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The general public via movies, education, or just life experience has heard the term "Exclusionary Rule" as it relates to criminal court proceedings. For civil court proceedings, it is referred to as the "Unclean Hands" rule. Financial institutions and lenders are becoming aware of the "Unclean Hands" defense as it is being utilized successfully in certain jurisdictions to block residential and commercial foreclosure actions. The worst case outcome from "Unclean Hands" for lenders is the underlying loan is deemed to never exist and the borrower walks away without any recourse to the lender (as if the lender gave the money to the borrower as a gift). While financial institutions and lenders are putting procedures in place to avoid this mishap in the future, they must also comply with the financial accounting ramifications to their balance sheets by following review procedures for impairments of receivables and upon discovery, make appropriate modifications including the possibility of the original loan transaction journal entry being categorized as an error under generally accepted accounting principles.[1] What was originally "recorded" as loan receivable, may in fact be a gift that will dictate lenders to follow generally accepted accounting principles for disclosing accounting errors.[2]

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This article addresses the background of the "Unclean Hands" defense as it relates to mortgage transactions via the unlicensed practice of law including recent legal decisions in North and South Carolina and the potential accounting ramifications financial institutions and lenders must follow per generally accepted accounting principles.

Background

The Exclusionary Rule

The "Exclusionary Rule" is a controversial bedrock principle to the U.S.'s criminal legal system that simply states a party may not utilize information in a criminal court proceeding that was obtained illegally. During criminal court proceedings, courts will bar the admission of an item into evidence or proceedings as punishment for the illegal acquisition of the item. In law school, students are taught all criminal court cases are required to follow the Rules of Criminal Procedure (think of these as the rules for the ballpark in which you play the game) and that violations of said rules can destroy a case. A common outcome in criminal proceedings is excluding any evidence against the defendant that was ascertained unconstitutionally (illegally). For example, if police gather a confession from a defendant in custody without reading the defendant his or her Miranda rights prior to the confession or gather the confession after the defendant has invoked his right to counsel, the confession and all evidence gathered based upon the confession will more than likely be excluded from trial because the manner in which it was gathered is deemed a violation of the defendant's constitutional rights. The Court believes the punitive effect of the constitutional violation merits the exclusion of the evidence. This highly sensitive tactic is in place to protect the general public and maintain the integrity of the constitution in criminal proceedings. When the only piece of evidence holding the defendant was procured in violation of the "Exclusionary Rule," the Courts will grant the release of the defendant rather than allow police misconduct to trample constitutional rights.

Unclean Hands

What the "Exclusionary Rule" is to criminal court proceedings, "Unclean Hands" is to civil court proceedings. "Unclean Hands" is an equitable defense available to a defendant to bar a plaintiff equitable remedy based upon information/evidence that was procured by the plaintiff acting illegally, unethically, or in bad faith. In addition, the plaintiff may request to prohibit the defendant's use of evidence/information obtained by the defendant via illegal, unethical, or bad faith behavior. When "Unclean Hands" is invoked by a civil court defendant, it typically is done to bar introduction of evidence or cease the plaintiff's original action.

Unlicensed Practice of Law

All fifty states treat the unlicensed practice of law as a crime—EVERY SINGLE STATE—penalties range from misdemeanor to felony for each violation. Each jurisdiction has the authority to define what constitutes the unlicensed practice of law (hereinafter "UPL") and review potential violations on a case by case basis. Most jurisdictions generally identify the practice of law as

1) giving advice, consultation, explanation, or recommendations on matters of law;

2) instructing individuals in the manner in which to prepare and execute such documents; and

3) matters entailing specialized legal knowledge and ability.

More than half of the jurisdictions in the United States believe real estate closings (including refinancing) fall within the scope of the practice of law and require an attorney to supervise or prepare closing documents. This typically includes the property title search; preparation, closing, and recording of loan documents; and disbursement of funds.

UPL provisions in each jurisdiction are not designed to protect attorneys from losing business and creating a monopoly; they are designed to protect the general public from erroneous and inaccurate legal documents, legal advice from those untrained in that jurisdiction's law, and incompetent, unethical, and irresponsible representation.

North and South Carolina Judicial Opinions—"Unclean Hands" and Lenders

North and South Carolina statutes[3] state UPL is a felony and the Courts in both jurisdictions have taken very punitive viewpoints of UPL violations in real estate transactions (closings as well as refinancing).

Beginning with *South Carolina v. Buyers Serv. Co.*, 357 S.E. 2d 15 (S.C. 1987), the South Carolina Courts have consistently stated the preparation of deeds, mortgages, and other legal instruments related to transfers of real estate fall within the definition of the practice of law. The South Carolina Supreme Court ruled that "real estate and mortgage loan closings should be conducted only under the supervision of attorneys, who have the ability to furnish their clients legal advice should the need arise."[4]

Over time and through litigation, South Carolina Courts expanded UPL to include researching and recording title documents as acts that must be supervised by a South Carolina licensed attorney (*Doe v. McMaster*, 355 S.C. 306, 585 S.E. 2d 773 (2003)). The South Carolina Supreme Court clarified in *Doe Law Firm v. Richardson*, 371 S.C. 140, 636 S.E. 2d 866 (2006) that a lender may prepare loan documents so long as they are reviewed by an independent licensed South Carolina attorney who makes the changes necessary to ensure their compliance with South Carolina law.

While financial institutions and lenders have been aware of South Carolina rules for closing real estate transactions for some time, compliance by out of state entities was commonly overlooked. Within the last few years, South Carolina Courts have had several cases updating South Carolina's position of UPL for closing real estate transactions, a few of which will require lenders and financial institutions with a South Carolina loan portfolio to review loan receivables for potential impairment, which may lead to treatment as an accounting error under GAAP.

In 2010, the South Carolina Court of Appeals ruled in *Wachovia Bank v. Coffey* (389 S.C. 68, 698 S.E. 2d 244) the financial institution that closed a home equity line of credit without attorney representation committed UPL and was barred from all equitable and legal remedies leaving it unable to pursue foreclosure or sue on its note. The 2010 South Carolina Supreme Court decision in *Matrix Financial Services Corp. v. Frazer* (394 S.C. 134, 714 S.E. 2d 532) implied that once a lender has "Unclean Hands" with respect to the real estate transaction, it forfeits all equitable claims concerning that transaction to the point the lender has no legal recourse for repayment from the transaction (subsequent cases have lessened the penalties based upon timing of the original mortgage). The decisions in *Wachovia* and *Matrix* were foreseeable based upon the UPL case history in South Carolina real estate transactions, nonetheless, lenders and financial institutions with South Carolina real estate loan portfolios may be in jeopardy based upon lack of UPL oversight. In 2012, the South Carolina Supreme Court under pressure from the business community and legislators clarified *Matrix* and *Wachovia* via *BAC v. Kinder* (Opinion No. 27146, S.C. Sup. Ct. filed July 25, 2012) that the use of UPL to block foreclosure actions was prospective only for mortgages filed after the South Carolina Supreme Court's decision in *Matrix* (August 8, 2011). Thus, if the mortgage was recorded on or before August 8, 2011, any claimed unenforceability due to UPL will not bar the lender from seeking other equitable relief. While this clarification softens the blow to lenders and financial institutions, all mortgages entered into after August 8, 2011, must be verified to ensure the South Carolina UPL statute was not violated, thereby creating an impaired loan receivable. Going forward, lenders and financial institutions under GAAP must verify the validity and collectability of each South Carolina real estate transaction closed after August 8, 2011, for potential impairment. If the impairment appears to be a violation of the South Carolina UPL statute, lenders under GAAP must make necessary changes according to the doctrine of accounting errors as if the loan transaction never occurred.[5]

Transitioning to North Carolina, in early 2013 the North Carolina Court of Appeals addressed the same issue in a unanimous opinion, In *re foreclosure of Gray*, (12-854). While North Carolina by statute has legislated UPL as a serious offense punishable as a felony, the North Carolina Court of Appeals did not take the same punitive approach to the violation as South Carolina.[6] In *Gray*, the Court recognized UPL may occur during real estate closings; however, the Court put the burden on borrowers to prove the following items:

1) to assert the statute violated;

2) the facts evidencing the violation and that the violation was material;

3) the specific harm resulting from the violation;

4) that the resulting harm was what the statute was intended to avoid; and

5) the borrower's actions did not shift the equities.

The Court went further by stating the violation has to be asserted at the trial court level. If the borrower fails to assert the violation in a timely fashion at the trial court, it may not be raised at a later date. While this provides greater weight to lenders, the proliferation of mortgage clinics (law school programs run by law school faculty that oversee law students assisting home owners with loan modification programs and/or foreclosure actions) will alert borrowers to this defense to foreclosure. If the borrower meets the provisions outlined by the Court in *Gray*, the best outcome for borrower will be a) as if the loan is either non-recourse and/or b) as if it never occurred; thereby, denying reimbursement to the lender. At a minimum, the borrower may be able to leverage the provisions of the Court's decision in *Gray* to force the lender to enter into a mutually beneficial loan modification.

Generally Accepted Accounting Principles

Generally Accepted Accounting Principles ("GAAP") are the core fundamental accounting rules to prepare, present, and report financial statements. The Financial Accounting Standards Board ("FASB") applies GAAP and establishes rules for public and private companies while the Governmental Accounting Standards Board ("GASB") pronounces principles for governmental organizations.

To simplify a complex set of rules, GAAP states basic financial accounting objectives for every preparer of financial statements. The financial statements should be useful to present financial information to potential investors, creditors, and users for use in rational financial decisions. One of the core principles to accomplish this objective is the "Full Disclosure Principle." Information disclosed should be sufficient to make a judgment while keeping costs reasonable. Information is typically presented in the main body of financial statements, in the notes or as supplementary information.

Full Disclosure of Impaired Assets

As part of the "Full Disclosure Principle," businesses are required annually to review assets for impairment (reduction in value).[7] In the financial accounting realm, "impairment" represents the diminishment in quality, strength, amount, or value of an asset. Loan impairment is an inherent risk for all financial institutions and lenders based upon the business model of granting credit.

While lenders try to make informed financial decisions that will provide the greatest return on investment, it is a calculated probability that some loans will not be collected in full. Thus, a loan receivable is impaired when, based upon current information and events, it is probable that the creditor will be unable to collect all amounts due according to contractual terms of the loan.

As the residential and commercial real estate market has adjusted the past few years and borrowers' financial conditions have deteriorated, prudent loan modifications are often in the best interest of financial institutions. Any form of debt restructuring as a result of a troubled borrower's financial position, which a financial institution would not otherwise have granted, is a recognition by the financial institution the loan is impaired or at risk of impairment.

Full Disclosure of Accounting Errors

Mistakes happen; however, when errors are discovered, GAAP requires the financial statements be corrected and accounted for retrospectively. Previous year's financial statements that were incorrect as a result of an error may leave investors in the dark and, if error amounts are material, the error may prompt litigation.

While some errors may seem immaterial to the financial statements as a whole, GAAP requires investors be notified of the potential impact of all errors via disclosure in financial statements. Companies must correct errors as soon as their error are discovered by adding proper entries into the appropriate accounts and reporting the errors in the financial statements pursuant to the full disclosure principle. A company must treat corrections of errors as a prior period adjustment in the year discovered and retrospectively report them in former financial statements for comparative financial statements purposes.

Accounting Error vs. Impairment

With the collapse of the residential and commercial real estate markets and uptick in litany of foreclosure actions, financial institutions and lenders, as part of the annual impairment review process under GAAP guidelines, must now consider the applicability that portions of the loan portfolio may, in fact, not be deemed a qualified loan receivable but instead an incorrectly recorded journal entry.

While not applicable to every loan transaction, based upon recent court opinions, when a previously classified loan receivable has been deemed a non-recoverable asset, rather than writing down the amount of "bad debt," the lender must reconcile the financial statements as an accounting error in the year the loan receivable is deemed a non-recoverable.

Based upon the recent North Carolina ruling, lenders, as part of the annual loan impairment analysis, should review all North Carolina foreclosure litigation claims for potential hazards of the Court's decision in *Gray*. If applicable, the lender should make necessary adjustments under GAAP for loan impairment and, in extreme cases, make necessary changes to accounting records as an accounting error when transactions previously assumed to be a valid loan have been barred due to a UPL violation.

Financial institutions and lenders with loan portfolios in South Carolina should incorporate the Court's decisions in *Matrix*, *Coffey*, and *Kinder* into the annual loan impairment analysis under GAAP. Lenders determining South Carolina loan transactions recorded prior to August 8, 2011, may have involved UPL in the real estate transaction, should consider the loan "impaired" and make necessary changes and disclosures. Lenders determining South Carolina loan transactions recorded after August 8, 2011, having UPL violations during the real estate transaction, should follow GAAP procedures to remove the loan transaction from the accounting records as an accounting error. The lender, then, is barred by the Court's rulings from seeking reimbursement or relief for lost funds.

Summary

Although this analysis and the financial ramifications from the fallout of the real estate boom and lack of oversight in closing processes are solely based upon two jurisdictions, North and South Carolina, the financial ramifications may, clearly, be material and transferrable. When seeking quantitative information to determine the impact of these recent cases, interesting informal feedback was received; for example, several South Carolina-based financial institutions were well aware of the UPL issue, including more than one that had put in place review safeguards for real estate transactions shortly after the decision in *Buyers* (1987). Regional and national financial institution feedback indicated the lenders were aware of the cases; however, they indicated it could never happen to them or, as one very frank statement from a banking official stated, lenders did not want to perform the necessary reviews to avoid educating the public and creating a fiduciary duty to notify good standing debtors that the debtor may, in fact, be paying on an invalid loan. Due to the lack of assistance from lenders and indicators that South Carolina-based financial institutions were aware of the issue and had placed safeguards in place to avoid the issue, research was done on non-South Carolina-based lenders to compare South Carolina loan portfolio to total loan portfolio. Utilizing an annual UPL rate of 1 percent on South Carolina transactions[8] completed after the South Carolina Supreme Court's decision in *Coffey*, the estimated impairment/error was sufficient to meet GAAP standards to pursue disclosure in the lender's financial statements. To date, it appears not one financial institution has made a detailed UPL disclosure outlining impaired loans and subsequent necessary accounting changes. This issue is out there—the question is whether any of the lenders will actually look for it.

Endnotes

1. Financial Accounting Standard 5; Accounting Codification Standard 310-10; Accounting Codification Standard 450-20.

2. Statement of Financial Accounting Standard 154; Accounting Principles Board 20; FASB Statement 3.

3. S.C. Code Ann. § 40–5-310; N.C. Gen. Stat. § 53-243.03.

4. *South Carolina v. Buyers Serv. Co.*, 357 S.E. 2d 15 (S.C. 1987).

5. Financial Accounting Standard 5; Accounting Codification Standard 310-10; Accounting Codification Standard 450-20.

6. The author thinks South Carolina did not go far enough—UPL may be an enforceable solution to mortgage reform.

7. Financial Accounting Standard 5; Accounting Codification Standard 310-10; Accounting Codification Standard 450-20.

8. An annual South Carolina loan portfolio for commercial, residential, and refinancing in excess of $50 million, the figure may not be material to the overall loan portfolio