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# California Senate Bill 94: Tilting the Playing Field for Unscrupulous Mortgage Servicers

*by Sean R. Olender, Esq.*

On January 22, 2009 California State Senator Ron Calderon (D Montebello) introduced SB 94, a bill seeking to impose civil and criminal liability on any person performing a loan modification, or related activity who collects an "advance fee" including real estate agents, but not lawyers. The bill also sought to prohibit servicers from charging loan modification fees. The bill's preamble provided that it would:

> *...prohibit real estate licensees from charging or receiving an advance fee, and finance lenders and brokers and residential mortgage lenders and servicers from charging or receiving any interest or charge, for performing services for borrowers in connection with the modification of the terms of a loan secured directly or collaterally by a lien on single-family residential real property, except as specified.*

Existing law at that time allowed real estate licensees to charge borrowers advance fees for negotiating loan modifications so long as the California Department of Real Estate reviewed the fee agreement and had no objection to it. It also exempted attorneys and accountants, among others, from the requirements of the law.

SB 94 posed an interesting political challenge because it pitted the interests of very large banks against the California Association of Realtors and the National Association of Realtors. The Realtors' associations wanted *something* their idle members could do to make money. Ideally, agents could contact all the people they had convinced to buy homes they couldn't afford and offer to try to modify their loans for a few thousand dollars. The National Association of Realtors and the California Association of Realtors both wrote Senator Calderon urging him to exempt real estate agents. And the California Association of Realtors is his largest campaign contributor. Interestingly, Senator Calderon stood his ground. But his bill was up against another that sought to ban anyone from collecting any fee for assisting a homeowner in a residential loan modification.

A coalition of fair housing and anti-predatory lending groups, including the Consumer's Union, ACORN, and the San Francisco and Los Angeles District Attorneys, wrote Senator Calderon urging him to strengthen the bill by removing the exemption for attorneys, removing the exclusion of real estate agents from the definition of foreclosure consultants and increasing the maximum criminal penalty to one year instead of six months. Shortly after this, Senator Calderon amended the bill to include attorneys. After further comment, including a letter from San Francisco District Attorney Kamala Harris suggesting that the criminal penalty be lengthened to one year, the Senate Committee on Banking, Finance, and Insurance amended the bill on April 7, 2009 to include a one-year criminal penalty.

On June 25, 2009 the State Bar of California wrote Senator Calderon in support of SB 94 as amended, noting that the State Bar's Office of the Chief Trial Counsel has been receiving between 850 and 900 calls per month on its attorney discipline complaint line related to promised loan modification services where attorneys charged advance fees, but did no work.

## Securitization and the Role of Investors, Servicers and Borrowers

Securitization is the process where an investment bank pools loans into a fund and then sells tradable securities from that fund to investors. Securitization "atomized" the mortgage lending industry by separating each aspect of the loan process.[1] Instead of a single bank managing the entire loan process from origination to the last payment, a different entity manages each aspect of the loan process.[2] A mortgage broker might "sell" the loan to the borrowers; a separate company may originate the loan[3]; then another may buy it to package with other loans and then a Wall Street investment bank may sell securities backed by the

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Illustration by Matthew Snow

Mike Keefe/Denver Post

loans, a special purpose vehicle (SPV) like a trust may hold the loans for investors, a servicer may collect payments from the borrowers, and a special servicer may be called in to attempt to foreclose in the event of default.[4]

The servicer is the one who transacts with borrowers during the life of the loan. The servicer sends the bills, collects payments, applies part to principal and part to interest, assesses late fees, sends a notice of default, and otherwise monitors insurance and property tax status. The way a loan is serviced often has a greater effect on the borrower than the way it was originated.[5]

Brokers, originators, investment banks, credit rating agencies and servicers play together as friends and sometimes adversaries. Each makes money on different aspects of the transaction and each is exposed to certain risks.

### The Incentive to Fraud — Origination

Most Americans can't figure the tax on a Big Mac, let alone the amortization schedule on a negative amortization loan[6] with a second mortgage with a balloon payment where both loans are tied to LIBOR[7] after an introductory rate expires and unpaid principal is added to the principal balance.

Lew Ranieri, the man credited with creating the mortgage-backed securities market, estimated that more than half of all borrowers in subprime loans qualified for a lower-cost loan, often a prime loan,[8]

> *...but more importantly, [lenders] argued that looking at the production [of loans], the subprime production, in those five or six quarters [in 2005-2006] that as much as 50 percent of that production could have gone to the agencies, meaning, Fannie, Freddie and FHA. That's a pretty profound statement because a subprime loan is, at best, an eight plus coupon.[9]*
>
> *And usually, there's a second mortgage with a 12 coupon, so you're talking about an average coupon, a little bit over nine and you know, an agency piece of paper would've been a 6.5, so if you translate that...for half these*

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*loans, the homeowner could have been put into a coupon at 6.5 versus 9.5 and that led to the question, the 800-pound gorilla in the room we dealt with: is the system broke[n]?*[10]

As much as 50% of subprime lending resulted exclusively from lender kickbacks. Lenders paid yield spread[11] premiums to brokers for steering borrowers into high-cost subprime loans even though half of those borrowers qualified for a prime rate. This wasn't a rogue group of mortgage brokers; it was all of them. I still argue with brokers today who tell me that lying on a stated income loan is not illegal. And they are only right in the sense that no one will prosecute it.

## The Incentive to Fraud — Mortgage Servicers

Servicers typically receive a fee of 0.25% to service prime loans and 0.50% for subprime loans.[12] Servicing contracts usually give the servicer the right to keep all late fees, legal fees, and other charges aside from the principal and interest due.[13] One reason servicers keep late fees is because persuading delinquent borrowers to pay imposes additional costs on the servicer. But another reason is simply the drive to profit. Late fees are a "crucial part of servicers' income" and one servicer's CEO noted that fees charged to borrowers, including late fees, were paying all operational costs of servicing, leaving the base servicing fee as almost pure profit.[14]

Investors may have an interest in allowing servicers to engage in a certain amount of fraudulent fee billing because when a servicer takes more money from borrowers, investors can pay lower servicing fees while servicers remain profitable. Investors also have an interest in servicers not defrauding borrowers of too much money, or pushing them into foreclosure in a down market because this may result in investor losses on foreclosure sales.

Borrowers also have difficulty proving the date a servicer receives payment and this allows servicers to charge late fees even when they receive a borrower's payment on time.[15] Many borrowers have trouble figuring out what their principal balance is, the appropriate portion of each payment that should be applied to interest and principal and other aspects of their account.[16]

## Loan Modification Used as a Trap Against Borrowers

Loan modifications, forbearance agreements and other negotiations with lenders are very dangerous. Most government "advice" clinics and hotlines assume that the servicer is acting in good faith. Almost no one realizes that servicers often earn a significant portion of their income from fraudulent billing practices, from claiming that borrowers are in default when they in fact are not in default, and even from foreclosures when those foreclosures generate significant fees paid out of the proceeds of the foreclosure sale.

Additionally, there is some evidence that some lenders use the loan modification process for at least four clandestine purposes. Some servicers use it as a method for getting homeowners to pay additional fees and payments on loans the servicer absolutely intends to foreclose anyway. Servicers also use loan modification as a way to delay foreclosure because investors feel that they have a better chance of fooling new home buyers into paying above-normal market prices by holding vast quantities of homes off the market and releasing foreclosed inventory onto the market gradually over

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time. Servicers may also engage in loan modifications to pad loan files with new information about a borrower's income and assets in an effort to increase the market value of the loan for sale to other investors. And, indeed, thousands of homeowners have reported that their loans were sold to a new investor or servicer that then commenced foreclosure proceedings in the midst of what they believed was an ongoing loan modification process. And lastly, servicers may use the loan modification process to simply generate fees under the guise of participating in the federal government's misplaced loan modification "assistance" programs, which appear so far to have assisted mortgage servicers more than homeowners.

According to a report from the Special Inspector General for the Troubled Asset Relief Program, the Obama Administration has inflated the success of its foreclosure prevention programs, and those programs may end up doing more harm than good by "spreading out the foreclosure" crisis over several years. The report notes that the US Treasury Department's focus on "trial modifications" as a metric for the program's success is highly misleading because so few trial modifications result in permanent changes in the borrower's loan terms.[17]

State and federal authorities have pointed repeatedly to the availability of "free" or "nonprofit" providers of loan modification advice and assistance and also that the bank itself will consider and "work with" borrowers on loan modifications. Yet these claims overlook the intense conflict of interest that servicers have with borrowers and also the poor understanding that free loan modification hotlines agents have of how this process works. The servicers have the best lawyers money can buy, while borrowers are now relegated to finding volunteer call support agents to advise them on matters worth multiples of the borrower's annual income.

**Examples of Servicer Fraud Abound**

There are countless examples of mortgage servicers sending delinquency notices to on-time borrowers. Often these servicers then force the borrowers into a burdensome "forbearance agreement" that requires the borrower to pay fees, penalties and additional sums that are not actually due. The terms of most servicing agreements allow the servicer to keep all of these fees, charges and payments as a windfall. The servicer needs only to remit to the investors or the trust holding the mortgages principal plus interest due. Bogus fees and charges are pure profit.

In *Ronemus v. FTB Mortgage Services*[18], FTB misapplied a Chapter 13 debtor's payments and then began placing the payments into a "suspense account" and collecting unauthorized late fees. FTB ignored letters from the borrowers' attorney, sent regular demands for late fees and instituted collections efforts. When the borrower sued, FTB introduced into evidence a fraudulent statement showing that the borrowers owed more than they actually did.

Wells Fargo has been sanctioned numerous times in the past year for overcharging Chapter 13 debtors, threatening to foreclose on the debtors' homes and keeping incorrect loan records.[19]

In *Wells Fargo Bank v. Jones*, 391 B.R. 577, 582 (Bankr. E.D. LA 2008) the Bankruptcy Court sanctioned Wells Fargo for collecting sums far in excess of the amounts reasonably necessary to satisfy the loan, for collecting both pre and post-petition charges from property of the estate without authorization, for delaying the return of the debtor's property for over one year, for failing to provide a reasonable accounting of the loan history, and for improperly applying payments resulting in significant additional and unwarranted interest charges.

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*Today Is Too Late*
*and Yesterday Isn't Fast Enough*

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In *Myles v. Wells Fargo*, 395 B.R. 599, 601 (Bankr. M.D. LA 2008) the Bankruptcy Court admonished Wells Fargo for failing to comply with the terms of the Chapter 13 plan and for violating the automatic stay by treating the debtors' mortgage debt as if they were in default rather than current as of the petition date, for misapplying the debtors' monthly mortgage payments, for depositing debtors' direct monthly payments on the current mortgage debt into a "suspense account," for not applying them to the post-petition mortgage debt, and for failing to disclose any of these actions to the debtors.

In *Antoinette de la Fuente v. Wells Fargo Bank*, (Bankr. S.D. TX 2010), Bankruptcy No. 03-43483-H4-13, the Bankruptcy Judge found Wells Fargo in contempt of court, instituted civil fines and awarded the petitioner attorneys' fees. The Judge found that Wells Fargo overbilled the borrowers for amounts not due, inflated the borrowers' principal balance, *stating that the borrowers owed more than they actually did.* Wells Fargo refused to make changes to these accounts and at one point, Wells Fargo's General Counsel testified that the bank's online account and records interface was not an "official" bank record and that debtors conducting business online relied on those records at their peril. For most borrowers the online system is the only way borrowers can see and pay their balance.

In *Williams v. HOMEQ Servicing Corp.*, 184 NC App 413, 06-674, 2007, homeowners sued HOMEQ for harassment, claiming that records showed HOMEQ employees called their home at least 2,200 times, up to six times per day, over a six year period and that the calls were rude, abrasive and demeaning.

Mike Keefe/Denver Post

Bank of America agreed this month to pay $108 million to settle federal charges that Countrywide Financial Corp. collected illegal and fraudulent fees from borrowers in default and foreclosure. Bank of America acquired Countrywide in July 2008 with extremely generous support from American taxpayers.[20]

Countrywide charged borrowers who were behind on their mortgages thousands of dollars in fees for services such as property inspections and landscaping. A Federal Trade Commission spokesperson said that Countrywide created subsidiaries to hire vendors who then marked up

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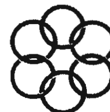

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the price of these services, allowing Countrywide to earn "substantial profits by funneling default-related services through subsidiaries that it created solely to generate revenue."[21] The FTC also alleged that Countrywide made false claims against borrowers in bankruptcy regarding the amount they owed and failed to tell the borrowers about fees and other charges.[22]

This single FTC suit alleges that Countrywide defrauded more than 200,000 borrowers. And this suit and most others arose from evidence acquired during bankruptcy proceedings. Millions of foreclosures do not result in bankruptcy and therefore no bankruptcy judge has the opportunity to order an accounting to determine what the borrower owes. For this reason, it is unknown how many more hundreds of thousands, or millions, of borrowers have been fraudulently billed by servicers, sent notices showing the total loan balance being higher than it should be, and even forcing borrowers into default when they, in fact, made all payments on time. When compared to the State Bar of California's "epidemic" of loan modification fraud resulting in 13 involuntary attorney resignations, five pending loan modification fraud trials, and another 2,000 attorney loan modification misconduct investigations, it appears that the real epidemic is servicer fraud.

Removing attorneys from the loan modification and forbearance process ensures that servicers can prey on the epidemic of innumeracy[23] among American borrowers. Servicers can simply claim that borrowers owe an untrue payment amount, have an untrue loan balance, or have made late payments when in fact the borrower was on time. The borrower can say that this is not true, but if the servicer says, "sign this forbearance agreement promising to pay 150% of your regular payment for the next twelve months, or we will foreclose and auction your house," what is the borrower to do? The borrower, remember, can't hire an attorney in California to advise him unless the attorney volunteers her time.

## Action by the California Attorney General and State Bar to Enforce SB 94

During the campaign for SB 94, the State Bar of California wrote a letter to Senator Calderon on June 25, 2009, noting that it had been receiving "between 850 and 900 calls per month on its attorney discipline complaint line related to promised loan modification services during this foreclosure crisis, and to advance fees being made but then no work being done." The letter does not refer to actual written complaints that are verifiable and it does not explain what portion of these calls resulted in actual discipline. The State Bar has engaged in some high profile prosecutions against attorneys engaging in fraud and collecting fees from homeowners in schemes where they then provide no assistance.[24] Apparently the California Department of Real Estate is somehow involved in the investigation and prosecution of these cases.[25]

The California Attorney General has been sending letters to attorneys and others stating, "The Office of the


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California Attorney General has determined that you may be engaged in the business of offering to assist homeowners avoid foreclosure on their homes by, for example, helping them to negotiate a loan modification, repayment plan or forbearance."[26] The letters then ask the recipient to prove either that she is not engaged in providing such services, or that she has not in fact charged anyone for the services.

The *California Bar Journal* cover has prominently displayed attorneys jailed because of their loan modification activities on its cover in 2010, including one of an attorney's mug shots. It issued "FAQs" explaining that it is illegal for attorneys to collect any fee from a borrower for any service related to forbearance, loan modification, or foreclosure until all of the services contracted for are completed and the services cannot be split into segments.

In a recent case involving a temporary injunction that a California attorney filed against One West Bank, opposing counsel representing One West cited a State Bar of California "Ethics Alert" from the Spring 2009 State Bar publication entitled "Ethics Hotliner," concerning the provision of services to homeowners in default on their mortgages. The citation noted California Rule of Professional Conduct 3-200 and California Business & Professions Code §§6068(c), (d), and (g) noting that a California lawyer "may not without good cause file a lawsuit or motions in a lawsuit that are simply intended to delay or impede a foreclosure sale." In this case the client obtained a loan modification, made all of the payments on time and yet One West filed a notice of trustee's sale. The homeowner had proof that he made all payments on time and One West rejected several of the payments.

The effect of this very public campaign against attorneys who represent homeowners in foreclosure brings a real, direct benefit to servicers, banks and investors. They now have the benefit of using teams of highly qualified lawyers in transactions with borrowers who are unable to hire attorneys of their own.

### The Law Mischaracterizes Advance Fees in a Manner to Effectively Bar Legal Representation

SB 94 amends California Civil Code §2944.7(a)(1) to provide:

> *Notwithstanding any other provision of law, it shall be unlawful for any person who negotiates, attempts to negotiate, arranges, attempts to arrange, or otherwise offers to perform a mortgage loan*


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> *modification or other form of mortgage loan forbearance for a fee or other compensation paid by the borrower, to do any of the following: (1) Claim, demand, charge, collect, or receive any compensation until after the person has fully performed each and every service the person contracted to perform or represented that he or she would perform.*

The State Bar and the Attorney General of California have confirmed that they interpret SB 94 to mean that an attorney may not collect any fee from a client for these services until the representation is complete. It is a violation of the law resulting in a year in jail, professional discipline and fines if the attorney, for example, performs 80 hours of work and bills the client for this work already performed. That is described by the Legislature, State Bar and Attorney General's office as an "advance fee." Most people delinquent on their mortgage, or in foreclosure proceedings, are in financial distress. The idea that an attorney would work for 40 or 80 or 200 hours and then send a bill to the homeowner when the representation was complete is difficult to believe. The odds are against the homeowner paying regardless of the result.

The State Bar has confirmed that an attorney who collects a deposit or retainer and places it in his trust account has violated this law and is subject to a penalty of up to one year in jail, professional discipline and fines of up to $10,000 per violation.

SB 94 amends California Civil Code §10026 (relating to real estate) to provide:

> *The term "advance fee" as used in this part is a fee, regardless of the form, claimed, demanded, charged, received, or collected or contracted by a licensee from a principal before fully completing each and every service the licensee contracted to perform, or represented would be performed. Neither an advance fee nor the services to be performed shall be separated or divided into components for the purpose of avoiding the application of this section.*

This section generally applies to real estate agents, but the term "advance fee" is not mentioned under Civil Code §2944.7 that applies to everyone, or the attorney professional conduct section at Business and Professions Code §6106.3. While the language of CCC §2944.7 notes a person may charge for such services only "after the person has fully performed each and every service the person contracted to perform or represented that he or she would perform" it is a bit different to say that the services cannot be divided into components as the provision at CCC §10026 states.

This vagueness creates the possibility that an attorney who collects a fee for six months of work after the work is completed, but then later performs additional work for

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the same client on the same issue has violated the criminal statute and is subject to a year in jail. And then again, maybe not. Is an attorney who brings an action in civil court to enforce a loan modification performing "a mortgage loan modification or other form of mortgage loan forbearance" barred by the statute? It's difficult to say. If yes, must borrowers represent themselves *pro se*, or hope there are enough *pro bono* service providers? The law is sufficiently vague as to make ethical attorneys quite frightened of practicing in this area at all except as volunteers.

The point is that a rational attorney won't want to take the chance and will refuse this sort of work entirely. It also raises the specter of selective prosecution, selective discipline, and the potential that mortgage servicers, commercial banks and others could use the threat of criminal prosecution or professional discipline to shut down a successful attorney who was able to get borrowers results and in the process frustrated mortgage servicers.

Illustration by Matthew Snow

Another unfortunate side effect of this law is to reduce the intensity of investigation, litigation and judicial involvement in the American mortgage fiasco. Because both state and federal officials have investigated and prosecuted so few cases when considering the magnitude of this crisis and the countless witnesses who claim that fraud pervades the majority of major US financial institutions, the civil litigation process may be our last hope to uncover the frauds underlying this catastrophe.

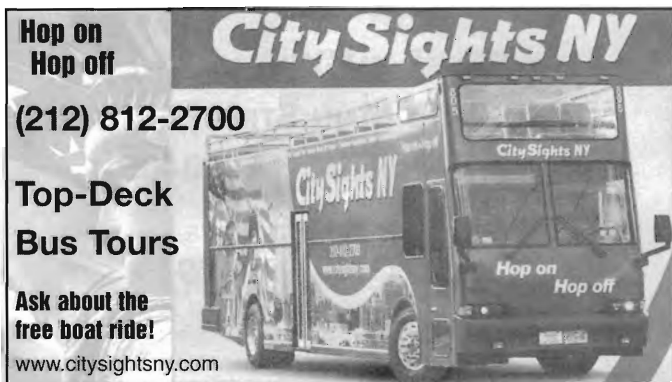
### Chilling Freedom of Speech

One attorney to whom the Office of the Attorney General sent an SB 94 enforcement letter had spoken a short time before that on a radio station about his view that SB 94 was unconstitutional. The California Attorney General's office later confirmed that the reason it targeted him for investigation was because of the radio interview. The Attorney General's Office claimed that a company that performed loan modification services appeared on the same radio show and so they wanted to know whether he was involved with that company. The investigator initially demanded a detailed declaration from the attorney addressing eight separate areas of inquiry.

While the Office of the Attorney General is bound to enforce the laws and appears to have been doing nothing more than that, the vagueness of this law and the problems enforcing it risk creating the impression that the State is trying to silence critics. Worse, it risks chilling freedom of speech including the First Amendment right to retain and consult with an attorney.

### Need for Free Attorney Representation for Borrowers

Since origination and servicer fraud is the big problem, why doesn't the State of California provide free attorney representation to borrowers facing mortgage problems? The State of California has spent and/or allocated $300 million, giving anyone and everyone a check for $10,000 if they buy a house.[27] These two "homebuyer tax credit" programs had the unfortunate consequence of pushing unsophisticated first-time buyers into the market, most of whom were age 30 or younger. This group made up 47% of all home sales in 2009, an historical record.[28] It's a group with little financial sophistication and no experience buying homes. The tax credit artificially inflated home prices by about $10,000 and it

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should result in prices falling by about $10,000 when it ends. It also combined with the ridiculously low 3.5% FHA down payment requirement to effectively require no down payment, just the sort of environment that caused this catastrophe in the first place. The tax credit heavily impacts middle-income taxpayers and hands money to homebuyers regardless of income.

If the State of California is going to bar attorneys from collecting fees from borrowers to represent them against servicers and banks (which is effectively barring borrowers from hiring attorneys), then why doesn't the State spend $50 million or $100 million to set up a funded department to provide free or low-cost legal assistance for borrowers to fight the banks and servicers in loan modifications, forbearance and foreclosure matters? If the State of California can use taxpayer money to push up home prices, making them less affordable for Californians who then must borrow more money at riskier terms to buy homes, then why not spend a fraction of that money to provide them with legal representation?

The California Senate passed a new bill, SB 1275, to provide homeowners with legal claims against loan servicers who erroneously foreclose on their homes, foreclose during a loan modification and make other sorts of mistakes. SB 1275 is now with the Assembly for review. The Center for Responsible Lending explained that *"the legislation continues to face some opposition from Assembly members who oppose allowing California homeowners to pursue claims against their lenders and servicers."*

That a bloc of the Assembly does not believe borrowers should have the right to pursue claims against their lenders and servicers illustrates how very odd it is that California lawmakers passed SB 94 with a one-year jail term to protect California homeowners from their attorneys.

**Why Are Loan Modifications Failing?**

Loan modifications are failing because many servicers have no intention of permanently modifying mortgages and are merely buying time, because many borrowers are deeply underwater and have no incentive to make payments even if they could afford them, and because most borrowers lied about their incomes and borrowed so much more than they could afford to pay back that they would require an enormous principal reduction to render their loans sustainable.

The Mortgage Asset Research Institute, which investigates lending fraud, suggests the number of borrowers who exaggerated income on stated income loans could be as high as nine out of ten. In a study of 100 stated income loans, 90 percent of borrowers exaggerated income by five percent or more and nearly 60 percent exaggerated income by 50 percent or more. According to Fitch Ratings, 80 percent of option ARM borrowers — i.e, an adjustable-rate mortgage (ARM) with the option to make a minimum payment, which could be payment on no principal and not all interest owed, such that the unpaid interest gets added to the principal owing, creating a negative amortization — make only the minimum less-than-interest payment every month. Thus there are a lot of loan balances rising even as house values are falling.

In 2007 44.6% of all Alt-A "stated income" loans in the United States were made in California.[29] According to the Federal Reserve Bank of New York, as of May 2009 California had 632,215 Alt-A loans in force.[30]

California has a long way to go before this is over. Banks and servicers want to eliminate lawyers from the process so that they can use lawyers and accountants and other sophisticated parties when they do battle with innumerate borrowers who are on their own. Borrowers

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need legal representation. Thorough investigation and accounting will serve the important public purpose of uncovering the myriad frauds that gave rise to this generational catastrophe.

## Why SB 94 Is Unconstitutional

*The First Amendment Right to Consult with and Retain Legal Counsel*

Business and Professions Code §6106.3 relating to attorney misconduct has a sunset provision retiring the law on January 1, 2013 unless the Legislature takes some action before that time and Civil Code §2944.7(e) provides the same sunset provision. The sunset provision is curious for several reasons. If the law seeks to stop an illegitimate activity, then why the sunset provision? The sunset provision appears to accomplish two things, (1) it places the law in effect during the period when the banks will be foreclosing, suing and otherwise engaging in battle with the most borrowers, and (2) it creates a sufficiently short period of validity to arguably reduce the likelihood of a constitutional challenge, not least because it could take two years or longer to litigate and the law might expire before the suit is ended.

The right to hire and consult an attorney is protected by the First Amendment's guarantee of freedom of speech, association and petition.[31] It has long been recognized that the First Amendment prohibits the state from interfering with collective action by individuals to seek legal advice and retain legal counsel.[32] In a case involving the ability of a union to hire an attorney, the U.S. Supreme Court found that the freedom of speech, assembly, and petition guaranteed by the First and Fourteenth Amendments gives petitioner the right to hire attorneys on a salary basis to assist its members in the assertion of their legal rights.[33]

The Supreme Court has held that a state cannot impede an individual's ability to consult with counsel on legal matters,[34] or infringe in any way the right of individuals and the public to be fairly represented in lawsuits.[35] A State cannot, by invoking the power to regulate the professional conduct of attorneys, infringe in any way the right of individuals and the public to be fairly represented in lawsuits authorized by Congress to effectuate a basic public interest.[36] And the right to obtain legal advice does not depend on the purpose for which the advice is sought; it applies equally to legal representation intended to advocate a political or social belief,[37] or to recover damages in a personal injury suit.[38] In sum, the First Amendment protects the right of an individual or group to consult with an attorney on any legal matter.

In *Bates v. State Bar of Arizona*,[39] the prominent case involving attorney advertising, the U.S. Supreme Court clarified that underlying the collective action cases involving unions was the Court's concern that the aggrieved receive information regarding their legal rights and the means of effectuating them. The Court held in *Bates* that this concern applies with at least as much force to aggrieved individuals as it does to groups.

## SB 94 Is a Facially Invalid Criminal Statute and also Vague and Overbroad

SB 94 purports to proscribe attempts to negotiate, arrange, or otherwise offer to perform a mortgage loan modification or other form of mortgage loan forbearance. However, a loan modification or forbearance may result from any sort of litigation between a borrower and servicer or note holder. An attorney and his borrower client may seek a forbearance or modification as part of a settlement of a suit for quiet title or an action under the Real Estate Settlement Procedures Act.

Perhaps borrowers themselves could be targeted for engaging in a conspiracy. Suppose, for example, that a borrower wants to sue his servicer for refusing to accept payments and filing a default notice when the borrower was current on all payments under a loan modification agreement. Suppose the borrower wants to hire an attorney and the two of them conspire to violate SB 94, the borrower clandestinely paying the attorney to file suit against the lender to enforce the loan modification. This appears to be a conspiracy to commit a misdemeanor and ought to subject both the attorney and his client to a maximum sentence of a year in jail. Imagine

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also that the servicer who is a defendant in such a suit reports her suspicions of this to a friend at the Office of the District Attorney or the California Attorney General's Office. It might be possible to derail the litigation by intimidating the plaintiff and his attorney.

A criminal law is facially void if it "does not aim specifically at evils within the allowable area of government control but...sweeps within its ambit other activities that constitute an exercise of protected rights."[40] First Amendment rights are secured to all persons by the Fourteenth Amendment against abridgment by a State.[41] And a law that seeks to censor a First Amendment right is pernicious, not merely by reason of the censure of particular comments, but also by reason of the threat to censure comments on matters of public concern. The U.S. Supreme Court noted in *Thornhill v. Alabama*,

> *The power of the licensor against which John Milton directed his assault by his "Appeal for the Liberty of Unlicensed Printing" is pernicious not merely by reason of the censure of particular comments, but by reason of the threat to censure comments on matters of public concern. It is not merely the sporadic abuse of power by the censor, but the pervasive threat inherent in its very existence that constitutes the danger to freedom of discussion.*[42]

The right to confer with and retain an attorney is an important right protected by the First Amendment because it is part of the dissemination of ideas and the expression of important political speech. Every borrower who seeks legal assistance is seeking information about his rights that are both legal and political in nature.

And even if a court finds that the statute is not facially invalid, its application to particular conduct may be determined to be invalid on grounds of vagueness in that the actor did not have reasonable notice that the particular conduct was proscribed. In such instances the statute is "invalid or unconstitutional as applied," rather than on its face.[43]

The due process clause of the Fifth Amendment requires that criminal statutes give reasonably certain notice that an act has been made criminal before it is committed. Every person should be able to know with certainty when he or she is committing a crime.[44]

A criminal statute is also constitutionally void for vagueness when persons of common intelligence must necessarily guess at its meaning and differ as to its application.[45] A statute is void when it is vague either as to what persons fall within the scope of the statute, what conduct is forbidden, or what punishment may be imposed.

> *Due process requires that criminal statutes, administrative crimes, and common law crimes be reasonably definite as to persons, and conduct within*

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> *their scope and the punishment which may be imposed for their violation. In determining whether a legislative, judicial or administrative definition is void for vagueness, the following inquiries are appropriate: (1) Does the law give fair notice to those persons potentially subject to it? (2) Does the law adequately guard against arbitrary and discrimnatory enforcement? (3) Does the law provide sufficient breathing space for First Amendment Rights?*[46]

## Digging Out of this Hole

The mortgage crisis will be with us for some time to come. Banks need to unload millions of foreclosed homes and seek to foreclose on as many as four million additional households. In addition to this the Federal Reserve has recognized shadow inventory and pent up supply as factors that will place downward pressure on home prices for many years. Economists believe that there are more than a million homeowners who want very much to sell their homes, but have kept them off the market waiting for a rebound. Any signs of stability will trigger these owners to flood the market with their homes as well.

The banks and servicers have a clear goal, and that is to streamline the process to keep foreclosures as uncontested and inexpensive as possible. The relatively mild resistance they've received so far has resulted in cavalier behavior, including several reported instances of banks foreclosing on homes that were paid off and belonged to homeowners who were never customers of the bank or servicer foreclosing. The courts have generally been skeptical of borrowers' complaints and most judges require almost no documentation from the party seeking to foreclose. Banks and servicers regularly fabricate evidence and submit declarations regarding the transfer of notes and other matters over which they have no personal knowledge. Borrowers are helpless to stop this.

Even on the level of mathematics there is much that can be done to encourage borrowers to review their loan documents and ask their lenders for a full accounting of the balance due on their loans and their loan terms and for the borrower to work through the math and carefully check whether the servicer is padding its income with fraudulent charges.

Obviously it is important that attorneys don't assist foreclosure consultants or anyone else in the unauthorized practice of law. But this is already proscribed by California Rule of Professional Responsibility 1-300(A). Attorneys also should not split fees with a foreclosure consultant[47] or pay a referral fee to a non-attorney.[48] The State Bar should also sanction attorneys for accepting fees and yet doing little or no work in return.[49] And it should certainly discipline attorneys who form a partnership with a foreclosure consultant or non-attorney to provide legal services.[50] But these activities are already a violation of the California Rules of Professional Conduct and subject an attorney to discipline, suspension, or disbarment.


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It is notable that filing unwarranted lawsuits or motions solely intended to delay or impede a foreclosure sale is a violation of law.[51] But, apparently, a servicer foreclosing on a home when the borrower has not been late or violated a loan modification agreement is something different because some Assembly members oppose allowing California homeowners to pursue claims against their lenders and servicers.

Involving lawyers in this crisis will increase the likelihood that borrowers and the courts uncover the frauds and thefts accomplished by many lenders and servicers. Lawyer involvement will help unravel the trusts, trustees, payoffs, kickbacks and other nefarious relationships hidden deep within this crisis and as yet uncovered. Rumor has it that some certificate holders were compensated three or more times the face of the note because of credit default swaps and bond default insurance. Sometimes the party foreclosing has absolutely no legitimate interest in the house.

The banks and servicers know that the absence of attorneys will give them free rein to dictate the borrower's terms regardless of what some "unofficial" document like the note or mortgage says. It's why the Federal Trade Commission now seeks to introduce a rule similar to SB 94 nationally. And it's why someone should challenge the constitutionality of SB 94 without delay.

If the State of California wants to help borrowers avoid unscrupulous attorneys, it should fund a civil law project to provide all homeowners with free legal representation. Not just a call agent who knows almost nothing about this area of law, but an actual attorney who will file a lawsuit, conduct discovery and pressure the servicer or lender at every turn. Absent that, it is unfair and politically dangerous for the state to deprive homeowners of legal counsel. With the paucity of legal protections in California for borrowers, buying a house in California seems a very unwise thing to do.

*1 Limiting Abuse and Opportunism by Mortgage Servicers, Kurt Eggert, Housing Policy Debate, 753, 754, Volume 15, Issue 3, © Fannie Mae Foundation 2004.*

*2 Id.*

*3 Often the originating bank will pay the mortgage broker a secret kickback called a "yield spread premium" that increases as the loan's terms get worse for the borrower and better for the bank. For example, a bank will pay a very big yield spread premium to a broker for finding a borrower who qualifies for a 30-year fixed rate mortgage at 6% and selling him an adjustable rate loan that starts at 2%, but rises to 9% in year three. Yield spread premiums can exceed $20,000.*

*4 Limiting Abuse and Opportunism by Mortgage Servicers at 754, footnote 1, supra.*

*5 Id, quoting Walter E. Zalenski, "Mortgage Loan Servicing: The Rest of the Compliance Iceberg," a paper presented at the session on Current Issues in Mortgage Loan Servicing at the Annual Meeting of the American Bankers Association at San Francisco, August 10, 2003.*

*6 See page 28, column 2, infra.*

*7 The term "LIBOR" is short for London Inter-Bank Offer Rate. It represents the interest rate that the banks charge each other for loans (usually in Eurodollars). This rate is applicable to the short-term international interbank market and applies to very large loans borrowed for anywhere from one day to five years. This market allows banks with liquidity requirements to borrow quickly from other banks with surpluses, enabling banks to avoid holding excessively large amounts of their asset base as liquid assets. It is officially fixed once a day by a small group of large London banks, but the rate changes throughout the day.*

*8 Transcript of Lewis Ranieri at the Milken Institute Global Conference, Los Angeles, April 24-26, 2006.*

*9 A coupon is a negotiable certificate attached to a bond that represents a sum of interest due, or a detachable slip calling for periodic payments, as for merchandise bought on installment. An investor looks at a negotiable instrument as the right to receive a stream of income and the interest payment is often called the "coupon." Sometimes, as in the quote above, the interest rate is called coupon.*

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*10 Transcript of Lewis Ranieri, footnote 8, supra.*

*11 More descriptive words in English for yield spread premium include "kickback" or "bribe." See footnote 3, supra.*

*12 Limiting Abuse and Opportunism by Mortgage Servicers, at 758, quoting Economic Issues in Predatory Lending Working Paper, Office of the Comptroller of the Currency, 2003.*

*13 Id.*

*14 Id.*

*15 Id, quoting Home Ownership: Mortgage Servicing Transfers Are Increasing and Causing Borrower Concern, U.S. General Accounting Office 1989.*

*16 If you doubt that this is a problem, refer to the discussion of amortization on page 18.*

*17 Factors Affecting the Implementation of the Home Affordable Modification Program, Office of the Special Inspector General for the Troubled Asset Relief Program, SIGTARP-10-005, March 25, 2010.*

*18 Ronemus v. FTB Mortgage Services, 201 B.R. 458 (1996).*

*19 In re Antoinette de la Fuente v. Wells Fargo Bank, US Bankruptcy Court, S.D. Texas, Bankruptcy No. 03-43483-H4-13, May 18, 2010; Nibbelink v. Wells Fargo Bank, 403 B.R. 113, 116 (Bankr. M.D. FL 2009).*

*20 "Bank of America to Pay Borrowers $108 Million," Alan Zibel, Associated Press Real Estate, June 7, 2010.*

*21 Id.*

*22 Id.*

*23 A term meant to convey a person's inability to make sense of the numbers and mathematical functions that control much of a person's life, for example interest, tax, amortization. The word innumeracy was coined by cognitve scientist Douglas R. Hofstadter in one of his columns for Scientific American in the early 1980s. Later that decade mathematician John Allen Paulos published the book "Innumeracy."*

*24 As of June 2, 2010 the State Bar's Office of the Chief Trial Counsel obtained the resignations of 13 attorneys involved in loan modification misconduct since the creation of the Loan Modification Task Force in April 2009. Five loan modification trials are pending and the Task Force is actively investigating another 2,000 cases related to loan modification. See Press Release at www.calbar.ca.gov, June 2, 2010, Media Contact Diane Curtis, (415) 538-2028.*

*25 Id, noting "Shoemaker['s]... case was investigated and prosecuted with the invaluable help of the California Department of Real Estate."*

*26 February 18, 2010 letter from the California Attorney General to an unnamed attorney.*

*27 The Legislature passed the first California homebuyer tax credit in 2009 budgeting and spending $100 million. Then it enacted a second credit in 2010 budgeting a total of $200 million of which it has so far spent roughly half.*

*28 "NAR Survey Shows First-Time Home Buyers Set Record in Past Year," National Association of Realtors Press Release, www.realtor.org, November 13, 2009.*

*29 An Alt-A loan, also called an alternative documentation loan, is a "stated income" loan or one where the borrower can just write in what his income is instead of having to prove it. The borrower pays extra in interest to get this sort of loan, so it's reasonable to assume everyone with a stated income loan took it to mask their true income because the cost in interest is high enough that it would be irrational to take such a loan to avoid the "hassle" of making a photocopy of your W-2, 1099s and tax return.*

*Interestingly, Option ARM loans often have an Alt-A or stated income feature. So there are many Option ARM borrowers who simply stated their incomes and one reason those loans didn't explode early is that the borrower can make 1/3 of the normal monthly payment for the first several years making it look like the loan is "performing."*

Illustration by Matthew Snow

*30 CRL calculations based on Loan Performance data provided by the Federal Reserve Bank of New York, available (monthly) at http://www.newyorkfed.org/regional/subprime.html.*

*31 DeLoach v. Bevers, 922 F.2d 618, 620 (10th Cir. 1990) ("The right to retain and consult an attorney . . . implicates not only the Sixth Amendment but also clearly established First Amendment rights of association and free speech."), See also, Martin v. Lauer, 686 F.2d 24, 32 (D.C. Cir. 1982).*

*32 United Transp. Union v. State Bar of Mich., 401 U.S. 576, 585-86 (1971) ("[C]ollective activity undertaken to obtain meaningful access to the courts is a fundamental right within the protection of the First Amendment").*

*33 United Mine Workers of Am. v. Illinois State Bar Ass'n, 389 U.S. 217, 221-22 (1967), See also, Brotherhood of R.R. Trainmen v. Virginia, 377 U.S. 1, 6 (1964).*

*34 NAACP v. Button, 371 U.S. 415, 429-30 (1963).*

*35 Railroad Trainmen v. Virginia Bar, 377 U.S. 1, 7 (1964).*

*36 Id.*

*37 NAACP v. Button, 371 U.S. at 419-20.*

*38 United Mine Workers, 389 U.S. at 223.*

*39 433 U.S. 350, 376 n.32 (1977).*

*40 Thornhill v. Alabama, 310 U.S. 88, 97 (1940).*

*41 Id.*

*42 Id.*

*43 Cox v. Louisiana, 379 U.S. 559 (1965), see also, Dombrowski v. Pfister, 380 U.S. 479 (1965) (holding that the abstention doctrine is inappropriate where a statute is justifiably attacked on its face, or as applied for the purpose of discouraging protected activities).*

*44 Jordan v. de George, 341 U.S. 223, 230 (1951).*

*45 Connally v. General Construction, 269 U.S. 385, 391.*

*46 LaFave, Criminal Law §2.3 (3d ed. 2000).*

*47 California Rule of Professional Responsibility 1-320(A).*

*48 California Rule of Professional Responsibility 1-320(B).*

*49 California Rule of Professional Responsibility 4-200(A).*

*50 California Rule of Professional Responsibility 1-310.*

*51 California Rule of Professional Responsibility 3-200, Business and Professions Code §6068(c), (d), (g).*