SOUTH CAROLINA SUPREME COURT: LENDER THAT CLOSED A MORTGAGE LOAN WITHOUT A LAWYER'S SUPERVISION CANNOT AVAIL ITSELF OF EQUITABLE REMEDIES

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Introduction

In August 2010, the South Carolina Supreme Court announced a rule that prevented a mortgage lender from obtaining equitable relief if the lender violated the state's unauthorized practice of law[1] rules when it closed the mortgage loan. The case was decided on principles of equity, with the court finding that the lender's UPL violation meant that it came to court with unclean hands and thus could not obtain an equitable remedy. On Monday, August 8, 2011, following a petition for rehearing, the court withdrew its August 2010 opinion and substituted a new opinion in which it reached the same result without relying on the doctrine of unclean hands. *Matrix Fin. Servs. Corp. v. Frazer et al.*, Op. No. 26859 (S.C. Sup. Ct. filed Aug. 8, 2011) (Shearouse Adv. Sh. No. 26).

Without explanation, the majority jettisoned the "unclean hands" rationale: "We do not believe the doctrine of unclean hands is the appropriate basis for resolution of this case." *Id.* at 18. The court noted that since 1987 it had required attorney supervision of four key steps in the residential mortgage loan process, *State v. Buyers Serv. Co.*, 292 S.C. 426, 357 S.E.2d 15 (1987), and that in 2003 it made clear that this rule applies to refinancing as well as purchase money mortgages, *Doe v. McMaster*, 355 S.C. 306, 585 S.E.2d 773 (2003). South Carolina requires lawyer involvement in mortgage loan closings, said the court, "for the protection of the public." *Matrix*, Adv. Sh. No. 26 at 20. Thus, in the majority's view, "[e]nforcing this requirement will come as no surprise to any lender." *Id.* The court was emphatic: "We take this opportunity to definitively state that a lender may not enjoy the benefit of equitable remedies when that lender failed to have attorney supervision during the loan process as required by our law." *Id.*

The court's decision, the first in a long line of UPL decisions to afford mortgagors a defense or remedy based on UPL violations, applies only prospectively: "We apply this ruling to all filing dates after the issuance of this opinion." *Id.* Justice Kittredge joined in the result "because of its prospective-only application." *Id.* at 21 (Kittredge, J., concurring). Justice Pleicones dissented.

Background: South Carolina's UPL Rules Affecting Mortgage Loan Closings

The South Carolina Constitution vests in the state supreme court the duty to regulate the practice of law. *See* S.C. Const. art. V, § 4; *In re Unauthorized Practice of Law Rules*, 309

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

S.C. 304, 422 S.E.2d 123 (1992); *see also* S.C. Code Ann. § 40-5-10 (1986). South Carolina has developed its rules governing the unauthorized practice of law by court decision, and in 1992, when presented with proposed rules governing the unauthorized practice of law, the supreme court opted to promulgate UPL rules through litigation instead: "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. at 305, 422 S.E.2d at 124. Consequently, South Carolina's UPL rules, including those that apply to mortgage loan closings, have developed in an evolving fashion, on a case-by-case basis.

In 1987, the South Carolina Supreme Court held that a lawyer must conduct residential real estate closings for purchase-money loans. *Buyers Service*, 292 S.C. at 434, 357 S.E.2d at 19. Title work, document preparation, closing, and recordation—four steps in the mortgage lending process—are all tasks that constitute the practice of law, and a lay person cannot perform these tasks in a residential mortgage loan closing.

In 2003, the South Carolina Supreme Court held that the same rule applies in a residential mortgage loan refinancing because the same four steps exist and "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." *McMaster*, 355 S.C. at 312, 585 S.E.2d at 776.

Later, in *Doe Law Firm v. Richardson,* 371 S.C. 14, 636 S.E.2d 866 (2006), the South Carolina Supreme Court held that disbursement of loan proceeds constituted the practice of law also, bringing to five the number of tasks that must be performed or supervised by a lawyer. Recognizing that its holding represented a new rule, the court delayed the effective date of this decision to January 22, 2007, "in order to afford persons with ongoing business relationships the opportunity to adjust their practices and procedures to conform to this new rule." *Id.* at 18, 636 S.E.2d at 868.

From the late 1980s on, however, courts have declined to recognize a private right of action for enforcement of the UPL rules promulgated in *Buyers Service* and its progeny. As the court explained in *Linder v. Insurance Claims Consultants, Inc.*, 348 S.C. 477, 560 S.E.2d 612 (2002), an individual who becomes aware of the unauthorized practice of law may bring a declaratory judgment action in the original jurisdiction of the supreme court to determine whether the conduct is legal or not. As a result of the rule that there is no private right of action for UPL violations in the context of mortgage loan closings, attempts to sue mortgage lenders for UPL violations have been unsuccessful.[2]

How courts will square the *Matrix* decision with the *Linder* "no private right of action" rule remains to be seen. It seems inevitable that courts will have the opportunity to address

[2] There are other reasons that such suits, which have surfaced intermittently in South Carolina courts since at least the mid-1990s, have been unsuccessful. They often fail, for example, because the plaintiff is unable to allege or prove any injury as a result of the alleged UPL violations.

this and other issues, however, as *Matrix* seems certain to lead to increased litigation over what is and what is not the practice of law, and what remedies, if any, are available when it occurs.

The Matrix Case[3]

The Frazers had borrowed money to purchase a home, and their mortgage had been assigned to Matrix. 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. Meanwhile, Matthew Kundinger obtained a default judgment against the Frazers in another state and enrolled the judgment in South Carolina on October 31, 2001. *Matrix*, Adv. Sh. No. 26 at 15.

The Frazers filed for bankruptcy, and Matrix sought to foreclose. Kundinger counterclaimed, alleging that his judgment had priority because it was filed first. Matrix sought equitable subrogation, arguing that when it refinanced the Frazers' mortgage, it paid the prior mortgage, and it was thus entitled to be subrogated to the rights of that prior mortgage. The master-in-equity agreed. The South Carolina Supreme Court reversed, denying equitable subrogation to Matrix and according priority to Kundinger's judgment lien. *Id.* at 16–18.

The holding on equitable subrogation was dispositive of the case, as in the August 2010 opinion, but the court proceeded nevertheless to address whether the mortgage lender's closing the loan without attorney supervision barred it from any equitable remedy.

The Majority's Decision on Equitable Remedies

The court began its brief analysis by rejecting the doctrine of unclean hands as the basis for its disposition of the case. *See id.* at 18. The court then turned to its UPL decisions, citing *McMaster* and *Buyers Service,* as well as the South Carolina Court of Appeals' decision in *Wachovia Bank, N.A. v. Coffey*, 389 S.C. 76, 698 S.E.2d 244 (Ct. App. 2010).

According to *Buyers Service*, performing a title search, preparing title and loan documents, conducting the closing, and recording the instruments constitute that practice of law and must be performed or supervised by a lawyer. According to *Doe v. McMaster*, because these four steps must be done in connection with a refinancing, the same rule applies to refinance loans as to purchase money loans. *Matrix*, Adv. Sh. No. 26 at 18–19. Matrix committed the unauthorized practice of law by hiring LandAmerica OneStop to conduct the title search, prepare documents, and close the loan—all done without lawyer supervision in violation of South Carolina law. *Id.* at 19.

The court emphasized that consumer protection is the reason for its UPL rules. As stated in *Buyers Service*:

[3] This commentary addresses only the second holding of *Matrix*, regarding the unauthorized practice of law. The court's treatment of the first issue, equitable subrogation, is interesting in its own right.

> The reason preparation of instruments by lay persons must be held to constitute the unauthorized practice of law is not for the economic protection of the legal profession. ***Rather, it is for the protection of the public from the potentially severe economic and emotional consequences which may flow from erroneous advice given by persons untrained in the law.***

Matrix, Adv. Sh. No. 26 at 19 (citing *Coffey*, 389 S.C. at 76, 698 S.E.2d at 248) (emphasis added). This consumer-protection purpose is "of paramount concern," said the court, quoting again from *Buyers Service*. *Id.* at 20 (citing *Buyers Service*, 292 S.C. at 433, 357 S.E.2d at 19).

The court's concluding words herald its intent to enforce what it views as a longstanding requirement of South Carolina law:

> Enforcing this requirement will come as no surprise to any lender. Lenders cannot ignore established laws of this state and yet expect this Court to overlook their unlawful disregard. We take this opportunity to definitively state that a lender may not enjoy the benefit of equitable remedies when that lender failed to have attorney supervision during the loan process as required by our law. We apply this ruling to all filing dates after the issuance of this opinion.

Matrix, Adv. Sh. No. 26 at 20.

Given the drastic effect of the court's decision on certain loans, the last sentence of the preceding quotation is noteworthy. One of the concerns voiced in the wake of the court's August 2010 opinion was that applying the court's holding retroactively would be unfair and potentially devastating. In his August 2010 dissent, Justice Pleicones observed that "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.'" *Matrix Financial Services Corp. v. Frazer et al.*, Op. No. 26859 (S.C. Sup. Ct. filed Aug. 16, 2010) (Shearouse Adv. Sh. No. 32). The court's prospective-only application of the rule seems designed to cure the unfairness.[4] The meaning of this limitation, however, is sure to be litigated. As highlighted by the dissent, the wording is vague, yet the

[4] 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).

concurring opinion's reference to the decision's "prospective-only application" seems to support the proposition that the holding should not be applied retroactively under any circumstances.

Justice Kittredge's Concurrence

Justice Kittredge joined the majority on the UPL issue: "Concerning the majority's broader holding voiding a real estate mortgage secured through the unauthorized practice of law, I join today's result because of its prospective-only application." *Id.* at 21 (Kittredge, J., concurring).

Justice Pleicones's Dissent

As in August 2010, Justice Pleicones dissented on both the equitable subrogation and UPL issues. First, Justice Pleicones would have held that Matrix was equitably subrogated to the rights of the mortgage that it paid through refinancing. Second, Justice Pleicones seemed unconvinced that the majority's proclaimed consumer protection purpose would be achieved in the result, stating, "I see only detriment to the borrowing public and a windfall to junior lienholders in this decision," in the form of reduced availability of credit or increased fees. *Matrix*, Adv. Sh. No. 26 at 24–25 (Pleicones, J., dissenting). Finally, in Justice Pleicones's view, the majority's description of the prospective-only nature of its opinion was vague. *Id.* at 25 n. 6 ("I am unsure what filing date the majority is referring to in this passage.").

Conclusion

The *Matrix* decision will inevitably lead to increased litigation about the availability of equitable remedies to foreclosing mortgage lenders and servicers, in the form of contested foreclosures and counterclaims. Further, *Matrix* is almost certain to be used not only as a shield but also as a sword, producing offensive actions by consumers against mortgage lenders and servicers. Finally, while a truly prospective application of the court's holding would limit its effects to mortgages recorded after August 8, 2011, the meaning of the words "all filing dates after the issuance of this opinion" is almost certain to be disputed.

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