

**SOUTH CAROLINA SUPREME COURT HOLDS THAT CLOSING A LOAN
WITHOUT A LAWYER’S SUPERVISION CONSTITUTED UNCLEAN HANDS,
BARRING THE LENDER FROM SEEKING EQUITABLE RELIEF**

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Capping a long line of unauthorized practice of law¹ cases arising from real estate loan closings, the South Carolina Supreme Court has published a decision that may produce “chaotic unintended consequences.” *Matrix Financial Services Corp. v. Frazer et al.*, Op. No. 26859 (S.C. Sup. Ct. filed Aug. 16, 2010) (Shearouse Adv. Sh. No. 32 at 46 and 50) (Pleicones, J., dissenting). In *Matrix*, the court has enunciated a rule (albeit in dicta) that could prevent a mortgage lender from foreclosing on a mortgage if the lender closed the loan without a lawyer’s supervision of the title search, document preparation, and closing. Though this decision follows a May 6, 2010, decision of the South Carolina Court of Appeals, it is a case of first impression from our supreme court with potentially dramatic import.

The mortgage loan at issue was a refinance. The court determined that the mortgage lender “closed the refinance loan unlawfully, and thus has unclean hands.” *Matrix*, Adv. Sh. No. 32 at 42. The closing was unlawful because the vendor that Matrix hired to perform the title search, prepare the loan documents, and close the loan did all of these things without a licensed attorney’s supervision. *Id.* at 43. Thus, Matrix was guilty of the unauthorized practice of law, and in an opinion authored by the Chief Justice, the court declared: “This Court will not grant a discretionary, equitable remedy to a party who refused to follow the laws of this state.” *Id.*

In 1992, the South Carolina Supreme Court declined to adopt comprehensive rules governing the unauthorized practice of law, opting instead to promulgate UPL rules through litigation: “We are convinced . . . that it is neither practicable nor wise to attempt a comprehensive definition by way of a set of rules. Instead, we are convinced that the better course is to decide what is and what is not the unauthorized practice of law in the context of an actual case or controversy.” *In re Unauthorized Practice of Law Rules*, 309 S.C. 304, 305, 422 S.E.2d 123, 124 (1992). Consequently, South Carolina’s UPL rules governing mortgage loan closings have developed in an evolving fashion, on a case-by-case basis. By definition, this case-and-controversy approach has lagged marketplace practices, so that it is almost inevitable that there are mortgage loan refinances, home equity lines of credit, and other real-estate-secured loans that were closed in a manner *only later* determined by our court to constitute the unauthorized practice of law.² Holders of such loans are at risk of never being able to enforce their mortgages through foreclosure.

¹ From time to time, the abbreviation UPL will be used to refer to the unauthorized practice of law.

² As noted below, this is exactly what happened to Matrix. The Matrix refinance occurred in 2001, but it was not until 2003 that the South Carolina Supreme Court applied to refinance loans the same requirements it had established for purchase-money mortgage loans.

Background

The case came to the South Carolina Supreme Court in a somewhat unusual posture, with the primary issue being lien priority between Matrix and a judgment creditor, Matthew Kunding.

The Frazers had borrowed money to purchase a home, their mortgage had been assigned to Matrix, and Matrix subsequently refinanced the mortgage loan—closing the refinance without a lawyer’s supervision on November 26, 2001, and recording the mortgage several months later, on April 3, 2002. *Matrix*, Adv. Sh. No. 32 at 40. Meanwhile, Kunding had obtained a default judgment against the Frazers in another state and enrolled the judgment in South Carolina on October 31, 2001. *Id.*

The Frazers filed for bankruptcy, and Matrix sought foreclosure. Kunding, the judgment creditor, counterclaimed, alleging that the judgment had priority because it was filed first. Matrix sought equitable subrogation, arguing that when it refinanced the Frazers’ mortgage, Matrix paid the prior mortgage, thus entitling it to equitable subrogation. The master-in-equity agreed. *Matrix*, Adv. Sh. No. 32 at 40. The supreme court reversed, holding that Matrix did not qualify for equitable subrogation and thus giving priority to appellant’s judgment lien. *Id.* at 44.

The holding on equitable subrogation was dispositive of the case, but the court proceeded nevertheless to address whether the mortgage lender’s closing the loan without attorney supervision constituted unclean hands that would bar it from any equitable remedy.

The Majority’s Decision on Unclean Hands

The court began its analysis of the unclean hands issue by reciting its 2003 holding in *Doe v. McMaster*, 355 S.C. 306, 585 S.E.2d 773 (2003), that mortgage loan refinance closings must be supervised by an attorney, and performing a title search, preparing title and loan documents, and closing a refinance loan without an attorney’s supervision constitute the unauthorized practice of law. *Matrix*, Adv. Sh. No. 32 at 42. The court then observed that equitable remedies are discretionary and courts can refuse an equitable remedy when a party has failed to act equitably. *Id.*, citing *Ingram v. Kasey’s Assocs.*, 340 S.C. 98, 531 S.E.2d 287 (2000). Interestingly, the court next cited an opinion of the South Carolina Court of Appeals, *Wachovia Bank v. Coffey*, Op No. 4685, (S.C. Ct. App. Filed May 5, 2010) (Shearouse Adv. Sh. No. 18 at 64),³ in which the court of appeals applied the doctrine of unclean hands to prevent a mortgagee from foreclosing on home equity line of credit (HELOC) because the HELOC was closed without attorney supervision.

Matrix had hired LandAmerica OneStop to perform the title search, prepare documents, and close the refinance. *Matrix*, Adv. Sh. No. 32 at 43. According to the court, each of these

³ At the time of the court’s August 16, 2010, decision, the *Coffey* decision was not final because of a pending petition for rehearing.

steps was admittedly performed without a lawyer's supervision. *Id.* This conduct precluded Matrix from pursuing any equitable remedy:

Thus, Matrix has committed the unauthorized practice of law in closing the refinance mortgage, clearly violating South Carolina law. The dissent's protestations aside, a party cannot violate the law and expect not to bear the consequences of its actions. This Court will not grant a discretionary, equitable remedy to a party who refused to follow the laws of this state.

Id. Consequently, *in addition* to failing to qualify for equitable subrogation, Matrix "has unclean hands barring it from receiving an equitable remedy." *Id.* at 44. As South Carolina is a judicial foreclosure state, barring a mortgage lender from any equitable remedy effectively closes the courthouse doors and precludes enforcement of the lender's security interest in the real estate. As the dissent noted, "[t]o hold that equity will not aid the lender in such a situation, will deny it the right to foreclosure." *Id.* at 50-51 note 3.

Justice Kittredge's Concurrence: Limit Holding to Equitable Subrogation

Justice Kittredge concurred in the result but wrote that he would not go so far as the majority: "I see no need to reach the broader question of the underlying efficacy of a real estate mortgage secured through the unauthorized practice of law and the general availability of foreclosure in such circumstances." Instead, Justice Kittredge would go no further than to hold that equitable subrogation was not available when the mortgage was secured through the unauthorized practice of law. *Matrix*, Adv. Sh. No. 32 at 45.

Justice Pleicones's Dissent: Unclean Hands Holding Has Potential Chaotic Consequences

Justice Pleicones dissented on both the equitable subrogation and unclean hands issues. Justice Pleicones identified two serious problems with the holding on unclean hands.

First, the majority did not explain how the appellant could assert an equitable bar arising from a transaction to which he was not a party—"leaving the reader to assume the Court is altering the requirement that only a party to the transaction may assert the bar." *Matrix*, Adv. Sh. No. 32 at 50. Justice Pleicones declined to extend the doctrine beyond the normal bounds.⁴

Second, Justice Pleicones recognized the potentially devastating impact of the majority's decision:

Perhaps more disturbingly, the impact of a decision holding that equity will not aid a mortgagee when the closing was unlawful will be devastating, undermining

⁴ "The expression 'clean hands' means a clean record with respect to the transaction with the defendants themselves and not with respect to others." *Arnold v. City of Spartanburg*, 201 S.C. 523, 532, 23 S.E.2d 735, 738 (1943).

lender confidence in an already unstable market, and making title insurance virtually unavailable in South Carolina.

Id. at 50. Thus, Justice Pleicones observed that “[e]ven if we were to adopt such a harsh rule, the Court should acknowledge in fairness and equity, that the law has been evolving in the area of residential real estate closings, and thus many mortgagees may hold mortgages that were closed ‘unlawfully.’” *Id.* at 50-51.⁵ “To suggest that a mortgage given in an unlawful closing will not be protected in equity leads to uncertainty and increased costs.” *Id.* at 51.

Since 1987 South Carolina has held that a lawyer must conduct residential real estate closings in purchase-money loans. *State v. Buyers Serv. Co.*, 292 S.C. 426, 357 S.E.2d 15 (1987). The Matrix refinance was closed in 2001 and, as Justice Pleicones observed, only in 2003 did the court hold that refinance loans were subject to the same rules as purchase-money loans. *Doe v. McMaster*, 355 S.C. 306, 585 S.E.2d 773 (2003) (holding that in a refinance of a mortgage loan, the title search, document preparation, closing, and recording of the mortgage must be supervised by a licensed attorney, as in a purchase-money transaction, because “refinancing affects identical legal rights of the buyer and Lender as initial financing and protection of these rights is the crux of the practice of law.”).

The majority’s one-sentence dismissal of “[t]he dissent’s protestations” implies that the dissent argues for allowing law-breakers to escape the consequences of their actions. In light of the fact that since 1992 the court has promulgated UPL rules in the context of a case and controversy, necessarily adopting a rule *after* the conduct at issue has occurred, the dissent seems instead to be asking, fairly enough, why Matrix should be punished for violating the law when its conduct predated by 21 months the decision that adopted the rule it supposedly violated.

Conclusion

The *Matrix* decision, if it becomes final,⁶ will inevitably lead to increased litigation about the availability of foreclosure to mortgagees, and we can expect foreclosures in equity courts to be delayed while masters-in-equity wrestle with what *Matrix* means and how far its implications can be taken. We can expect debtors’ attorneys to challenge mortgages in foreclosures and declaratory judgment actions based on UPL allegations, and the risk of class actions is undoubtedly present.

⁵ There is precedent for such restraint. It was not until 2006 that the court held that the disbursement of proceeds from a mortgage loan must be conducted under the supervision of a licensed attorney, and when the court established this rule it acknowledged that its decision represented a new rule and thus delayed its effective date, presumably intending to give only prospective force to the rule. *See Doe Law Firm v. Richardson*, 371 S.C. 14, 636 S.E.2d 866 (2006) (“We hold that disbursement is an integral step in the closing of a residential refinancing or credit line transaction which must be conducted under the supervision of an attorney. Since our decision today is a new rule, and since it is likely that lenders and attorneys may have established procedures which do not account for this step in the closing process, we delay the effective date of this opinion until January 22, 2007.”). Similarly, in 2003, the court limited its opinion about mortgage loan refinances to the stipulated facts before it. *See Doe v. McMaster*, 355 S.C. 306, 585 S.E.2d 773 (2003).

⁶ The decision becomes final fifteen days after the filing of the opinion unless a motion for rehearing is filed. *See* SCACR Rule 221.

There remain a number of issues to be unraveled, in addition to those raised by the dissent. Our supreme court traditionally has recognized several functions that must be performed or supervised by an attorney: (1) title search; (2) document preparation; (3) loan closing; (4) recording instruments; and (5) disbursement of loan proceeds. In *Matrix*, three of these functions were identified as occurring without a lawyer's supervision. Suppose only one of the five occurred without attorney supervision—would that suffice to bar the mortgagee from availing itself of equitable remedies? What if loan proceeds were disbursed without lawyer supervision prior to 2007? Though *Doe v. Richardson*'s rule requiring lawyer-supervised disbursement became effective only in 2007,⁷ does the *Matrix* court's application of the *Doe v. McMaster* 2003 holding to a 2001 transaction encourage a litigant to argue for the retroactive application of *Doe v. Richardson*?

What equitable factors might outweigh the lender's unclean hands or otherwise affect the outcome of case involving a mortgage loan like that in *Matrix*? In *Matrix*, it appears that the foreclosing lender originated the loan and participated in the conduct that barred a resort to equity. What if the loan had been pooled, securitized, and sold, or otherwise assigned, and the foreclosing plaintiff were an assignee or a loan servicer and not the guilty originator? Would an assignee or servicer be barred from pursuing foreclosure because of the originator's unauthorized practice of law? On different facts, what if the borrower elected to proceed without a lawyer, desiring to close a loan as cheaply as possible—would such a borrower be allowed to deny the security interest he granted to obtain a loan? What if the borrower himself had unclean hands? What if the lender hired a law firm and the firm allowed a paralegal to attend the closing?

The *Matrix* decision probably raises more questions than it settles, and if it becomes final, these and other questions threaten to provoke much litigation, consume court time, delay judicial foreclosures, and put lenders and servicers at risk for the foreseeable future.

Click the link to read the full opinion

http://www.nelsonmullins.com/DocumentDepot/Smith_Matrix_Decision.pdf

For more information or questions about the Matrix decision, contact Mr. Smith at 803.255.9492 or John Moore at 803.255.9415.

⁷ See note 4 *supra*.