated the Real Property Law, and was therefore barred by DR 7-102(A)(7), and did not reach the question of "dishonest . . . deceit, or misrepresentation."

[3] 2001 WL 1949450.