Navigating The Paper Chase: Defending a Mortgage Fraud Prosecution

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The "Nuts and Bolts" of a Mortgage Fraud Case
John Nicholson, AFPD Dallas

So, What is Mortgage Fraud (MF) Anyway? What is the Theory?

I. MF is a catch-all term for a type of crime that enriches the participants by tricking a lender into extending a mortgage that it would not otherwise extend.

A. Well, what is wrong with making money in real estate? This is America, right? Buy low and sell high?

1. How an investor makes money in a traditional real estate transaction *is* buy low and sell high.

a. "House A" is for sale for $275K and Investor X determines that it is *really* worth $350K. Investor X can buy it from the original seller for $275K, then sell it to a third party for $350K, and make the $75K profit (minus expenses).

2. But, this traditional process has a number of undesirable aspects, especially for someone like X that makes his living in the real estate market in the early 00s.

a. What if nobody sees that House A is really worth $350K? How will X get the $75K profit that he is expecting if nobody puts in an offer of at least $257K?

b. How long is it going to take to sell House A after X buys it? What if X needs the $75K profit now?

c. What if X already has too many mortgages in his name and no lender will extend the mortgage necessary to buy House A?

d. Even if X can get a mortgage to buy House A, will the

APR for an investment property be too high?

e. What if nobody buys House A at all? X doesn't want to get stuck with the House. X doesn't want his assets and credit at risk.

f. X doesn't like "traditional" methods of buying and selling real estate because the corresponding laws and rules only exist to exclude all but the wealthy from the market. By contrast, X does like creative methods of buying and selling real estate (e.g. "renting credit").

B. How does a "MF scheme" work (according to the government) and how is it different from a traditional real estate transaction? How does it avoid the potential problems common with traditional transactions? How does a MF scheme get Investor X the $75K profit for House A?

1. **Investor X is going to acquire the $75K profit on House A not from a third-party buyer, but rather from a lending institution.** X is going to arrange for a series of transactions that result in a lending institution unknowingly loaning $75K more than is necessary to part the original seller from House A. X will get this $75K.

2. A MF "scheme" changes speculative events to certain events.

a. Getting $350K for House A is no longer speculative, but rather guaranteed, because it is within the control of Investor X. Not involving neutral, third-party buyers.

b. Making the $350K profit on House A will take place within a few weeks because the date of the transaction is within the control of Investor X. That X will successfully "sell" House A is a foregone conclusion.

c. Investor X need not worry about having too many outstanding mortgages to secure an additional mortgage to buy House A because, according to the lenders, Investor X is not the person applying for the mortgage.

3. How will Investor X do all of this?

    a. Investor X is looking for houses that, in X's opinion, are on sale for far less than their market value and are good candidates for a friendly appraisal. Investor X, or someone working for/with him, finds House A. It is on sale for $275K. House A is likely for sale by owner. The sellers are likely to be relatively unsophisticated and just want to get their asking price for the home.

        i. There are likely good "comps" for House A that could help support a friendly appraisal.

        ii. Realtors complicate the process since they might ask too many questions or not understand creative transactions.

    b. Investor X (or someone acting for him) makes an offer to the sellers of House A. Investor X offers them "full price" for their home, or $275K. However, as part of the deal, the Sellers must agree to sell the home not for $275K, but for $350K. X tells the sellers that his company has investors that are looking to buy property. X may also tell the sellers that the $75K difference is going towards some type of remodeling such as making the home appropriate for special needs occupants, corporate housing, etc.

        i. X thinks that this is America and people can sell their homes for whatever they want.

    c. X secures a friendly appraisal for House A. It comes out to $350K. This is unlikely to be a formal *quid-pro-quo.*

Rather, X may give the appraiser a "target number". Or, the appraiser may know from experience that if he/she does not appraise House A high enough, then he/she won't get any more work from X. This friendly appraisal of $350K is used in the mortgage application. The combination of this friendly appraisal and the "sales price" of House A is what causes the lender to loan the amount requested. Expect clients to protest that lenders do, or are supposed to do, their own appraisals and none of the lenders ever complained until after-the-fact.

d. X, or someone working for him, has previously found a person that is looking to make money in real estate. This is the person that the government will call a "straw borrower." This person, the straw, is the one to whom the lender extends a mortgage to buy House A for $350K.

e. Straws are almost always unsophisticated. They typically know next to nothing about what they are doing. They think that they are just signing some forms and making some money in real estate.

    i. The straws are compensated by X, typically per transaction. They are often told that they will receive some amount of money after closing on a house and also a portion of the profit when X sells the house at a profit.

    ii. Straws don't know, or in some cases don't want to know, that, according to the lenders, they are responsible for huge monthly mortgage payments. They don't know that they are going to end up in foreclosure and have their credit ruined forever. They think that X is going to take care of everything.

iii. Straws typically don't see the houses that they are "buying" or meet the people selling the houses until closing.

f. X, or someone at his discretion, or even a mortgage broker, does the paperwork for Straw to buy House A from the sellers. Someone puts together Straw's mortgage application for $350K to buy House A.

i. In the mortgage application, X includes the sales contract between the sellers and Straw for $350K. X also includes the friendly appraisal for $350K.

ii. Perhaps, to boost the apparent value of House A, X or someone else will include falsified documents such as rental agreements (houses producing income are worth more) or tax returns (showing Straw's income is much higher than it really is) in the loan application package.

iii. Don't be surprised if your mortgage broker client tells you that his/her contact person at the lender did not care if the mortgage application paperwork was accurate or truthful. Expect your client to ask you, "how can this be fraud if the victim knew exactly what I was doing?"

g. Once X learns that the lender has approved Straw for a $350K mortgage to buy House A as Straw's primary residence, X has the sale of House A set for a closing.

i. Closing officer may be chosen on purpose. Perhaps the closer is particularly negligent, averse to confrontation, etc.

ii. Closing offices were very busy during the real estate boom. A particular officer could have multiple closings in a day. It was unwise to turn away business, especially from someone like X that has lots of deals to close.

h. Some mechanism must be in place to ensure that seller gets \$275K, but only \$275K of the \$350K that lender extended to straw to buy House A.

i. A wide spectrum from "disbursement agreements" submitted to the closing officer to double-closings with duplicate documents.

ii. Perhaps an agreeable seller opens a joint bank account with X's employee. Perhaps a falsified "addendum" for remodeling expenses that will never be done.

iii. This mechanism, whatever it is, will be an important part of the government's case–especially if the loan proceeds were not disbursed according to the **HUD-1**.

iv. The HUD-1 is the official tally sheet that serves as a record of the transaction. The HUD-1 shows where the money involved came from and where it ends up. The lender, seller, buyer, and title/closing company all get a copy of the HUD-1. The person or officer that oversees the closing is responsible for generating the HUD-1. Make certain that you understand all of the entries in the HUD-1. Be on the lookout for large chunks of money that seem out of place.

i. After closing, the sellers have their \$275K. Straw owns House A and will soon owe huge monthly mortgage payments. X has \$75K that he keeps, disburses to his employees, or uses to pay the monthly note on House A or other houses. The lender owns a $350K mortgage that is to be paid by straws that have no hope of paying and that is collateralized by a house that, just weeks prior, could be had for $275K.

i. The lender probably did not extend Straw the loan in hopes of making profit from the interest that straw would gradually pay. Rather, the lender likely hoped to make profit by selling the mortgage to another institution or entity.

ii. If the lender intends to sell Straw's mortgage on House A to someone else, what incentive does the lender have to double-check straw's documents or investigate his representations? All the lender really cares about is that the numbers are right (profitable).

iii. Stated income / stated asset loans. What are they?

j. At some point, it all falls apart because X is running what is essentially a pyramid scheme. Once his business gets too big to support itself, X stops making the monthly payments on House A because he runs out of money. When the lender, or whomever ended up with Straw's $350K mortgage, confronts Straw about the delinquency, Straw probably tells the lender to talk to X. Once foreclosure happens, the mortgage's owner double-checks the documents and realizes that the Straw's mortgage is substantially under-collateralized. Then, the FBI gets involved.

k. What was your client's role according to the gov't?

i. Investor / organizer (like X).

ii. Straw borrower or buyer

iii. "Bird-Dog"

iv. Appraiser

v. Closer

vi. Mortgage Broker

l. What the HUD-1 can look like with a MF scheme. See the enclosed examples for "House B" and "House C."

What Charges Will the Gov't Present to the Grand Jury?

I. From a statutory standpoint, there is no such crime as "mortgage fraud." So, what charges can X and others involved expect? How will the gov't argue that a defendant violated a particular statute?

A. The government's theory is likely to be that the lender was deceived by a combination of misstatements and omissions into extending a mortgage that it would not otherwise have made.

1. The "true" sale price of House A was $275K, so when the sales contract and loan application say $350K, it is a lie.

a. If lender knew that $75K of its loan was going to X instead of being used to part seller with House A, it would not have loaned so much money. So, this is a material omission.

b. The $350K appraisal for House A must be inflated because the seller would not be that wrong and the lender's re-appraiser says it is not worth that much. So, this is a material misrepresentation.

2. The "true" purchaser of House A was not Straw, but X. So when the loan application lists Straw as the applicant and

purchaser, it is a lie. When the sales contract lists Straw as the buyer, it is a lie. When the documents say that House A is to be a Straw's primary residence, it is a lie. So, these are all material misrepresentations.

a. If lender knew that someone other than Straw was supposed to make the payments on the mortgage, it would not have loaned Straw the money. So, another material omission.

b. If lender knew that House A was not for a primary residence but instead for an investment, it either would have charged a higher APR or not made the loan at all.

3. In determining whether to make Straw the loan, the lender took into consideration that Straw paid his own earnest money and similar costs. If X actually paid them, then not so advising the lender is a material omission. If X "loaned" the earnest money to Straw, then not advising the lender of this liability is a material omission.

4. There are fraudulent documents in the mortgage application that make the Straw appear to be more credit-worthy than he is and/or make House A appear to be more valuable than it is.

a. Rental agreements for House A or Straw's own home (income producing property is more valuable), tax returns or other documents showing Straw's income and employment.

5. In sum, the gov't will argue that a MF scheme employs a number of material misstatements and omissions and that these misstatements and omissions violated a number of statutes.

B. Conspiracy to Commit Wire Fraud and/or Bank Fraud.
18 USC § 1349 (18 USC §§ 1343 and 1344)

a. The § 1343 is a wire fraud count. The gov't theory will be that X and others devised a scheme to defraud and used material misstatements and omissions in order to make $. That is the "fraud." The "wire" will be the funds "wired" to closing by the lender, wired out to the various parties by the closing office, etc.

b. The § 1344 is a bank fraud count. The gov't theory will be that X and others enacted a scheme to defraud a "financial institution" out of money by making material misstatements and omissions in connection with the financial institution's extension of a mortgage.

c. The § 1349 is the conspiracy statute. It punishes the conspiracy the same as the underlying acts. Expect each house to be an overt act in the conspiracy count.

C. Substantive Wire Fraud and / or Bank Fraud counts

a. The gov't can use each house not only as an overt act for a § 1349 conspiracy, but also as a substantive § 1343 and/or § 1344 count.

b. If used as a substantive count, expect the gov't to add § 2 "aiding and abetting."

D. Money Laundering & Aiding and Abetting

a. 18 USC § 1956(a)(1)(A)(i) & 2
Using the proceeds of unlawful activity in a financial transaction to promote or carry out a specific unlawful activity.

i. The gov't may argue that X committed the crime of money laundering if he used the $75K check he received from the closing of House A to further the MF scheme. For example, X could have used all or part of the $75K to pay the Straw, pay X's employees, pay the note on

House A or a similar house, etc.

b. 18 USC §§ 1957(a) & (d)(1) & 2.
Engaging in monetary transactions with criminally derived proceeds.

i. The gov't may argue that X or one of his employees deposited their share of the $75K from the "sale" of House A in a personal bank account and that the money was criminally derived proceeds (wire fraud, bank fraud, etc.).

E. Your client's exposure

a. The statutes potentially at issue all carry huge maximum sentences, especially when added together. Up to 30 years per count.

b. The guidelines will not be kind. However, there is some good precedent out there when it comes time to litigate the loss amount. The "fair marked value" of the homes is to be credited against the amount loaned by the "victim" lender when determining loss. United States v. Goss, 549 F.3d 1013 (5th Cir. 2008).

QUESTIONS?

A. U.S.DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Final

B.TYPE OF LOAN

1. [ ]FHA 2. [ ]FM 3. [X]CONV. UNINS.
4. [ ]VA 5. [ ]CONV. INS.

6. FILE NUMBER:

7. LOAN NUMBER:

8. MTG. INS. CASE NO.:

C.NOTE: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked ("p.o.c.") were paid outside the closing; they are shown here for information purposes and are not included in the totals.

D. NAME OF BORROWER: STRAW

ADDRESS:

E. NAME OF SELLER: SELLER

ADDRESS: HOUSE B

SELLER TIN: 7066

F. NAME OF LENDER: LENDER Corporation 15-55

ADDRESS:

G.PROPERTY LOCATION: HOUSE B

H. SETTLEMENT AGENT: CLOSER

ADDRESS:

PHONE NUMBER:

SETTLEMENT AGENT TIN:

PLACE OF SETTLEMENT: TITLE CO.

ADDRESS:

PHONE NUMBER:

I.SETTLEMENT DATE
Closing date: 02/23/05
Proration date: 02/23/05

J. SUMMARY OF BORROWER'S TRANSACTION

100. GROSS AMOUNT DUE FROM BORROWER:	
101. Contract sales price	239,300.00
102. Personal property	
103. Settlement charges to borrower(line 1400)	7,970.44
104.	
105.	
Adjustments for items paid by seller in advance:	
106. City/town taxes to	
107. County taxes to	
108. Assessments to	
109. Maintenance to	
110. School/Taxes to	
111.	
112.	
120. GROSS AMOUNT DUE FROM BORROWER:	247,270.44
200. AMOUNTS PAID BY OR IN BEHALF OF BORROWER:	
201. Deposit or earnest money	500.00
202. Principal amount of new loan(s)	191,400.00
203. Existing loan(s) taken subject to	
204. Commitment Fee	
205. 2nd lien amount	47,800.00
206.	
207.	
208.	
209.	
Adjustments for items unpaid by seller:	
210. City/town taxes 01/01/05 to 02/23/05	134.73
211. County taxes 01/01/05 to 02/23/05	133.69
212. Assessments to	
213. School/Taxes 01/01/05 to 02/23/05	451.73
214.	
215.	
216.	
217.	
218.	
219.	

K. SUMMARY OF SELLER'S TRANSACTION

400. GROSS AMOUNT DUE TO SELLER:	
401. Contract sales price	239,300.00
402. Personal property	
403.	
404.	
405.	
Adjustments for items paid for seller in advance:	
406. City/town taxes to	
407. County taxes to	
408. Assessments to	
409. Maintenance to	
410. School/Taxes to	
411.	
412.	
420. GROSS AMOUNT DUE TO SELLER:	239,300.00
500. REDUCTIONS IN AMOUNT DUE TO SELLER:	
501. Excess deposit(see instructions)	
502. Settlement charges to seller(line 1400)	8,196.61
503. Existing loan(s) taken subject to	
504. Payoff of first mortgage loan	144,000.00
505. Payoff of second mortgage loan	
506. Repairs	64,500.00
507.	
508.	
509.	
Adjustments for items unpaid by seller:	
510. City/town taxes 01/01/05 to 02/23/05	134.73
511. County taxes 01/01/05 to 02/23/05	133.69
512. Assessments to	
513. School/Taxes 01/01/05 to 02/23/05	451.73
514. Maintenance to	
515.	
516.	
517.	
518.	
519.	

stewart
title north texas

OUTGOING WIRE TRANSFER FORM

Fax to Accounting Dept @ 972-715-5620
15950 Dallas Parkway #100, Dallas Texas 75248

Primary Signature: CLOSER | Unit: 30 | Bank: TCMC

Prepared By: CLOSER | Debit: 1411007873

The following section must be completed prior to accounting initiating wire:

1. I have received my funds to disburse on by: Wire Check
   (If by check, funds must be banked)
2. Have your funds been receipted in AIM? Yes No

******PROCEEDS/OTHER******

File Number: 75

Date: 2/25/05

Amount: $164,500.00

Bank Name: BANK ONE

City/State: ~~11000614~~ DALLAS TX

ABA/Routing Number: 11 4

Intermediary Bank:

ABA:

Beneficiary Name: X'S Real Estate Co. S
(name of party receiving funds)

Beneficiary Account: 302

ADDITIONAL INFORMATION

Customer Contact Info:

Customer Reference:

Other:

FOR BUILDER UNITS ONLY

Lot:

Block:

Subdivision:

Property Address:

Other:

FOR ACCOUNTING USE ONLY:

INITIATED BY: TIME: SEQUENCE:

CONFIRMED BY: TIME:

A. [redacted] Department of Housing and Urban Development
Settlement Statement
[redacted]y National Title Agency, Inc.

B. TYPE OF LOAN — OMB 2502-0265

1. [ ] FHA 2. [ ] FmHA 3. [ ] Conv. Unins
4. [ ] VA 5. [ ] Conv Ins

6. Escrow Number: 7. Loan Number:

8. Mortgage Insurance Number.

NOTE: THIS FORM IS FURNISHED TO GIVE YOU A STATEMENT OF THE ACTUAL SETTLEMENT COSTS. AMOUNTS PAID TO AND BY THE SETTLEMENT AGENT ARE SHOWN. ITEMS MARKED "(P.O.C.)" WERE PAID OUTSIDE OF THE CLOSING. THEY ARE SHOWN HERE FOR INFORMATIONAL PURPOSES AND ARE NOT INCLUDED IN THE TOTALS.

D. Name of Borrower: STRAW

E. Name of Seller: ... and Stacy Ringer
SELLER

F. Name of Lender: New Century Mortgage Corporation

G. Property Location: 75 Dal
HOUSE C

H. Settlement Agent: CLOSER

Place of Settlement: TITLE CO. 00

I. Settlement Date: 10/28/04

J. SUMMARY OF BORROWER'S TRANSACTIONS		K. SUMMARY OF SELLER'S TRANSACTIONS	
100. GROSS AMOUNT DUE FROM BORROWER		400. GROSS AMOUNT DUE TO SELLER	
101. Total Consideration	399,000.00	401. Total Consideration	399,000.00
102. Personal Property		402. Personal Property	
103. Settlement charges to borrower (line 1400)	3,943.31	403.	
104.		404.	
105.		405.	
Adjustments. Items Paid by Seller in Advance		Adjustments: Items Paid by Seller in Advance	
106. City/Town Taxes		406. City/Town Taxes	
107. County Taxes		407. County Taxes	
108. Assessments		408. Assessments	
109		409.	
110.		410.	
111		411.	
112		412	
[redacted]		413.	
		414	
		415.	
116		416.	
117		417.	
118		418.	
120. GROSS AMOUNT DUE FROM BORROWER	402,943.31	420. GROSS AMOUNT DUE TO SELLER	399,000.00
200. AMOUNTS PAID BY OR IN BEHALF OF BORROWER		500. REDUCTIONS IN AMOUNT DUE TO SELLER	
201 Deposit or earnest money	1,000.00	501. Excess deposit (see inst.)	
202 Principal Amount of New Loan(s)	318,400.00	502. Settlement charges to seller (line 1400)	15,732.73
203. Existing loan(s) taken subject to		503. Existing loan(s) taken subject to	
204. 2nd New Loan	79,600.00	504. Payoff To ABN AMRO Mortgage	249,802.10
205		505.	
206.		506.	
207		507.	
208		508.	
209		509.	
Adjustments. Items Unpaid by Seller		Adjustments: Items Unpaid by Seller	
210 City/Town taxes		510 City/Town Taxes	
211 Taxes fr 01/01/04 to 10/28/04	2,734.60	511. Taxes fr 01/01/04 to 10/28/04	2,734.60
212 Assessments		512 Assessments	
213		513.	
214.		514.	
215		515.	
216		516.	
[redacted]		517.	
		518.	
		519	
220 TOTAL PAID BY/FOR BORROWER	401,734.60	520. TOTAL REDUCTIONS IN AMOUNT DUE SELLER	268,069.43
300. CASH AT SETTLEMENT FROM/TO BORROWER		600. CASH AT SETTLEMENT FROM/TO SELLER	
301. Gross amount due from borrower (line 120)	402,943.31	601. Gross amount due to seller (line 420)	399,000.00
302 Less amounts paid by/for borrower (line 220)	401,734.60	602. Less reduction in amount due seller (ln 520)	268,069.43
303. CASH (XX FROM) (TO) BORROWER	1,208.71	603. CASH (FROM) (XX TO) SELLER	130,930.57

000001

Mortgage

Transaction Letter of
Disbursement Agreement

Attn: Closing Officer

Re: Real Estate Closing Transaction: HOUSE C

_________________________________ (Address)

Closing Date on or before: 10-28-2004

I SELLER (Seller) hereby acknowledge, and confirm a mutual agreement to sell the above referenced property. It is understood that net proceeds from the sale are in the amount of $ 130,930.57, and I (seller) hereby direct the Title Company Establishment to disburse proceeds as indicated. We request disbursement of separate checks to the clients documented below. Disbursement of the $ 130,930.57 proceeds from this real state transaction are as indicated. The seller will receive $ 35,105.36 and the balance of the proceeds are to be distributed as indicated.

1. X'S Real Estate-Co. (Client) / Disbursement Proceeds $ 67,077.65
2. Bird Dog #1 (Client) / Disbursement Proceeds $ 14,373.78
3. Bird Dog #2 (Client) / Disbursement Proceeds $ 14,373.78
4. ______________ (Client) / Disbursement Proceeds $______
5. ______________ (Client) / Disbursement Proceeds $______

It is hereby acknowledge and confirmed that the referenced sale and disbursement of proceeds is agreeable to all parties. It is hereby agreed to indemnify and hold the Title Company Establishment harmless regarding the sale, and disbursement of sales proceeds.

Acknowledge and confirmed.

Sign: [illegible signature] SELLER (Seller) Date: 10/28/04

Sign: [illegible signature] SELLER (Seller) Date: 10/28/04