

Advisory Committee on Professional Ethics

Appointed by the Supreme Court of New Jersey

OPINION 710

Advisory Committee on Professional Ethics

**Misrepresenting Purchase Price or Other Material
Fact Regarding a Real Estate Transaction**

An inquirer asks if it is an ethical violation for an attorney to participate in a real estate practice 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 requested 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.”

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.

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 backed securities, and attracts investment dollars into the residential mortgage business.

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 sales 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. The inquirer believes this implicates the lawyers for the seller and the buyer in a deceitful practice in possible violation of the ethical rules.

RPC 1.2(d), *RPC 4.1* and *RPC 8.4(c)* are each implicated by the practice described by the inquirer. *RPC 1.2(d)* provides: “A lawyer shall not counsel or assist a client in conduct that a lawyer knows is illegal, criminal or fraudulent” *RPC 4.1 (a)* provides: “In representing a client a lawyer shall not knowingly: (1) make a false statement of material fact or law to a third person; or (2) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client.” *RPC 8.4* provides: “It is professional misconduct for a lawyer to . . . (c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation”

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.

The deception in the deliberate overstatement of the property's sales price with the offsetting credit is similar to the case *In re Labendz*, 95 N.J. 273 (1984). In that case a purchaser's attorney was suspended for a year for his participation in the preparation of a mortgage loan application to a savings and loan association that misrepresented that the sales price was \$107,000 instead of the actual price of \$100,000. The \$7,000 increase was to be offset by a seller's credit to the buyer. The motive of the buyer was to increase the mortgage amount to avoid the lender's loan limitations. The buyer was successful in obtaining the higher loan, but the scheme came apart when the seller's attorney refused to cooperate. The attorney in *Labendz* attempted to justify the credit as a legitimate expense, but the Court pointed out that no actual expenses or "additional terms of value accounted for the credit." *Id.* at 276. The Court found that the conduct was "serious" and involved "misrepresentations and violations of law," inconsistent with an attorney's "duty to act with total honesty and avoid participating in any fraud or misrepresentation." Although the conduct in *Labendz* was particularly egregious, since there was no actual amendment to the contract of sale containing the offsetting credit, the underlying deception is otherwise the same as presented here.

The Committee also notes that New Jersey case law imposes a duty upon an attorney to act fairly and in good faith, *Davin, LLC v. Daham*, 329 N.J. Super. 55 (App. Div. 2000), and that candor and honesty necessarily require disclosure of significant facts even though disclosure might not be in the best interests of the client. *Id.* at 76. In *Davin* the Appellate Division held that a lessee stated a claim against a lessor's attorney, where the lessee was induced to enter into

a lease despite the lessor's attorney's knowledge that, due to a pending foreclosure proceeding, the lessee would be subject to ejectment. The lessor's attorney not only failed to mention the foreclosure, he also inserted a covenant of quiet enjoyment in the lease, knowing his client could not fulfill it.

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. Nevertheless, the conduct of lawyers engaging in this practice violates *RPC* 1.2(d) and *RPC* 4.1(a) because the lawyers have advised their clients, and have knowingly participated, in the making of a false statement of a material fact to a third party. The conduct also violates *RPC* 8.4(c) 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. This conduct compromises the integrity of the underwriting of the loans because it exposes the lender and those who purchase the resulting loan to a greater risk of loss than is knowingly accepted. It is the lawyers' duty to see that the true terms of a real estate transaction are disclosed by their clients to the lender and to prevent false and misleading information from becoming available by their acts or omissions to those who, in due course, may purchase the loan. It cannot be disputed that the practice involves a "material" fact for if it were not expected to cause the lender to increase the loan, it would not be requested.

In conclusion, it is the opinion of the Committee that the participation of an attorney in the transaction presented by the inquirer would constitute ethical misconduct.