ETHICAL ISSUES IN REPORTING PURCHASE PRICES

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Reporting purchase prices can be a grey area, because this task does not necessarily belong exclusively to the lawyer – it is not a duty entrusted solely to those who practice law, and in many instances it is *not* the lawyer completing the certificate of value used to report the purchase price, but a title company or some other entity. Consequently, it is difficult to say what the hard and fast rules and ethical obligations for lawyers are pertaining to such instruments. Frequently, however, even if the lawyer is not the one reporting the purchase price to the assessor's office or taxing office through completing the certificate of value (Statement of Value, Preliminary Change of Ownership Report, etc.), the lawyer is still party to the transaction in a way that at the very least means the lawyer is aware of what the client is doing. The lawyer is documenting the transaction, or is asked his input on what consideration to record, or is a party to the deed with which the recording instrument is filed. These circumstances mean that the rules can be difficult to apply. As an illustration, consider the following scenarios.

CERTIFICATES OF VALUE. As a part of the closing documents, the client, a buyer of a partially vacant strip mall completes, signs (or has a title company sign) and files a certificate of value showing a price lower than the contract purchase price. The client's lawyer is fairly sure that the client is reporting this price with the intent that the county assessor use it for reassessing the value of the property, which will consequently lower the client's future property taxes. What if the parties placed ten percent of the purchase price in escrow pending post-closing lease up or repair requirements? What if the ability to satisfy the post-closing lease up is highly unlikely, and the purchase price was originally inflated to show the seller's investors a higher price to get them to approve the sale, or show the buyer's lender a higher purchase price which might justify a higher loan amount?

Hearing about this type of transaction likely gives most people pause, and if it does not, the ABA Model Rules of Professional Conduct say it should. The problem here is that reporting a lower price in the certificate of value rather than the actual value is not inherently a product of the intention to mislead the assessor's office. There is also a genuine duty to work for the client's best interest, which usually involves securing the lowest property tax burden possible. There is a very fine discretionary line between good legal representation and questionable professional conduct, which is illustrated by the following purchase transaction. The contract price in a commercial real estate sale is $10 million, $1 million of which is escrowed at closing. Accordingly, the buyer's lawyer lists the full consideration on the certificate of value at $9 million. It is not exactly clear if that is an instance of being deceitful or just representing the client's interest.

ARTIFICIAL INCREASE OF PURCHASE PRICE. By way of further illustration, suppose the owner of 100 unsold condo units in a condo development makes a "friendly" sale of one condo to a longtime buddy at a contract sale price $200,000 over the fair market value of the unit. The seller's lawyer is asked to document the sale and the lawyer knows that the client will report this sale price so that it hits the public records. The lawyer is also fairly certain that the seller's intent is to use this higher price as a justification to future buyers and their banks and appraisers to show a higher value of the remaining unsold condo units.

There is a laundry list of ethical implications in this scenario which should encourage lawyers to tread lightly in efforts to avoid not only sanctions for violating professional codes, but also criminal charges. The most immediate effect of such a transaction is the overpayment for another unit within the development by a potential buyer who is unaware of the transaction between the seller and his friend. Because the certificate of value becomes a document of public record, it is not a stretch to imagine other future buyers (possibly even the website Zillow.com) relying on the content of the certificate when determining a fair price.

A second and much more consequential effect is a bank lending money based on an inflated sale price. Several ethics opinions have been issued on this particular topic, and none of them look favorably on the practice of attempting to acquire a mortgage loan based on a falsely increased sale price. The Labendz case, heard by the Supreme Court of New Jersey, involved a seasoned real estate attorney whose client needed an $80,000 loan to

meet his $100,000 purchase price.[1] The bank would not allow a mortgage for more than 75 percent of the purchase price. Attorney Labendz then advised his client to "renegotiate" the purchase price and amend the purchase contract to $107,000, despite there being no consideration for the extra $7,000.[2] The seller would then give the buyer a $7,000 closing credit to be shown on the closing statement. For this advice, attorney Labendz charged his client $100. Mr. Labendz was suspended from practicing law for 1 year for violating several provisions of New Jersey's professional code, the most damning of which was knowingly assisting his client in defrauding the bank.[3] Further, he was sanctioned for violating the law by assisting in completing and submitting documentation he knew to be false.[4] While altering a purchase contract and reporting a falsified purchase price are not exactly the same, they do present some of the same issues. Both acts raise the question of what the correct professional conduct is when a lawyer knows his client is attempting to manipulate the real price of his transaction to either avoid taxes or acquire a loan for which he does not actually qualify.

If attorney Labendz's story strikes a nerve, then the recent case of Nicholas Pellegrini, heard by the Supreme Court of New York, will strike a couple: attorney Pellegrini not only chose to represent both the purchaser/borrower and the lender at the closing, but also hiked up the sale contract price from $560,000 to $607,000 in order to secure the loan.[5] The lender agreed to a mortgage loan based on the higher number, and instructed the Mr. Pellegrini that the seller's contribution was not to exceed the lesser of the purchaser's actual closing costs or three percent of the purchase price.[6] At the closing, Mr. Pellegrini created a settlement statement that listed the amount of the seller's contribution as three percent of the purchase price ($18,210), and that stated the seller had received $27,348 from the purchaser at closing.[7] These numbers were false—the seller's contribution was $47,000, and the seller had not received $27,348 from the purchaser.[8] Not only did Mr. Pellegrini certify the statement himself as true and accurate while knowing that it was false, he directed the purchaser to certify it as well.[9] A slew of charges followed. The charges against Mr. Pellegrini included fraud, deceit, dishonesty, misrepresentation, false statements to third parties, conflicting representation, and assisting a client in illegal or fraudulent conduct, all violations of the New York Code of Professional Responsibility.[10]

Alarmingly, attorney Pellegrini engaged in this behavior even *after* receiving five letters of caution from the Grievance Committee of the New York Bar regarding representing clients on both sides of a transaction.[11] In light of those letters, and Mr. Pellegrini's admission that he misrepresented the closing figures because he knew the lender would not approve the loan with the actual numbers, the court suspended him from practice for two years.[12] Notably, the court flat out rejected Mr. Pellegrini's request to mitigate his punishment because no party to the transaction was actually injured (the transaction never came to fruition).[13] The clear and deliberate intent to get a better loan through lying was enough to dissuade the court from heeding his request.

While the Labendz and Pellegrini cases are examples of overt misbehavior, less extreme examples have also been subject to sanctions. In another New Jersey opinion from 2006, the Advisory Committee on Professional Ethics determined that amending a purchase contract to include a "seller's concession" – in other words, to increase the stated purchase price – violated several rules of the state's professional conduct code, despite the amendment being disclosed to the original mortgage lender.[14] The committee's concern was not the original lender, as it was made aware of the altered purchase price, but instead was the investors in the secondary market, who were not

[1] In the Matter of Ralph W. Labendz, an Attorney At Law, 95 N.J. 273, 275 (1984).
[2] *Id.*
[3] *Id.* at 277.
[4] *Id.*
[5] In re Pellegrini, 95 A.D.3d 179, 223 (2012).
[6] *Id.*at 223–24.
[7] *Id.* at 224.
[8] *Id.*
[9] *Id.*
[10] *Id.* at 224–25.
[11] *Pellegrini*, 95 A.D.3d at 225.
[12] *Id.*
[13] *Id.*
[14] NJ Eth. Op. 710 (N.J. Adv. Comm. Prof. Eth.) (2006).

certain to have notice of the circumstances of the manipulated price and would act in reliance solely on the price listed in the contract, and by implication, the price reported.[15] Taking its lead from the New Jersey Opinion, the New York Bar Association later published an opinion stating that while seller's concessions in real estate transactions could be legitimate and are not *per se* unethical or illegal, any seller's concession that is "a misnomer with no foundation in logic or mathematics because the seller concedes nothing to the purchasers" violates the Rules of Professional Conduct (New York's equivalent to the ABA Model Rules).[16] Liability, the opinion suggested, may fall particularly hard upon any lawyer who represents a lender and knows of an illegitimate seller's concession, because "the lender's representative – the very person who might be expected to detect a misrepresentation (the supposedly increased sales price that is fully offset by an unexplained seller's concession) – is encouraging the misrepresentation."[17]

Though the particular rules violated in these cases were those of the state of New Jersey, practitioners from all other states cannot afford to ignore them. Like every state except one, New Jersey has adopted the ABA's Model Rules of Professional Conduct. The one state that has opted for a different set of model rules is California. The 49 other states have generally adhered to the ABA's Model Rules, meaning that the implications for reporting false purchase prices are going to be felt universally. California's rules are a little broader, but still applicable in many instances.

ABA MODEL RULES. There are four ABA Model rules in particular that will arise in reporting purchase price issues: Rules 1.2, 1.3, 2.1, and 4.1. Before examining these rules, however, a clarification is necessary in distinguishing them, as it affects how they are understood. The Preamble and Scope of the ABA's Model Rules (also adopted by most states) makes clear a distinction between two types of rules: the *imperative* rules, which define proper and improper conduct by their use of the word "shall," and the *discretionary* rules, which by their use of "may" call for professional judgment. The relevant rules for reporting purchase prices are of the "shall" category. This means that if a lawyer's behavior is found to violate these rules, there is not much room to reinterpret – the lawyer cannot defend herself by relying on her professional judgment.

ABA Model Rule 1.2(d) reads, "A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal and fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law."[18] Nearly every state has adopted this provision in its entirety; some, like Ohio, substitute "illegal" for "criminal," but except for California, the effect is generally the same. The grey area with applying this rule to reporting purchase prices is that modifying the price that is recorded is not always going to be considered a fraudulent act. Recall the earlier example about the transaction where a $1 million of the $10 million price was escrowed. In the real life instance from which this example is drawn, the price reported on the certificate of value was, in fact, closer to the fair market value; there was no intent to deceive, and the parties to the purchase knew that. As a safeguard, however, and to be sure that the assessor was aware of the discrepancy between the purchase price in the contract and the one listed on the certificate of value, the buyer attached a short statement explaining the discrepancy.

St. Louis County, where this transaction occurred, issues a certificate of value with specific instructions about what to do in the event that the purchase price does not reflect market value, but many statement of value forms do not. In that case, it is still prudent to attach an explanation of why the price in the contract and the price on the form are different. This is especially true in recent years, because some states have gone even further through broadening the reach of the rules of professional conduct. New Jersey, for example, has expanded Model Rule 1.2(d) not only to prohibit a lawyer from counseling or assisting a client in illegal activity, but also to forbid counseling or assisting "in the preparation of a written instrument containing terms the lawyer knows are expressly prohibited by law." This addition to the rule has serious consequences; notice that both of the ethics opinions cases referenced earlier were in New Jersey, and the second one was found to be in direct violation of Model Rule 1.2.[19]

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[15] *See id.*
[16] NY Eth. Op. 882 (N.Y. Comm. Prof. Eth) (2011).
[17] *Id.*
[18] ABA MODEL R. PROF. CONDUCT 1.2 (2007).
[19] NJ Eth. Op. 710 (N.J. Adv. Comm. Prof. Eth.) (2006).

STATE AND LOCAL LAW VIOLATIONS. In the aforementioned instance where $1 million was escrowed at closing, the buyer reported a lower purchase price. But special care must be taken when a client is attempting to report a higher price, because the possibility of violating more than just ethical guidelines can be at stake. Most cities and counties have ordinances penalizing a misrepresented statement of value. For example, in St. Louis, the City's Revised Code 5.70.060 penalizes anyone responsible for filing a certificate of value for allowing a certificate they know to be false to remain on file with the assessor's office.[20] Each day that a false certificate of value is allowed to remain on file constitutes a separate violation, and anyone convicted of such a violation is punished by a fine of up to $500 per day.[21] Even if the lawyer herself is not the party responsible for filing the certificate, it is poor professional conduct not to warn a client of the costly repercussions of filing a falsified certificate.

Some states, like Minnesota, have broadened this concept to apply across the state, and have left little confusion about whether the rules apply to lawyers. Minnesota Statute Section 287.24(2) states that "any person who, individually or jointly with others, had control over, supervision of, or responsibility for" a statement of tax due may be held liable for an underpayment of county taxes, if that underpayment is a result of a deed or mortgage related tax filing.[22] Similarly, the Missouri legislature heard a bill in 2013 that would prohibit all recorders of deeds from accepting any instrument by which an interest in real property is transferred unless and until a completed certificate of value for the property is submitted to the assessor.[23] The proposed form of certificate of value included a detailed financial breakdown, and the bill specifically listed "the attorney . . . representing the grantee in any such transaction" as one of the persons deemed responsible for delivery of a proper certificate of value.[24] The bill was referred to the Financial Institutions Committee and its fate is still unknown, but its existence reflects an institutional understanding that transparency is essential in the world of real property value reporting.

FEDERAL LAW VIOLATIONS. There is also the potential to violate federal law if the client is attempting to obtain a loan based on an inflated purchase price. 18 U.S.C. § 1014 states, in part, that "Whoever knowingly makes any false statement or report, or willfully overvalues any land, property or security, for the purpose of influencing in any way the action of the Federal Housing Administration…the Federal Reserve Bank…or a mortgage lending business, or any person or entity that makes in whole or in part a federally related mortgage loan…upon any application, advance, discount, purchase, purchase agreement, repurchase agreement, commitment, [or] loan…shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both."[25]

Federal laws and city codes or ordinances imposing penalties make apparent the need for ABA Model Rule 1.3 – diligence in representation.[26] It is not only the lawyer's job, but also her ethical obligation, to know the legal consequences that her client's behavior might invoke. For real estate attorneys, this means being familiar with the relevant federal and state or municipal laws that penalize falsification of instruments that report purchase prices. Failure to make a client aware of these laws and the consequences of breaking them also falls almost unquestionably within the scope of ABA Model Rule 2.1, which imposes the duty to exercise independent professional judgment and render candid advice, even when such advice is unpleasant.[27] Advising a client that he could be breaking federal and state law by manipulating a statement of value is an ethical obligation that cannot be disregarded. In California, where the rules are a little more restrictive, there is a provision that prohibits advising or counseling a client to participate in illegal activity, so even California practitioners should abide by these recommendations.[28]

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[20] Ord. 5.70 § 202(A), 1987.
[21] *Id.*
[22] MINN. STAT. ANN. § 287.24(2).
[23] Mo. HB207 (2013).
[24] *Id.*
[25] 18 U.S.C. § 1014 (2010).
[26] ABA MODEL. R. PROF. CONDUCT 1.3 (2007).
[27] ABA MODEL R. PROF. CONDUCT 2.1 (2007).
[28] CAL. R. PROF CONDUCT 3-210 (2010).

Also governing this behavior is ABA Model Rule 4.1 – truthfulness in statements to others. Every state, excluding California, expressly forbids a lawyer from knowingly making a false statement of material fact or law to a third party, and most states (the most notable exception being New York) also sanction the failure to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client.[29] Here, the third party would be the city or county assessor's office, which uses the reported sale price to determine appropriate taxation of the property. Allowing a client to report a fraudulent value to the assessor's office is behavior that Rule 4.1 is intended to prohibit. Note the distinction, however, between Model Rule 4.1 and Model Rule 3.3, which pertains to "candor before a tribunal".[30] Rule 3.3 does not apply because an assessor's office or county recorder of deeds is not a tribunal. While Rule 3.3 is more detailed in the specific type of behavior it prohibits, Rule 4.1 is broader and encompasses a misrepresentation of material fact or law to any third party, which could include not just the assessor's office, but a lender or other buyers and sellers.[31]

The preamble to the American Bar Association's Model Rules of Professional Conduct calls lawyers to be not only "officers of the legal system," but also "public citizens having special responsibility for the quality of justice."[32] In reality, those titles are true, regardless of in which area lawyers are exercising their professional capacity. Even those that seem mundane and hardly subject to a review of the professional rules.

CONCLUSION. The reporting and recording of property values may not be the raciest area of legal practice, but the need for the consideration of and adherence to the Model Rules is of critical importance in such a situation. Certificates of value and the consequences of misrepresenting them pose some serious ethical issues, many of which do not surface until months or even years after the fact. Attorneys interested in protecting their practice, as well as their clients, have at their disposal fairly simple, preventive measures. First, lawyers need to know the relevant law in their state. Second, lawyers must pay close attention to the language of statement of value forms, because the form occasionally offers a way to explain or reconcile the number being reported, especially if that number does not mirror the contract sale price. Third and most important – and frequently the most difficult – is for lawyers to make a good judgment call. If a lawyer senses that an activity constitutes fraudulent behavior, his wisest assumption is that such activity is violating the Model Rules in one way or another. As an advocate, a lawyer must never forget his client's interest, but should always use his head and trust his gut.

[29] ABA MODEL R. PROF. CONDUCT 4.1 (2007); *See also* ABA MODEL R. PROF. CONDUCT 1.6(b), which states, *inter alia*, "A lawyer may reveal information relating to the representation of a client to the extent that the lawyer reasonably believes necessary: (1) to prevent reasonably certain death or substantial bodily harm; (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services; (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services; …" Model Rule 1.6(b), unlike 4.1, has generally been interpreted as discretionary and was enacted to promote, among other things, the concept of a lawyer's duty to society equaling or superseding his duty to his client when certain interests of another are at substantial risk.

[30] ABA MODEL R. PROF. CONDUCT 3.3 (2007).

[31] ABA MODEL R. PROF. CONDUCT 4.1 (2007).

[32] ABA MODEL R. PROF. CONDUCT PREAMBLE [1] (2007).