

# **ARBITRATION ADVISORY**

**10- 01**

## **Arbitration of Loan Modification Fee Disputes**

**February 11, 2010**

Points of view or opinions expressed in this document are those of the Committee on Mandatory Fee Arbitration. They have not been adopted or endorsed by the State Bar's Board of Governors and do not constitute the official position or policy of the State Bar of California.

### **INTRODUCTION**

This advisory discusses the new law, Senate Bill 94 effective October 11, 2009, handling objections by lawyers to the mandatory fee arbitration program's jurisdiction, assessing claims in fee arbitration before and after the law became effective, and other related issues connected with loan modification work in the mandatory fee arbitration context.

### **BACKGROUND**

The home foreclosure crisis facing homeowners in recent years resulted in the proliferation of mortgage modification scams affecting Californians as well as consumers across the nation. In general, these scams involve businesses that market foreclosure rescue and mortgage modification services to homeowners. Although consumers are charged a fee up-front by the business on a promised or even "guaranteed" relief, most of these companies did little or nothing to help homeowners stop foreclosure or renegotiate their mortgages. To make matters worse, after failing to provide the promised services, the companies that promised a refund did not honor those promises. In 2009, federal and state law enforcement agencies joined forces to crack down on these services, resulting in a number of lawsuits, criminal prosecutions and civil injunctions in many states.

California, in particular, experienced an unusually high volume of lawyer involvement in these mortgage modification and foreclosure rescue scams. Consumer harm also led to an increase in the number of clients requesting refunds from the lawyer through the mandatory fee arbitration program. In addition, a new California law was passed effective October 11, 2009 prohibiting

lawyers involved in loan modification work from charging or accepting an advanced fees.

## DISCUSSION

In response to homeowner complaints regarding practices by foreclosure consultants, the Legislature passed Senate Bill 94 ("SB 94"). The law went into immediate effect when it was signed by the Governor on October 11, 2009. Under existing law, "foreclosure consultants," as defined by Civil Code §2945(a), were prohibited from collecting a fee for any services until the services had been fully performed.<sup>1</sup> However, because attorneys were excluded from the definition of "foreclosure consultant," many loan modification companies developed relationships with attorneys in an effort to avoid the statutory prohibition on collecting an advance fee by having a lawyer work with them in foreclosure consultations.

SB 94 is intended to protect California homeowners from scam loan modification companies and attorneys who charged distressed homeowners up-front fees and often delivered nothing in return. SB 94 attempts to overhaul certain code sections covering the activities of real estate brokers and agents in the "loan modification" field. In order to cover attorneys for the same services (including filing suit), SB 94 added section 6106.3 to the Business and Professions Code ("Bus. & Prof. C."). Bus. & Prof. C. §6106.3 provides that as of October 11, 2009, it is grounds for discipline for an attorney to engage in conduct in violation of Civil Code sections which make it "unlawful" for "any person" who provides mortgage loan modification services or other forms of mortgage loan forbearance for a fee from claiming, charging, demanding, or collecting any compensation until after that person has fully performed the services the person contracted to perform.

Thus, as of October 11, 2009, (the bill is not retroactive) attorneys may no longer charge or receive "advance fees" when engaged for loan modification services relating to 1 to 4 unit residential dwellings. Should they do so, they are subject to discipline and potential criminal penalties. The discipline to which they are subject is not outlined in the bill and that aspect appears to be clearly the responsibility of the State Bar Court and its personnel.

"Advance fees" is a term used in Department of Real Estate ("DRE") parlance (See, Bus. & Prof. C. §10026.). It has specific elements tied into Business & Professions Code §10146, which requires that an "advance fee" paid to a real estate broker be deposited in a trust account and sets forth the conditions under which funds may be withdrawn from that account. In other words, while it has some of the attributes of a "retainer" or "deposit" it is not such for purposes of attorney fee agreements. Both "advance fees" and "retainers" should be deposited into the trust account. Both remain the property of the

---

<sup>1</sup> The Mortgage Foreclosure Consultants Act (Civil Code §§ 2945, *et seq.*)

client. Both can only be transferred to the general account once the services have been rendered. Both are refundable, regardless of any language (*i.e.* "non-refundable") in the retainer agreement to the contrary.

It is clear that following passage of SB 94, the term "advance fees" is being used to define "retainers" as well as "deposits" as they relate to attorney fee agreements. The language of the new law clearly, and at various specific places in the statutes, states that no funds may be received by an attorney prior to the completion of all work contemplated by the client. This means that not only can an attorney not take a retainer for services to be rendered in the future, he/she may not take an advance to cover costs either. In addition, because the statute prohibits collecting or receiving any compensation until all of the services have been performed, an attorney cannot place an advance fee into a client trust account and hold the money in trust until the services have been fully performed. While it is reasonable to assume that such a law would make it difficult for clients to find representation should they need to not just negotiate with a lender to restructure a mortgage but to file suit to postpone foreclosure, that aspect of the ramifications of the bill is not the focus of this advisory.

Issues raised by SB 94 with respect to jurisdiction of and claims made pursuant to the mandatory fee arbitration program ("MFA") with reference to "loan modification" services owned, supervised or performed by lawyers include the following:

1. Does MFA have jurisdiction over a fee dispute between a client and a lawyer where the lawyer denies the existence of an attorney-client relationship or claims that he/she was retained to provide non-legal services?
2. Are there special considerations in MFA arbitration for post October 11, 2009 loan modification fee agreements in light of the potential criminal and disciplinary penalties set forth in the statutes which may limit an attorney's ability to defend his/her self.?
3. How is a fee arbitrator to handle "advance fee" arrangements entered into after October 11, 2009 in the context of mandatory fee arbitration?
4. How is a fee arbitrator to handle fee disputes arising from pre-October 11, 2009 service agreements which contain "advance fee" arrangements or involve advance fee payments as it relates to claims to be determined in mandatory fee arbitration?

**1. Does MFA have jurisdiction over a fee dispute between a client and a lawyer where the lawyer denies the existence of an attorney-client relationship or claims that he/she was retained to provide non-legal services?**

In *National Union Fire Insurance Co. v. Stites Professional Law Corp.* (1991) 235 Cal.App.3d 1718, 1724, the court held that fee arbitration pursuant to the MFA provisions (Business & Professions Code §6200, et seq.) is limited to fee disputes between attorneys and their clients, and that the fee arbitration statute does not confer jurisdiction over the threshold issue of whether an attorney-client relationship existed.

However, in *Glassman v McNab* (2003) 112 Cal.App.4th 1593, the court held that the parties may voluntarily submit the issue of whether an attorney-client relationship existed to a fee arbitration panel by stipulation. Thus, in the absence of a stipulation, MFA programs and arbitrators lack subject matter jurisdiction to determine whether an attorney-client relationship existed between the parties. Handling objections to jurisdiction after *Glassman* is the subject of a prior arbitration advisory (Arbitration Advisory 05-01, Jurisdiction of the Mandatory Fee Arbitration Program to Determine the Existence of an Attorney-Client Relationship - January 21, 2005.)

In the loan modification context, attorneys have formed loan modification companies which are purportedly separate from their law practices or they have formed partnerships or joint ventures with foreclosure consultants. In response to a client's request for mandatory fee arbitration, some lawyers may object to MFA jurisdiction on the grounds that there was no attorney-client relationship between the parties or that the nature of the employment did not involve the performance of legal services. It is the position of the State Bar Committee on Mandatory Fee Arbitration ("CMFA") that a reasoned approach requires that cases not be declined by fee arbitration programs merely based on one party's denial of the existence of an attorney-client relationship or a claim that only non-legal services were rendered.

Rather, CMFA suggests that when a "client" petitions for arbitration of a fee dispute involving loan modification services and the attorney denies the existence of an attorney-client relationship, that programs and arbitrators refer to Arbitration Advisory 05-01 and follow the steps in Program Advisory "How to Proceed When a Party Denies the Existence of an Attorney-Client Relationship" (August 9, 2008)<sup>2</sup> before deciding whether to proceed with arbitration when there is a question regarding the existence of an attorney-client relationship. In short, those advisories suggest that absent a stipulation by the parties specifically conferring the issue of jurisdiction on the arbitrator to determine the existence of an attorney-client relationship, that the program's chairperson or functional equivalent should obtain additional information from the parties bearing on the issue of whether an attorney-client relationship existed or if only non-legal services were contemplated by the client or performed by the attorney. If the arbitration proceeds after the program determines that there is sufficient

---

<sup>2</sup> This Program Advisory may be obtained by contacting the local bar association program staff or the State Bar Fee Arbitration Office, 180 Howard Street, San Francisco CA 94105, telephone (415) 538-2020, facsimile (415) 538-2335.

evidence establishing MFA jurisdiction, the party against whom the jurisdictional ruling was made could later petition the court to vacate the award for lack of subject matter jurisdiction.

In conclusion, a party's mere assertion that an attorney-client relationship did not exist or that the attorney's employment covered only non-legal services is not fatal to a mandatory fee arbitration request. The objection should be scrutinized by the program chair and a determination made as to whether or not there is a sufficient evidentiary showing to establish subject matter jurisdiction to proceed to arbitration.

**2. Are there special considerations in MFA arbitration for post October 11, 2009 loan modification fee agreements in light of the potential criminal and disciplinary penalties set forth in the statutes which may limit an attorney's ability to defend his/her self.**

Business & Professions Code §6106.3(a) reads: "It shall constitute cause for the imposition of discipline of an attorney within the meaning of this chapter for an attorney to engage in any conduct in violation of Section 2944.6 or 2944.7 of the Civil Code."

Civil Code §2944.6 requires that prior to entering into a retainer agreement any person, including an attorney, must provide the client/borrower with a separate statement in no less than 14-pitch bold type informing the prospective client that it is not necessary to pay a third party to arrange a loan modification or other mortgage forbearance and other disclosures as set forth in the statute. Civil Code §2944.6(c) makes a violation of that section a public offense punishable by a fine not exceeding \$10,000, by imprisonment in the county jail for a term not to exceed one year, or both.

Civil Code §2944.7(a)(1) bars any person, including an attorney, who negotiates, attempts to negotiate, arranges or attempts to arrange or otherwise offers to perform a loan modification or other form of mortgage loan forbearance from claiming, demanding, charging, collecting or receiving any compensation until after the person has fully performed each and every service the person contracted to perform or represented that he/she would perform in the loan modification area. Civil Code §2944.7(a)(2) bars any person from taking any security to secure the payment of compensation for loan modification services. These provisions therefore bar an attorney from taking any retainer or advance fee in the loan modification area (which is defined very expansively, including aspects of real estate which one might not normally associate with "loan modification services").

Civil Code §2944.7(b) makes a violation of the section a public offense punishable by a fine not exceeding \$10,000, by imprisonment in the county jail for a term not to exceed one year, or both. As noted above, Business. &

Professions Code §6106.3(a) makes it a disciplinary offense to engage in any conduct in violation of Civil Code Sections 2944.6 or 2944.7.

If criminal charges have been filed against an attorney, the attorney may refuse to participate in the fee arbitration process despite the mandatory provisions of the MFA statutes, or the attorney may choose to appear but cite his or her Fifth Amendment right against self-incrimination and refuse to testify. In such circumstances, fee arbitration should be abated while the criminal charges are pending if the attorney makes an offer of proof that he/she cannot defend him or herself without waiving their Fifth Amendment rights. If, however, criminal charges have not been filed, the client should have the right to proceed with mandatory fee arbitration.

### **3. How is a fee arbitrator to handle "advance fee" arrangements entered into after October 11, 2009 in the context of mandatory fee arbitration?**

If a retainer agreement for post October 11, 2009 loan modification services calls for an "advance fee," it is clear that the fee agreement is unenforceable and void as a matter of law. The lawyer would probably then be required to refund the fees. This seems to be the case regardless of whether services were actually rendered and costs advanced on behalf of the client. The reason for this conclusion is that SB 94 made the act of entering into such an agreement an ethical violation, including possible discipline, such that disgorgement of the entire advanced fee would be warranted.

If there was no retainer agreement calling for advance fees, none were charged or paid, and the attorney is claiming that he or she has fully performed all of the services that were contracted for or represented to be performed, then the MFA program would still have jurisdiction to decide the parties' fee dispute. In such situations, whether the client paid the fee after the services were performed or is disputing the fee billed by the attorney, the initial question will be: were the services contracted for fully performed.<sup>3</sup> If they were, then a valid fee agreement, as it relates to Business & Professions Code §6106.3, existed. The arbitrator will then have to find that no fees were charged or paid until all of the services were performed and that the separate statement required by the new law was provided. Assuming that no fees were paid or charged in advance, and that written disclosure was provided, the arbitrator would then determine whether the amount paid or billed was appropriate for the services rendered. Obviously, if there are grounds to void the fee agreement for reasons other than a violation of Business & Professions Code §6106.3, (for example - the attorney rate and/or costs are deemed to be unconscionable; the billing was not properly itemized, or was not provided in a timely fashion), the analysis would be the same as that

---

<sup>3</sup> The attorney's services do not have to have resulted in a successful modification in order for the attorney to collect a fee. The Governor did not sign Assembly Bill 764, citing provisions in that bill which would have only allowed fees to be collected if a loan modification was successful.

used to find “the reasonable value of services rendered”[See Arbitration Advisory 98-03 “Determination of a ‘Reasonable’ Fee,” - June 23, 1998.)

**4. How is a fee arbitrator to handle fee disputes arising from pre-October 11, 2009 service agreements which contain "advance fee" arrangements or involve advance fee payments as it relates to claims to be determined in mandatory fee arbitration?**

This analysis may not be simpler than the analysis used for post-October 11, 2009 retainer agreements, but it has precedent behind it which can be cited in order to aid an arbitrator in making his or her award in this regard.

Prior to October 11, 2009, there were no restrictions on attorneys from collecting an “advance fee” in relation to loan modification services. There were restrictions on the collection of advance fees for DRE licensees, brokers and/or agents. As a result, DRE licensees, brokers and/or agents, including those advertising themselves as “foreclosure consultants,” joined forces with attorneys to perform “loan modification services”.

In some situations, the attorney was involved in name only and only in order to allow for the collection of an “advance fee” by those barred by law from collecting such fees. In some other situations, the attorney owned or supervised a business but did not personally provide services, the services being provided by lay or real estate personnel only. As more and more distressed homeowners sought aid with reference to “loan modification services” and as their displeasure grew when the promised services were not rendered, claims for refunds resulted. If an attorney was involved in the business that marketed the services, clients also sought out mandatory fee arbitration against the attorney.

The MFA program and the fee arbitrator may provide MFA arbitration for a fee dispute involving a pre-October 11, 2009 fee agreement. Until October 11, 2009, California attorneys were allowed to charge and collect an advanced fee for mortgage modification work. Therefore, a retainer agreement requiring advanced fees would not be void and any collection of advanced fees before all services were performed was not illegal. Once the arbitrator has determined whether or not there is a valid written fee agreement (if no agreement exists or if an agreement is void for other reasons, then “the reasonable value of services rendered” analysis is used), the arbitrator may continue to rely on existing California Rules of Professional Conduct and case law to render his or her award.

A helpful source of information for arbitrators faced with such a case is the February 2, 2009 Ethics Alert, (“Alert”), issued by the Committee on Professional Responsibility and Conduct, (“COPRAC”). In that Alert, COPRAC identifies the major areas where an attorney may run afoul of his or her ethical requirements

which consequently translates into a possible reduction -or elimination- of the fees collected or charged. The Alert identifies the following areas of concern:

- 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 [CRPC, Rule 1-320(B); Bus. & Prof. C. §§6151, 6152, 6155].
- 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 [CRPC, Rule 1-320(A), 2-200(A), 2-200(B); In the Matter of Jones, III (Review Dept. 1993) 2 Cal.State Bar Ct. Rptr 411; In the Matter of Scapa and Michael S. Brown (Review Dept. 1993) 2 Cal.State Bar Ct. Rptr 635; In the Matter of Bragg (Review Dept. 1997) 3 Cal.State Bar Ct. Rptr 615.)
- 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 [CRPC, Rule 1-300(A), 1-310; In re Carlos (Bankr. C.D. Cal. 1998) 227 B.R. 535; 2 Cal.State Bar Ct. Rptr 411; In the Matter of Jones, III (Review Dept. 1993) 2 Cal.State Bar Ct. Rptr 411; In the Matter of Bragg (Review Dept. 1997) 3 Cal.State Bar Ct. Rptr 615.)
- A California lawyer may not contact a distressed homeowner in person or by telephone 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, may, however, write to a distressed homeowner who is a prospective client [CRPC, Rule 1-400(B), 1-400(C), 1-400(D)(1) and (2); Shapero v. Kentucky Bar Assoc. (1988) 486 U.S. 466].
- A lawyer may not intentionally or recklessly fail to perform legal services with competence. A lawyer should be wary of accepting fees for little or no work [CRPC, Rule 3-110(A), 4-200(A), 4-200(B)(1), 4-200(B)(10); Bus. & Prof. C. §6450; In re Ivan O.B. Morse (1995) 11 Cal.4<sup>th</sup> 184; In the Matter of Scapa and Michael S. Brown (Review Dept. 1993) 2 Cal.State Bar Ct. Rptr 635.)

If the arbitrator determines that the attorney committed an ethical violation in conjunction with the attorney's relationship with a non-attorney foreclosure consultant or the attorney's conduct violated the standards in handling a loan



modification, the arbitrator should determine whether the ethical violation is grounds for denying all or part of the attorney's fees [See e.g., *Pringle v. LaCheppelle* (1999) (fee forfeiture is not automatic – there must be a serious violation to warrant a forfeiture of fees); *Jeffry v. Pounds* (1977) 67 Cal.App.3d 6 (conflict of interest preclude attorney from recovering fee incurred after the ethical breach); *Day v. Rosenthal* (1985) 170 Cal.App.3d 1125 (fee recovery denied because ethical violations rendered the services valueless)].

## CONCLUSION

Recently, in the wake of fraudulent mortgage modification services involving California lawyers, the mandatory fee arbitration programs may be faced with claims arising from these services. Notwithstanding a challenge to jurisdiction, the MFA program may proceed if there is a sufficient basis to conclude that an attorney-client relationship exists or that legal services were also contemplated. New law effective October 11, 2009 prohibiting attorneys from collecting an advanced fee prior to performing all services and requiring written disclosure will impact the usual analysis employed by the arbitrator in MFA cases. The arbitrator must determine the fee dispute based on whether the new law controls. Special considerations such as abatement, and possible ethical violations likely to appear in this particular area as flagged in the recent COPRAC February 2, 2009 Ethics Alert should also be considered before rendering a MFA award.