

“Cash Back” at Closing: Legal or Ethical for the Attorney?

If you are an attorney who focuses your practice in residential real estate, you likely have noticed that, as the once high-flying and thriving real estate and mortgage market has tightened, buyers and sellers have become more creative in order to complete deals. Where once sellers chose among multiple offers over the asking price just days after putting their home on the market, and lenders were cutting interest rates and mortgage qualifying scores, now houses may sit for months before any potential buyer makes even a low ball offer.

To entice hesitant buyers to close on a house, sellers increasingly have resorted to offering closing incentives such as “cash back at closing,” wherein the buyer agrees to pay a slightly higher price for the property, and the seller agrees to immediately “refund” a set amount to the buyer after the deal closes.

In some situations, the parties describe the process as having the seller fund the buyer’s closing costs or providing a cash advance for needed “repairs.” In other situations, the deal is structured to allow an arguably otherwise unqualified sale meet a lender’s loan to value percentage limits to allow the buyer to secure a required mortgage amount. To accomplish this, the selling price of the real estate is artificially increased to enable the buyer to qualify for the

loan amount they desire, and the “extra” money is refunded to the buyer at the closing.

For example, a seller agrees to accept a \$100,000 offer for a house, contingent upon the buyer securing a mortgage for \$80,000. However, based on the buyer’s credit history and other factors, lenders will not allow him a mortgage for more than 75% of the purchase price. To address this issue and close the deal while meeting the \$80,000 mortgage contingency, the buyer and seller agree to increase the purchase price to \$107,000 and have the seller refund \$7,000 to the buyer at closing.

While these “cash back” scenarios have become a common practice in the real estate industry that seemingly benefit everyone involved, they actually present potential professional liability and disciplinary risks for attorneys who help close these deals.

What’s the downside?

On the surface, “cash back at closing” scenarios appear to be an acceptable practice in the real estate industry. “Cash back at closing” proposals occur frequently, and are even openly advertised.¹ Moreover, they appear to be a win/win for everyone involved.

The seller is relieved to finally sell the house at a price close to or even higher than the original asking price. The buyer

¹ A simple search for “cash back at closing” on *Craigslist* will yield many results.

obtains cash that can be used to pay off other debts or a loan amount they would not otherwise qualify for. The real estate broker earns higher commissions. The lawyer earns up-front legal fees and possibly title insurance fees as well.² The mortgage broker makes money, and the lender earns financing fees and benefits from the additional interest paid over the life the loan, enabling them to sell the loan for a higher price on the secondary market.

So, what is the problem?

While everyone may be “doing it,” the “cash back at closing” scheme may not be as beneficial as it seems to all the parties. Worse, “cash back at closing” may constitute a fraudulent transaction and may not be ethical or legal.

There are multiple potential problems with this scenario. First, the buyer may obtain a mortgage in excess of the lender’s loan to value percentage limits. This increases the risk that the buyer will default on the loan, and the buyer’s overall debt to asset ratio. In addition, in most “cash back at closing” schemes, the originating lender that approves the loan may be unaware of the true market value of the home. In the event the buyer defaults on the loan, the lender may not recover the full amount of the debt in the foreclosure proceeding. Even in situations wherein the originating lender is aware of the “cash back at closing” scheme,

² Note that, depending on jurisdiction, there may be certain required disclosures and client consent for an attorney to both represent a real-estate client and provide title insurance services. See *In re Rukavina*, 07CH0096.

secondary market investors may not be aware of the artificially increased value of the loan.

While the typical “cash back” scheme may be just an attempt to bring buyers and sellers together to “close the deal” and stimulate slow real estate sales, some are actually part of wide-ranging fraud schemes involving straw buyers with no intention of repaying the loans. These buyers instead “flip” the property shortly after closing, sharing the proceeds of the inflated second sale with the original seller.

What are the potential legal and/or ethical ramifications for the closing attorney?

Attorneys’ ethics rules generally prohibit lawyers from engaging in conduct involving dishonesty, fraud, deceit or misrepresentation and from assisting a client in conduct that the lawyer knows is fraudulent by failing to disclose material facts to a third person. See, e.g., Model Rule 1.2(d), 4.1 and 8.4(c).³ The duty of an attorney to act with candor and honesty also requires an attorney to disclose all significant facts, even if the disclosure might not be in the best interests of the client.⁴

At their essence, these deals involve deception and misdirection. They require collusion on the part of the participants, and their success relies on misstated purchase

³ Generally, professional liability policies do not cover claims alleging or based upon intentional, fraudulent, criminal or malicious conduct.

⁴ See, e.g., *Kath v. Western Media, Inc.*, 684 P.2d 98 (Wyo. 1984).

prices, providing inaccurate information to the market and other parties interested in the deal, and rests on artificial premises. It is no wonder then that an attorney connected to such a deal faces increased risk for civil, disciplinary and even criminal consequences.

As the attorney for the buyer or seller, you may not have been involved with the “cash back” part of the negotiations. A contract prepared by a real estate broker for the sale of a residential property may have been presented to you as a *fait accompli* by your prospective client. But even if you merely prepared paperwork to document what the buyer and seller had already agreed to, you may have exposure for participating in the “cash back at closing” scheme.

A New Jersey ethics opinion found that an attorney who participates, even *indirectly*, in a scenario to overstate a property’s sale price with an offsetting credit would be at risk of committing ethical misconduct in light of those rules.⁵ In a different case, a lawyer was suspended from the practice of law for one year for engaging in a deliberate overstatement of a property’s sale price by misstating the true purchase price in the mortgage loan application and including an offset through a seller’s credit to the buyer.⁶ The court found that the attorney’s attempt to justify the credit as a legitimate expense when it was not was inconsistent with an

⁵ See “Misrepresenting Purchase Price or Other Material Fact Regarding a Real Estate Transaction” Op. No. 710, 15 N.J.L. 2572, 186 N.J.L.J. 1198, 2006 WL 3891474 (December 25, 2006).

⁶ *In re Labendz*, 95 N.J. 273, 471 A.2d 21 (1984). See also *The Florida Bar v. Stephen G. Beneke*, 464 So.2d 548 (Feb. 21, 1985) (attorney reprimanded for failing to inform mortgagee that mortgage was issued in amount exceeding actual negotiated purchase price of property)

attorney's duty to act with "total honesty and avoid participating in any fraud or misrepresentation."⁷

In terms of civil liability, depending upon who your client was in the transaction, you could be sued by:

- the *lender*, for allegations ranging from negligent misrepresentation to fraud in connection with the artificial inflation of the sale price and the undisclosed return payment;
- the *buyer*, for indemnification if s/he faces claims from the lender or later purchasers of the mortgage;
- the *seller*, if the contract is found to be unenforceable, or
- *subsequent purchasers* of the mortgage.

Even in the situation where the originating lender is aware of the "cash back" scheme, any assignees in the secondary lender market may not be aware of the underlying closing procedure that increased the size of the mortgage loan. Sometimes an unscrupulous originating lender may attempt to shift blame to the real estate broker and closing attorneys, and subsequently claim that the institution was unaware of the "cash back" scheme.

To be sure, there may be situations where "cash back at closing" scenarios can be perfectly legal and acceptable. For instance, it may be acceptable when a real estate agent agrees to refund a portion of his or her commission at the closing. However, in almost any situation where cash is

⁷ See *Labendz*.

being returned to the buyer, the minimum criterion is that the arrangement must be fully disclosed to the lender on all closing documents.

Avoiding unethical “cash back” scenarios

The key to avoiding risk in these situations is to carefully review all closing documents and to insist on full disclosure of all elements of the deal to all parties involved.

Watch for last minute changes in the stated purchase price of the real estate. If it appears from your review of the closing documents that there are two sets of settlement statement numbers, you should not go forward with the closing. The lender must be made aware of the true value of the home, and there must be an accurate appraisal. If two settlement statements are being contemplated by any party to the transaction, it is highly likely that the scheme is problematic and possibly fraudulent.

If a buyer is legitimately seeking funds to make repairs to a newly purchased home, suggest that the buyer refinance the mortgage to cash out some or all of the equity in the home in a separate closing transaction. This allows the proposed repairs and any increase in the value to the home to be fully disclosed through the refinancing.

There is an old adage that “no good deed goes unpunished.” In most “cash back at closing” scenarios, the

attorney is merely trying to help make the deal work between a buyer and a seller. There is no ill intent and often the attorney is not actively participating in the fraud. However, the attorney must act with candor and honesty in all real estate transactions, or risk being held accountable for fraud or unethical misconduct.

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by Gawain Charlton-Perrin, J.D., Risk Control Consultant, CNA Lawyers Professional Liability, CNA Center, Chicago, IL 60604

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