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The newsletter of the Illinois State Bar Association's Section on Real Estate Law

Putting the short into short sales

Philip J. Vacco

In response to pressure to simplify the short sale and deed-in-lieu of foreclosure processes, in August of this year the Federal Housing Finance Authority [FHFA] announced a new set of short sale guidelines[1] that will be standardized across both the Fannie Mae (FNMA.OB) and Freddie Mac (FMCC.OB) platforms designed to assist struggling homeowners.[2] Effective November 1, 2012, Fannie Mae's and Freddie Mac's new and improved preforeclosure sales program will officially be known as "Standard Short Sale/HAFA II." It is hoped that this amended short sale program, which will consolidate the existing short sale programs into a single uniform program, will provide servicers with more clear and consistent guidelines with the goal of making it easier to process and execute short sales and provide a much needed alternative to borrowers facing foreclosure.

Under the prior guidelines, Fannie Mae and Freddie Mac did not allow a borrower facing imminent default of their mortgage obligation to qualify for preforeclosure relief.[3] In fact, to qualify for assistance a borrower had to be seriously delinquent; this meant that the borrower had to have at least two payments that were 31 days or more in arrears. Unfortunately this rule resulted in some homeowners, who were meeting their mortgage obligations even though they were upside down and in financial distress, making ill-advised decisions to voluntarily default on their payments in a desperate attempt to qualify for relief. Regrettably, such actions typically only exasperated the borrower's financial distress buy forcing them to incur additional late fees and penalties, damaging their credit, and adding the additional stress and uncertainty associated with a foreclosure action; all without any certainty

Continued on page 2

Real estate ethics corner

By Michael J. Rooney

"Mortgage fraud" is a term familiar to real estate practitioners and it encompasses a number of variations, each with the same result: a lender is defrauded into lending more money than a property is really worth and/or more money than the borrower can qualify for and repay. In the end, all of us taxpayers end up bearing the cost in one way or another no matter whether the fraud is property kiting, straw buyers/borrowers or phony loan documentation for actual buyers/borrowers. Two recent disciplinary cases illustrate that lawyers can get caught up in mortgage fraud as an active participant or as "merely" an attorney for one (or more) of the parties to a real estate transaction.

In re: Marc Robert Engelmann, Commission No. 2012 PR 9 resulted in disbarment by consent (M.R. 25211, March 19, 2012) of a lawyer convicted by the federal court in the Southern District of Iowa of conspiracy, bank fraud and wire fraud. A real estate owner, real estate agent and mortgage broker identified unqualified buyers to purchase rental properties owned by the seller. The owner agreed to sell at an inflated price to obtain larger loans and the contracts even contained an

Continued on page 5

INSIDE

Putting the short into short sales 1

Real estate ethics corner 1

ISBA President challenges Illinois lawyers to fight hunger . . . 7

Upcoming CLE programs 7

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Putting the short into short sales

Continued from page 1

that a short sale would be approved by their servicer.

In addition, every borrower was required to submit a completed Borrower Response Package in which the borrower provided a thorough and detailed financial disclosure of all of the borrower's assets, complete a Hardship Affidavit,[4] and supply an array of documents supporting the borrower's claims.[5] The gathering and reviewing of these documents took time which resulted in typical delays of several months before the servicer would be in a position to approve of the sale.

Further adding to the uncertainty of completing a short sale were the additional road blocks created by second lien holders who refused to release their lien claim unless they received amounts that were much higher than what the servicer would approve. And when junior lien holders held out for more money, the short sale was often jeopardized.

Under the new guidelines the Federal Housing Financing Agency attempts to address many of these shortcomings by consolidated existing short sales programs into one streamlined standard short sale program intended to enable lenders and servicers to quickly and easily qualify eligible borrowers for a short sale.[6]

Perhaps the two most significant changes contained in the new guidelines are that they now permit servicers of Fannie Mae or Freddie Mac loans to allow homeowners who are current on their mortgage obligation, but deemed to be in a position where default is imminent, to sell their home in a short sale before they become delinquent; as long as they have an eligible hardship.[7] And the adoption of a streamlined short sale process for borrowers deemed most in need, which permits servicers to approve of a short sale without obtaining any additional approval from Fannie Mae or Freddie Mac.[8] A principal component of the streamline process is that it abolishes the need for a qualifying borrower to make a financial contribution to the short sale. This in turn eliminates the obligation for the borrower to provide a Borrower Response Package; reducing the time necessary to approve a short sale by eliminating the time expended on gathering, submitting, reviewing and ultimately qualifying the borrower.

Qualifying borrowers who are current on their mortgage obligations

As of November 1, 2012 there will now be a mechanism in place for Fannie Mae and Freddie Mac servicers to offer relief to mortgagors who are current on their payments but are otherwise facing financial hardships. Under the new guidelines as long as the homeowner can demonstrate that they are suffering a recognized "hardship,"[9] servicers can expedite the short sale process without

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any additional approval from Fannie Mae or Freddie Mac. The hardships enumerated by FHFA are as follows:

- Death of a borrower or death of the primary or secondary wage earner in the household.
- Unemployment.
- Increased housing expenses (i.e. ARM loan rate adjustment).
- Disaster (natural or man-made).
- Business failure.
- Long-term or permanent illness or disability of borrower, co-borrower or dependent family member.
- Divorce or legal separation of a borrower or co-borrower.
- Employment transfer / relocation (including Permanent Change of Station order for military personnel) greater than 50 miles from current primary residence.
- NOTE: If a borrower faces a hardship not listed above and provides relevant documentation to the servicer, the servicer must review the Borrower Response Package and make a determination if the short sale request is legitimate. It must then submit that recommendation to Fannie Mae / Freddie Mac for approval.[10]

Streamlined short sale approach for borrowers most in need

For borrowers that are 90 days or more delinquent in their mortgage payments, have credit scores of less than 620, and have serious financial hardships, the documentation previously required to demonstrate need; that is, the Borrower's Response Package, has been all but eliminated. These borrowers are deemed to have qualified for a short sale and are exempt from the requirements to make any cash contribution or sign a promissory note as part of the short sale process. For borrowers that qualify these changes should significantly cut the delays associated with getting a short sale approved. In addition these borrowers will qualify for a "relocation" incentive of up to $3,000 from Fannie Mae to be paid following the successful completion of a short sale.[11]

Military personnel with Permanent Change of Station (PCS) orders

The new guidelines provide special treatment for service members who are being relocated. Now military personnel with PCS orders are automatically eligible for short sales, even if they are current on their existing mortgage obligations. In addition, these personnel will be under "no obligation to contribute funds to cover the shortfall between the outstanding loan balance and the sales price on their homes."[12] Likewise, non-military borrowers who need to relocate more than 50 miles from their current home for a job transfer or new employment opportunity, qualify for a short sale even if the borrower is current on their mortgage payments.[13]

Dealing with second mortgages

In addressing the log jam that has been created by junior lien holders refusing to release their lien claims in deals that have otherwise been approved for a short sale by the servicer, Fannie Mae and Freddie Mac are now requiring subordinate lienholders to accept from the proceeds of the short sale the sum of $6,000 in exchange for a release of their lien claims and a full release of liability for the borrower.[14] (Note: it doesn't matter how many subordinate lien holders there are, the $6,000 amount is an aggregate amount).

Waiving the right to pursue deficiencies

Unless the borrower qualifies for the streamlined documentation short sale process, is active military personnel with PCS orders, or the collection of a deficiency is otherwise exempt by applicable law, the guidelines require the borrower to be evaluated to determine if they will be required to make what FHFA refers to as a "reasonable contribution"[15] or be asked to execute a promissory note as a condition of approving the short sale.

When determining whether or not a borrower who is delinquent on their mortgage payments or in imminent default will have to make a cash contribution, the servicer is required to examine the borrower's financial health; and they do so by examining the disclosures the Borrower made on the Uniform Borrower Assistance Form.[16]

> [I]f the borrower has cash reserves, including assets such as cash, savings, money market funds, marketable stocks or bonds (excluding retirement accounts), . . . are:
>
> - in excess of the greater of $10,000; or
> - six times the contractual monthly mortgage loan payment including principal, interest, and

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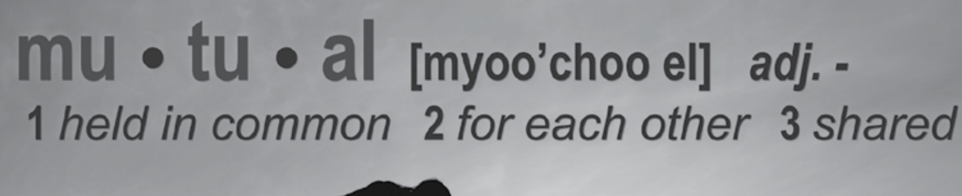

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tax and insurance escrows (PITI). (If the servicer does not escrow for taxes and insurance, it must estimate the borrower's monthly tax and insurance premium amounts).

If a borrower has cash reserves of more than $50,000, the servicer must request written approval from Fannie Mae for the contribution amount.

If the servicer determines that the borrower has the capacity to make a cash contribution, the servicer must initially request a contribution of 20% of the borrower's cash reserves, not to exceed the deficiency.[17]

It is of interest to note that the contemplated 20% contribution to the shortage is not written in stone and if a borrower who is more than 30 days delinquent on their payment is either unwilling or unable to pay 20% of their cash reserves, the servicer is given the ability to negotiate a lower cash contribution, "but must provide an explanation in the mortgage loan servicing file of the specific circumstances that limited the borrower's ability to make a full contribution."[18] Likewise, where the borrower

> is offered a short sale under the 'imminent default' standard and is either unwilling or unable to contribute 20% of their cash reserves, the servicer must request approval from Fannie Mae to accept less than the 20% contribution. However, if the borrower's hardship is death of the primary wage earner, the servicer may negotiate a borrower's cash contribution for less than 20% of the cash reserve, but must provide an explanation in the mortgage loan servicing file of the specific circumstances that limited the borrower's ability to make a contribution.[19]

In situations where cash reserves are unavailable the servicer must then evaluate the borrower to see if a contribution can be secured through the use of a promissory note.[20] To determine whether or not a borrower is an appropriate candidate for a promissory note the servicer is required to examine the borrower's future debt-to-income ratio of the borrower (i.e. "back-end-ratio"). If the borrower's total monthly debt is less than 55% then there is an initial determination that the borrower has the capacity to make a promissory note contribution. The borrower's total monthly debt is to include the borrower's future housing expenses,[21] monthly payments on all installment debts with more than 10 months remaining, credit card payments, alimony, child support, separate maintenance payments if more than 10 months remaining, car lease payments, as well as any negative rental income from other investment properties owned.[22]

Once this determination is made, the servicer as part of the short sale package must initially request the borrower to execute a five- to 10-year promissory note, at zero interest, with a monthly payment that does not exceed one-half of the difference between the borrower's future monthly housing expenses and 55%. The actual promissory note balance is the final monthly amount negotiated between the borrower and the servicer multiplied by the negotiated term (60 or 120 months) not to exceed the deficiency amount. (NOTE: promissory notes are NOT required if the note balance is less than $5,000).

So if we were to assume that a borrower had a future total monthly debt ratio of 49% with a Gross Monthly Income of $4,000 his initial monthly payments under the formula would be $120.[23] Assuming a five year payback, the total amount contributed by the borrower would be $7,200. Again, as we saw with borrowers making cash contributions, if the borrower is unwilling or unable to agree to a monthly promissory note payment based on the prescribed calculation, the servicer is given the authority to negotiate a lower payment, but must provide an explanation in the mortgage loan servicing file of the specific circumstances that limited the borrower's ability to make the payment.

Upon the completion of the short sale, the borrower will be released from any liability for deficiency and will be in a position to qualify for another Fannie Mae / Freddie Mac guaranteed mortgage within two years.

Conclusion

With 4.63 million loans in Fannie's and Freddie's combined portfolios underwater and approximately four out of five of those loans being current,[24] FHFA needed to modify their policies to address the situation faced by homeowners who are upside down on their property and in imminent danger of defaulting on their mortgage obligations. By streamlining the short sale approval process and providing servicers with the ability to make decision without going back to Fannie Mae or Freddie Mac for final approval, FHFA has taken major strides toward providing borrowers with new options for avoiding foreclosure.[25]

Combining these changes with the FHFA announced guidelines earlier in June of this year "that established strict timelines for servicers considering short sales[.]",[26] it appears that the lengthy delays now associated with short sales may actually become a thing of the past.

For transactional attorneys handling short sales these changes should assist in lessening the amount of time we will have to commit to gathering and transmitting financial information to the servicer, especially for delinquent borrowers and military personnel who qualify for the streamlined procedure; but more importantly, they provide us with an additional remedy that we can now offer our ailing clients who are struggling to keep their mortgage current payments. ■

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1. FHFA News Release, August 21, 2012.

2. To determine if you are dealing with a Fannie Mae or Freddie Mac loan you can access the following Web sites: <http://loanlookup.fanniemae.com/loanlookup> and <https://www.FreddieMac.com/corprate>.

3. Fannie Mae Servicing Guide Announcement SVC-2012-19, *Standard Short Sale/HAFA II and Deed-in-Lieu of Foreclosure Requirements,* (page 3) August 22, 2012.

4. Fannie Mae Hardship Affidavit Form 194. Purpose of the Hardship Affidavit was to establish that the borrower was unable to maintain his / her payments; typically due to a reduction in income, or increased monthly obligations caused by the loan resetting (ARMs), the additional of medical expenses, consumer debt, or increased utilities or property taxes.

5. Copies of the Borrower's tax returns, bank statements, W-2's and check stubs are often required by the servicer.

6. FHFA News Release, August 21, 2012. "These new guidelines demonstrate FHFA's and Fannie Mae's and Freddie Mac's commitment to enhancing and streamlining processes to avoid foreclosure and stabilize communities," said FHFA Acting Director Edward J. DeMarco.

7. FHFA News Release, August 21, 2012.

8. Id.

9. Id.

10. Fannie Mae Servicing Guide Announcement SVC-2012-19, *Standard Short Sale/HAFA II and Deed-in-Lieu of Foreclosure Requirements,* (page 4) August 22, 2012.

11. There are exceptions to this policy. Borrowers required to contribute funds or execute a promissory note; a military borrower who receives a Dislocation Allowance (DLA) or other governmental relocation assistance, or a borrower receiving relocation assistance from any other source is prohibited from receiving the $3,000 incentive.

Fannie Mae Servicing Guide Announcement SVC-2012-19, *Standard Short Sale/HAFA II and Deed-in-Lieu of Foreclosure Requirements,* (page 14) August 22, 2012.

12. FHFA News Release, August 21, 2012.

13. Id.

14. Fannie Mae Servicing Guide Announcement SVC-2012-19, *Standard Short Sale/HAFA II and Deed-in-Lieu of Foreclosure Requirements,* (page 11) August 22, 2012.

15. FHFA News Release, (attached fact sheet). August 21, 2012.

16. Fannie Mae/Freddie Mac Form 710.

17. Fannie Mae Servicing Guide Announcement SVC-2012-19, *Standard Short Sale/HAFA II and Deed-in-Lieu of Foreclosure Requirements,* (page 6) August 22, 2012.

18. Id.

19. Id.

20. Fannie Mae provides a Promissory Note template (Form 190) at eFannieMae.com. Use of this note is not mandatory.

21. If the actual future housing expenses of the borrower is not known, the servicer is to use 75% of the borrowers current monthly mortgage payment (PITI, including sums for assessment fees) to determine eligibility.

22. Fannie Mae Servicing Guide Announcement SVC-2012-19, *Standard Short Sale/HAFA II and Deed-in-Lieu of Foreclosure Requirements,* (page 8) August 22, 2012.

23. Initial Monthly Promissor Note Payment = (55% - future total monthly debt ratio) ÷ 2 x Gross Monthly Income.

24. Statement made by acting FHFA director, Edward J. DeMarco.

25. Fannie and Freddie Short Sale Guidelines – Positive for Housing, Michael Terry, Rubicon Associates, LLC, August 27th, 2012: "One of the potential outcomes of this program is pulling forward what would be distressed sales at short sale prices. While some owners continue to make payments even though they are upside down and in distress, these borrowers will now be able to engage in a short sale instead of adding to the REO inventory and at typically higher realized prices." <http://seekingalpha.com/article/829021-fannie-and-freddie-short-sale-guidelines-positive-for-housing>.

26. FHFA News Release, August 21, 2012. Servicers are required to review and respond to short sales within 30 days of receipt of a short sale offer; they must provide weekly status updates to the borrower if the offer is still under review after 30 days, and they must make and communicate final decisions to the borrower within 60 days of receipt of the offer and complete borrower response package.

Real estate ethics corner

Continued from page 1

addendum describing the true price and the manner of splitting up the excess funds! The lawyer knew of the scheme and represented to each closing agent, mortgage lender and bank that the inflated sales price was the actual selling price, concealing the fraud. He also created or caused to be created false HUD-1 Settlement Statements reflecting the bogus transaction information.

Well, now, everyone knows not to be the active fraudster in such a scheme, right? Is it possible for an innocent lawyer to be caught up in such a scheme unknowingly and suffer disciplinary consequences? You be the judge on *In re: Oscar Gallo, Jr.,* Commission No. 07 CH 110 based on the following information from the Report and Recommendation of the Review Board, which recommended a three month suspension for the lawyer.

Sellers owned real property and contracted to sell it to a buyer, but the sale dragged on and on and the buyer defaulted. Sellers had been trying to sell the property for a long time and a friend of a friend introduced them to a mortgage broker who offered to find a buyer for them, taking no up-front money but accepting a "finder's fee" upon closing. The mortgage broker found a new buyer in the person of a car mechanic who had worked on Mr. Gallo's car and indicated he needed to refinance his home. Mr. Gallo gave the mechanic the mortgage broker's phone number and although he did not refinance his home, he turned out to be the buyer the mortgage broker "found" for the sellers. The mechanic thought he was participating in the mortgage broker's "investment program" and the mortgage broker told him he did not need any money because he could buy property for less than it was worth, receive cash at the closing and the mortgage broker would manage the property for him, finding a tenant to rent the place to so the rent and cash from the closing would make the mortgage payments.

The mortgage broker prepared a one-page contract signed by the sellers and the mechanic as buyer. (You might want to re-read that sentence!) The contract provided that Mr. Gallo was the buyer's attorney. (That one, too.) The mechanic testified he did not consult with Mr. Gallo before signing the contract and did not know who put into the contract the provision about Mr. Gallo representing him. The mortgage broker told Mr. Gallo the buyer would need an attorney and Mr. Gallo began to prepare for the closing. The closing was continued twice as the lenders' documents (two separate loans for 100% financing) contained several errors. Mr. Gallo did not participate in the preparation of any loan documents, but he testified he reviewed the loan application with the mechanic and told him to review the personal information to make sure it was correct.

This next part may shock the reader, so be forewarned: There were several misstatements on the loan application which the mechanic buyer/borrower did *not* correct! The application said the property would be the mechanic's primary residence, which was not ever his intent, his monthly income was inflated and the application listed $23,000 in a bank account he did not have. Imagine that!

Although Mr. Gallo testified that he only represented the buyer, both of the sellers *and* the buyer all testified they believed he represented all of them. Furthermore, the Hearing Board found that belief to have been reasonable. In fact, one of the sellers testified that the mortgage broker introduced Mr. Gallo to her as her attorney. At some point, a HUD-1 was rejected by one of the lenders because the attorney's fees "made the ratios too high for the loan" so Mr. Gallo's solution was simply to have those fees paid outside of closing from the sellers' proceeds and submit a different HUD-1 for approval. Also, the mortgage broker was present and wanted his "finder's fee" paid. The settlement agent was asked to prepare separate checks for the sellers' proceeds and responded that a letter of direction would be required. As Mr. Gallo was the only lawyer present, he was asked to prepare such a letter which he did, even though he testified he represented "only" the buyer.

So, did the mortgage broker find a tenant for the buyer? Did the mortgage broker assist in managing the property? No, on

both counts. Eventually, the mechanic ran through the "extra" proceeds he took from the closing and lost both the property he bought and his home to foreclosure and he took bankruptcy. The mortgage broker did not testify at Mr. Gallo's ARDC hearing and the parties stipulated that if called he would have asserted his Fifth Amendment rights.

The Hearing Board recommended Mr. Gallo be suspended from the practice of law for three months. It found his testimony not credible in some instances and that he tried to avoid answering some questions and held back information. However, the Review Board quoted from the Hearing Board's finding that, "We do not find in aggravation that [Mr. Gallo's] actions caused harm to [mechanic], because [his] failed dealings with [mortgage broker] and the subsequent foreclosures of his properties and his bankruptcy proceedings cannot be attributed to [Mr. Gallo's] actions. Additionally, although the sale of the … property appeared to involve a fraudulent scheme, [Mr. Gallo] is not charged with participating in that scheme and we do not find in aggravation that [Mr. Gallo] engaged in any dishonest or fraudulent conduct."

However, the Review Board noted that the Hearing Board did specifically comment that Mr. Gallo "does not appear to fully appreciate his ethical obligations and therefore we conclude some period of suspension is appropriate in this case." The Review Board also recommended a three-month suspension. The Supreme Court imposed that discipline in its order M.R. 25259, May 18, 2012, effective June 8, 2012. It is clear from the Review Board Report and Recommendation that the discipline arises not because of the charged violation of Rule 1.4 dealing with communicating with the client, but because of the conflicts of interest covered by Rule 1.7 that he was also charged with violating.

While the materials do not discuss it, clearly a carefully drafted engagement letter could have prevented confusion as to whom Mr. Gallo represented. Furthermore, additional documentation clearly limiting the scope of representation concerning the letter of direction would have been helpful. And how many lawyers typically serve as attorneys for one side (or both sides) in a transaction where the contract has been prepared by the mortgage broker? Learn to recognize and respond to such red flags in order to protect your law license. ■

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