INSIDE THE MINDS™

MORTGAGE AND FINANCE FRAUD LITIGATION STRATEGIES

LEADING LAWYERS ON MANAGING THE COMPLEXITIES OF FRAUD CASES, UNDERSTANDING GOVERNMENT REGULATIONS, AND STRUCTURING AN EFFECTIVE LITIGATION PLAN

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Recent Developments and Issues in Mortgage Fraud Cases

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Introduction

I am the managing partner of Shustak Reynolds & Partners PC, a boutique firm with offices in California and New York. I have practiced law for forty years. I am originally from New York, where I started practicing at a large, top law firm. I formed my own firm thirty-eight years ago.

Over the years, my practice has primarily focused in the area of financial and securities fraud. We have represented many companies and individuals who have been the victims of various kinds of securities and financial fraud schemes, ranging from mortgage fraud to "Ponzi" schemes to Mafia-controlled "pump and dump" operations. Many of our clients have been victims of all kinds of financial abuse. We represent financial institutions, including banks, mortgage companies, mortgage brokers, broker dealers, investment advisors, individuals, and various types of businesses. I have seen quite a bit of mortgage and financial fraud over the past forty years, and it definitely is a high-profit, growth industry. Just as hard as most people work for their entire lives, others spend their time devising schemes and scams to separate the hardworking folks from their hard-earned money.

Recent Trends in the Mortgage Fraud Area: Macro and Micro Levels of Fraud

We learned a great deal about mortgage fraud when the bottom fell out of the housing market in 2007–2008. There is an old saying: "A rising tide raises all boats, and you do not know who is swimming naked until the tide goes out." That certainly was true of the real estate and mortgage boom and bust of the first decade of the twenty-first century. What we saw happening in 2007–2008 continues to this day because fraud is a lucrative business—there is fraud in both good times and bad. It is a recession-proof business, and mortgage fraud is no exception.

Essentially, there are two levels of mortgage fraud. The first is what I refer to as the "macro" level, which involves huge tranches of residential mortgage-backed securities (RMBS). These securities consist of large amounts of individual mortgages that were packaged and then sliced, diced, and cut up into many different tranches of securities, each with a particular twist intended for investors looking for a particular income stream or yield with different appetites for risk. Many of these packaged bundles of mortgage securities were then sold to investors, mostly financial institutions. Some of the institutions kept the bundles, while others, like brokerage firm "wirehouses," in turn, sold pieces of those bundled, securitized mortgages to individual investors in a retail distribution. Billions of dollars of fraud goes on each year at the macro level, typically by the institutions that purchase, originate, and bundle those individual, residential mortgages.

The second level is what I refer to as the "micro" level of fraud, typically involving an individual or group of individuals who commit fraud in connection with one or more individual mortgages. In the micro mortgage fraud world, there essentially are two types of fraudsters—individuals who commit mortgage fraud for profit and those who commit mortgage fraud for housing. The individual who truly cannot afford a home he or she actually wants to live in and who either overinflates his or her income or understates his or her liabilities, and the person acquiring a second, vacation home but states on the mortgage application the home will be the primary residence—both of those individuals commit mortgage fraud for housing.

Conversely, mortgage fraud for profit typically involves a small group of individuals simply looking to make a profit by committing mortgage fraud, not to acquire a home to live in. This group includes unscrupulous real estate agents, mortgage brokers, speculators, and individuals who enlist other people to work with them in committing mortgage fraud. Their goal is to make a profit out of mortgage fraud on an individual level. This could be the fraudster who approaches an unsuspecting homeowner with an upside-down mortgage; assures her that he can help her out of her problem by selling the home to a dummy or "straw man" at an artificially high price; obtains a mortgage for more than the property is worth; pockets the difference after paying off the first mortgage; and then walks away from the property, leaving the unsuspecting homeowner with neither a home nor a profit. Or it could be the scamster who approaches a desperate homeowner with a defaulted mortgage, promising to help renegotiate the mortgage for a fee; takes the fee and either walks away or negotiates unacceptable refinancing terms the homeowner cannot afford and then walks away, having pocketed a nice fee for virtually no work. These people commit mortgage fraud on an individual level for profit—not because they want to acquire property to live in.

All of the various types of mortgage fraud that are committed each year, whether fraud for ownership or fraud for profit, represent a great cost to society as a whole. Banks and other lenders are left with defaulted mortgages, some of which are packaged with other mortgages into the huge world of mortgage-backed securities. The RMBS market is a multi-trillion dollar industry—one of the biggest industries in the world. In the United States, we package more mortgage-related financial products on a gross number level than almost all other manufacturing businesses put together. The macro fraud level in this area is able to be perpetuated by all of the micro frauds going on that generate bad mortgages, which are then packaged and bundled together with good mortgages. When banks and other institutions are left with bad, fraud-based mortgages, a wide swath of shareholders of the institutions are left to bear the loss. When institutional investors, such as some of the large pension plans, are sold toxic mortgage-backed securities, the pensioners ultimately endure the worst of the losses.

Facts and Figures

Mortgage fraud is a growth business—and the numbers are quite mind-boggling. The most recent numbers I was able to find cover the twelve-month period ending in the second quarter of 2014, figures compiled within the past twelve months. Of the cross-section of mortgage loan applications surveyed and studied for that period, 11,100 residential mortgage loan applications, accounting for approximately $19.8 billion worth of individual mortgage loan applications, contained some kind of fraud. It should be noted that I am referring only to the incidences of fraud that have been identified from that selected cross-section of mortgage applications. There no doubt were many more. This is just the tip of the iceberg we are able to see above ocean level.

Simply put, more than 11,000 individual applications for loans that totaled just under $20 billion in a twelve-month period contained one or more fraudulent pieces of information, and in that same period, there was a 3.2 percent increase in mortgage fraud from the prior twelve-month period. Now, 3.2 percent does not sound like a big increase, but 3.2 percent of $20 billion is serious money.

Unfortunately, this type of fraud is growing—primarily on the micro level. On the macro level, the world where hundreds and thousands of individual mortgages are being packaged into large mortgage-backed securities, at least for now, the game has changed. Following the real estate crash of 2007–2008, like the old game of musical chairs, when the music stopped and the bottom fell out of the market for continued sales of mortgage-backed securities, there were people who did not have chairs to sit in. These people wound up holding, and not being able to sell, highly toxic bundles of mortgages that were extremely complicated and contained many different "slices," or tranches, of individual mortgages. It was like carving a chunk of baloney into 1,000 thin slices and selling each slice to a thousand people around the world. Even if you wanted to put the baloney back together, just finding out who had a slice of baloney from a particular chunk would be next to impossible. In the case of mortgage bundles, nobody knew who was holding what.

For instance, assume you gave twenty people twenty boxes that all looked the same. Each was sealed in the same wrapping, and each was the exact same size, shape, and box. You then told those people that only one of the boxes contained toxic waste, and asked them to try to guess who had the box with the toxic waste and decide whether each wanted to hold or trade the box they were given. You would soon find that nobody would want *any* of the boxes—even if you told them all but that one toxic box contained a $100 bill.

Similarly, because so many large institutions were burned in the recent mortgage-backed securities crisis, the macro level of fraud in this area is much lower. Institutions that were left without a chair to sit in—i.e., without a market to sell their potentially toxic bundles of mortgage-backed securities—are much more careful about buying those boxes that may or may not contain toxic waste. There is still a backlog of cases that are being settled and wrung out of the system, but I think the level of macro fraud has been greatly reduced primarily because the potential buyers of those types of mortgages are no longer willing to take the risk of buying—and potentially getting stuck holding—a box with toxic waste in it.

The same, however, cannot be said about fraud on the micro level, particularly with respect to conforming loans guaranteed by the Federal Housing Administration (FHA) or another one of the government agencies that insure and guarantee those loans, making them much easier to resell to investors and others. These conforming, government-insured or government-guaranteed loans typically require a loan-to-value ratio of 80 percent and up. Unfortunately, the fraud in this micro area is continuing and growing, as noted, for a number of reasons.

One reason pertains to the geographic areas where the fraud is being committed. I recently read a 2015 publication called the *Mortgage Fraud Program*, published by Fannie Mae, one of the government agencies that insure so-called conforming mortgages. Fannie Mae conducted a loan review that was completed at the end of August 2015—a review of all of the mortgages that were issued in the prior twelve months—and put together a list of "Fraud Finding Statistics" that broke down mortgage fraud on the micro level into a number of categories. The first category focused on the question of where the fraud is, which is generally some kind of misrepresentation in the loan application. Where in the United States was the fraud occurring in 2013, as compared to 2014? Fannie Mae found that the state with the highest percentage of fraudulent mortgage loan applications was California. In both 2013 and 2014, California loans accounted for more than 26 percent of fraudulent loan applications. The state with the second-highest level of mortgage fraud was Florida, which issued between 14 percent and 16 percent of all fraudulent loan applications. The bulk of all fraudulent loan applications have been coming from just a couple of states.

Why California and Florida? Simple reason: California and Florida are warm, mild-climate states that are desirable to live in. That desirability, in turn, makes housing dear and housing costs high. California is the leader in mortgage fraud because housing in southern and northern California, in particular, is extremely expensive—in fact, it is one of the most expensive housing markets in the country. Most people cannot afford homes in this state based on what they actually earn. Therefore, there is a great incentive for people who are looking for a home to occupy to commit what they consider "necessary housing mortgage fraud" to acquire a house they want but cannot afford. They may even have the best of intentions—e.g., they may assume that their income will eventually go up or that they will come into some money and easily justify fudging income, liabilities, expenses, or some other data on a mortgage application—but it is fraud nonetheless. The reasons for the fraud do not change the nature of the fraud.

Florida has a high degree of mortgage fraud for similar reasons. It is also a coastal state with a mild climate that is desirable to an aging US market looking for a pleasant retirement or vacation home. Since the early days of land speculation in Florida in the 1920s, developers and builders have always overbuilt Florida when the market was hot and booming—as in the early 2000s. Then they wound up with a huge number of unsold properties when the bottom fell out of the real estate market seven or eight years ago. The banks were forced to foreclose on developers' construction loans and speculators' mortgages, given the huge inventory of unsold properties in Florida. Those lenders, in turn, sold off unfinished condominium developments and unoccupied units that had been snapped up by speculators hoping the market would continue to rise.

With the large number of unfinished projects in the state, Florida lends itself to so-called location fraud. The state is home to numerous properties that were left unfinished or in disrepair, and they were not properly maintained or finished as planned. It is somewhat counterintuitive, but when an institutional lender forecloses on a property, it typically does not take care of or maintain the property. Those lenders do not want to assume responsibility for actually finishing or maintaining the property. They may fence it off and lock it up, but they do not maintain the property and make sure that everything is kept up to snuff. They do not water the lawns, fix leaking pipes, or repair damage that occurs on the properties. Instead, they simply foreclose on the properties and leave them untouched until they can figure out what to do with this real estate-owned collateral.

As the Florida housing market recovered, however, and legitimate, well-maintained, and finished projects and properties have increased in value, some speculators who acquired these previously foreclosed properties—which are not in the same condition and not worth the same amount as higher-priced, better-maintained property in the same general location—are able to commit so-called evaluation fraud. They say to an unsuspecting lender, "My property is in this zip code, and in this zip code, the typical condominium sells for X dollars a square foot. Therefore, my unit is worth the same amount of money as the unit down the street, even though mine is in disrepair, and the other one is in pristine condition." Since a well-maintained condo unit may be worth much more than a poorly maintained unit in an unfinished project around the corner, we find that the previously overbuilt Florida market has lent itself to a growing amount of micro fraud.

Current Mortgage Fraud Issues

In 2013, some 55 percent of individual fraudulent loan applications that were inspected and analyzed by Fannie Mae—a share that increased to more than 70 percent in 2014—involved a failure to disclose accurately the liabilities of the borrower. Alternatively, people who are intent on committing this type of fraud will review their credit scores and dispute every liability listed, knowing that, while the liability is being disputed (even though there is no basis for disputing it with Equifax or the other credit agencies), it will not appear as a liability on the credit report. Once a liability is disputed for a period, it is put into a different category on a credit report—in fact, such liabilities will not show up and count against the borrower's credit report and credit score.

The second-largest area of individual mortgage fraud is owner-occupancy fraud, which has decreased from 19 percent to 12 percent recently but still is a large percentage of mortgage fraud. Owner-occupancy fraud is simply certifying in the mortgage loan application that the home is intended to be used as a primary residence when, in fact, it will not be. There is a much lower incidence of mortgage foreclosures and defaults for owner-occupied properties. Certifying to a lender that you intend to live in the home, when you actually are acquiring it for investment or as a second or third home, is one type of mortgage fraud. The average person believes that potential mortgage borrowers overstating their income is the largest category of mortgage fraud, but in its study, Fannie Mae found that just 7 percent to 8 percent of fraudulent loan applications contained a misstatement of actual income. Primary residence, overstatement of value, and understatement of liabilities actually account for a much higher percentage of mortgage fraud.

Another key factor that has caused an increase in mortgage fraud is that the housing market has come back from where it was in the depths of the recession of 2008–2011. Starting in 2012, the market rebounded. At the same time, mortgage rates stopped falling—by 2012, they had hit their all-time low. By then, most potential buyers of residential property who had stayed on the sidelines waiting for the bottom to fall out of the market realized that prices had stabilized and were starting to go up. At the same time, mortgage rates were hitting all-time lows, with not much more to go down. By the end of 2012, most of those potential buyers who had been waiting on the sidelines to buy made the decision that it was the right time to get into the market and buy. Those qualified buyers had good credit and money for their down payments.

By 2015, most of the people who had good credit scores, had cash for their down payments, and could qualify for mortgages had already entered the market and purchased homes. What was left over, however, was a group of people who had marginal credit, had little or no cash for a down payment, and could not qualify for a mortgage to buy the home they wanted. As a result, while we saw less mortgage fraud in terms of the applications that were filed in the last two years or so, we are now seeing an increase in fraudulent applications because many of the people who are now trying to get into the market do not have good credit or sufficient funds to qualify for a mortgage loan.

Since the end of 2011, we have seen home values and prices rise—but we have also been seeing some equity issues that may lead to fraud. For example, assume a home was worth $500,000 at one time, and its owner has a $400,000 mortgage. When the value of the property went down to $400,000 or $350,000, there was no room or ability for that homeowner to refinance his property. When home values eventually rose above where they had been in 2007–2008, however, many homeowners suddenly found that they had paper equity left in their property. As a result, they now were able at least to consider refinancing their higher-cost, higher-rate mortgages. Those people with high loan-to-value ratios have been able to come into the marketplace and refinance their mortgages—and studies reveal that many of those applications contain some kind of mortgage fraud.

Among this group are the homeowners who overextended themselves to buy their homes to begin with. They took out "liar" no-income-verification loans, 100 percent mortgage loans, or some other mortgage loan that got them into trouble in the first place. These people are trying to refinance to a lower rate so they actually can afford to live in the homes they never should have purchased but were able to because of all of the creative mortgages intended to allow people to acquire a home but not necessarily hold on to it or keep up their mortgages as the initial "teaser" rates rose, along with the monthly payments. In other words, some people who were in trouble to begin with and who held on to their properties are now committing mortgage fraud to be able to continue staying in their homes with lower monthly mortgage payments. These people are desperate to refinance away their costly mortgages, and if committing mortgage fraud does that, that is just what it takes.

Victims of Mortgage Fraud

Who are the victims of mortgage fraud? The simple answer is that we all are.

Most of us have read about the recent settlements involving some of the major banks that were sued by the institutions that bought toxic mortgage-backed securities packages. Let us say that J.P. Morgan agrees to pay $500 million to settle such a case, and the lawyers who worked on the case will get a big chunk of that money. Where does that money come from? It comes from the shareholders—the tens of thousands of people who own shares of J.P. Morgan; the executives of the bank do not suffer. Large financial institutions are also owned, in large portion, by pension funds or by individual investors who have small stock portfolios. Therefore, as previously stated, the cost of bailing out a large financial institution that has committed mortgage fraud is borne by everyone.

When Fannie Mae or Freddie Mac insures a mortgage that turns out to be a fraudulent mortgage that someone walks away from or that is flipped or flopped, and the government has to make good on the mortgage because they guaranteed it to the investor, we all have to bail out the government agencies—i.e., Fannie Mae, Freddie Mac, and others that insure mortgages. Our society as a whole and our entire economy bear the cost of dealing with fraudulent mortgages. Some individuals profit from mortgage fraud, but our society as a whole is saddled with the cost.

Mortgage Fraud Remedies

Mortgage fraud remedies on the macro level tend to be brought as class actions. Typically, claims are asserted by the buyers of residential mortgage-backed securities—buyers that tend to be well-known, large institutions such as Allstate Insurance Co., AIG, Massachusetts Life Insurance Co., and the Federal Housing Finance Agency, which is the receiver for Fannie Mae and Freddie Mac. These are large institutions, and many of their claims are asserted as class actions, with claims brought under §§11 and 12 of the

Securities Act of 1933.[1] These claims tend to be brought by investors that purchased these toxic securities as part of an initial public offering (IPO), rather than as a private transaction or a purchase in the secondary market. It should be noted that these claims do not require proof that an actual misrepresentation was made—just proof that there was a misstatement or a material untruth in the offering materials. If, for example, a mortgage-backed securities offering memorandum stated that 90 percent of the mortgage loans in the portfolio contain mortgage loans made to borrowers with A credit or better, and that is not accurate, just proving the misstatement in the prospectus is sufficient to prevail. No proof that an investor actually read the prospectus, or relied on that representation is required to prove a case under § 11 or 12. These are strict liability claims.

Conversely, with respect to those people or institutions that did not purchase securities in an IPO—i.e., they bought in the secondary market or as part of a private placement—their claims are brought under the Securities Act of 1934, Section 10(b) and Rule 10(b)(5).[2] This is an anti-fraud provision wherein you must show that there was a material misrepresentation involved; that you relied on it reasonably; and, more important, that the defendant acted with the scienter or the intent to commit a fraud. This is a much higher standard of proof than a strict liability statute, which requires only that there was a false or untrue statement in the prospectus.

Most states also have their own securities laws. California, for example, has a very effective anti-fraud statute that is similar to Sections 11 and 12 of the federal Securities Act, wherein all that you have to show is that there was a factual misrepresentation in the offering materials, even if no one intended it to be in those materials; and there are common law claims for fraud and negligent misrepresentation under state laws, as well. These claims tend to be the kinds that are brought on the macro fraud level.

On the individual/micro level, there are both criminal and civil causes of action. When the government brings a criminal proceeding on the federal level, there is really one of three statutes that is used. There is a federal bank

[1] Securities Act §§ 11, 12.
[2] Securities Act § 10(b).

fraud statute (18 USC Section 1344),[3] which basically says that if you take an action that you intended to and do indeed defraud a bank, then you have committed a criminal violation, and the penalties are quite severe—i.e., a minimum of $1,000 or more in financial penalties, but, more important, up to 30 years of imprisonment. That statute has been around since the 1920s.

The Importance of FERA

In 2009, the federal government passed the Fraud Enforcement and Recovery Act (FERA)[4] as a direct result of the problems we experienced in 2007 and 2008. That statute amended the definition of a financial institution to include a mortgage lending business. Prior to 2009, if you committed mortgage fraud and attempted to or did defraud a mortgage lender, banker, or broker, that was not considered a criminal act under federal law. However, since FERA was passed in 2009, modifying the definition of a financial institution to include a mortgage lending business, the Justice Department has the capability to prosecute mortgage fraud cases as bank fraud and to seek enhanced penalties under the federal mail and wire fraud statutes. As a result, convictions for mortgage fraud, which could include fraud on a mortgage lending business, now carry a maximum thirty-year prison sentence, a maximum $1 million fine, or both.

The body of mortgage fraud law has evolved in recent times for several key reasons. The government—including the Federal Bureau of Investigation (FBI), Fannie Mae, and other agencies—conducted studies to determine how the mortgage fraud crisis happened, and they came up with a number of conclusions. One of the major conclusions was that some mortgage lending companies were either allowing their businesses to be used to commit mortgage fraud or committing mortgage fraud on their own volition, but because they were mortgage lending businesses, they were not subject to the regulations that applied to banks.

Ultimately, the government had to decide whom they wanted to go after and what penalties they could impose in this area. They initially lost a few cases where they tried to prosecute either individuals or institutions under the Federal Bank Fraud Statute because it often turned out that certain banks had

[3] 18 U.S.C.A. § 1344.

[4] Fraud Enforcement and Recovery Act, Pub. L. No. 111-21, 123 Stat. 1617.

their mortgage lending businesses set up as subsidiaries. In fact, one federal case in this area went up on appeal, and the court said that if a mortgage lending business is a bank subsidiary and it becomes the target of mortgage fraud or has committed mortgage fraud, you cannot rely on a federal bank fraud statute to prosecute the mortgage lender because, again, the mortgage lending business is not a bank; it is a separate subsidiary. Consequently, the government realized that it needed to expand the definition of bank fraud because banks were not the only entities being defrauded; much of the abuse in this area involved mortgage lending businesses, and that abuse fueled the growth of the mortgage business from the late 1990s through 2007.

Trends in Borrower and Lender Fraud

Fraud is either the first or the second oldest industry in the world. As my father always told me, if there is no cost of doing business and no inventory to deal with, then everything you get is profit. Certainly, if you are committing fraud, all you are actually doing is generating some paperwork and getting money at no cost. Unfortunately, the profit margin of fraud is very high. Therefore, for many people, committing fraud is worth the risk of a potential thirty-year incarceration.

Much of the fraud in this area involves fraudulent supporting loan documentation, where people submit forged or altered paycheck stubs or other false documentation to obtain a mortgage. We also see cases involving property flipping—i.e., someone buys a piece of real estate, gets an inflated appraisal of that property, and then quickly resells it and pockets the money from the sale. Usually the lender then winds up with a property that is foreclosed on, while the fraudulent appraiser and the scamster divvy up the proceeds.

We also see cases involving "straw buyer" fraud, where the actual borrower's identity is hidden. In other words, an individual can pay someone else to act as the buyer and borrower in their stead if the individual is not creditworthy. The straw buyer then turns the property over to the actual person in interest—and the property usually winds up going into delinquency at some point. This a very popular scam, even in this age of instant recording and high technology.

The fact is that most offices where deeds and mortgages are recorded are running behind by anywhere from three to five weeks in recording those deeds/mortgages. As a result, an unscrupulous buyer or borrower will often indicate a false source of a down payment on an 80 percent mortgage. They may say, "I am getting my down payment from these funds that I have in my bank account"—but those are actually funds that someone involved in the scam gave the person months ago, knowing that a bank asks for only the last two to three months of bank statements. Therefore, if someone else happened to put money into the borrower's bank account as little as four months ago, it will appear as if the borrower has a large amount of money in his bank account to cover a down payment.

The borrower then applies for two loans without disclosing to either lender that he is applying for another loan—he applies for a regular mortgage and, at the same time, a home equity line of credit (HELC) or a second mortgage, and he closes on both loans on the same day or back-to-back days. Again, neither lender is aware that the other lender has made a loan because the property recordings are done simultaneously. As noted, the recording offices are backed up by three to five weeks in most places, and after a loan closes, nobody looks at the documentation or does a search until two to three months later. In fact, nobody does a search at all until the property is in default and the bank has to start foreclosure proceedings. That is what is called a "silent second mortgage" scam.

Another scam that is prevalent, simply because so much identity theft is going on, involves stealing someone's identity and applying for a loan in that person's name. In many cases, the person whose identity was stolen has no idea that her identity was ever used to obtain a mortgage. In other words, a property might be purchased or a mortgage taken out in your name, and you would never know that your identity was used to commit mortgage fraud until the scamsters have already gotten their money and let the property go into foreclosure or rented it out, collected the rent, and then walked away from the property.

Similarly, there are inflated appraisal scams, which are always done with the collusion of an unscrupulous appraiser working with a mortgage broker or loan officer. The typical scam works this way. A sale is arranged from an owner to a straw-man buyer with a contract that is much higher than the actual value of the home. Let us say the home is worth $100, but the contract is written at $150. The dishonest appraiser certifies the home is actually worth $150 and, assuming an 80 percent loan-to-value mortgage loan, the straw-man buyer gets a loan for $120, buys the house for $100, and splits the extra $20 with the others in on the scam. Then he rents the house, pockets the rent, never pays the mortgage, and walks away from the property when the lender forecloses, which typically takes several years to wind through the system.

I once saw a show about card cheating in Las Vegas. One of the stories involved a fraudster who had his toes rigged to wires so that he could tap different combinations of his toes to keep track of the cards. That information was fed to a computer inside his pocket and was then relayed to a confederate. This scam took so much time and effort to develop and perfect, that I thought the scamster would have an easier time earning an honest living than putting all that work into this act of gambling fraud—not to mention having his toes broken when the casino realized he was cheating and took him into a locked room to "educate" him. I have learned, however, that some people know how to do things only the dishonest way and typically have time on their hands to think about how they will take money away from someone else. In my experience, most of the people who commit fraud just never think they will be caught.

The Role of Banks in Enforcing and Investigating Mortgage Fraud Crimes

Aside from the passage of FERA, there has not been much new legislation in this area recently. The government cleaned up the old Bank Fraud Act[5] and is leaving the task of resolving disputes in this area to private civil litigation.

Banks and lenders now have a better understanding of what they are looking for in a loan package and no longer rely on ratings from S&P, Moody's, or another bond rating firm, having learned that an A rating does not actually mean very much, and are conducting much more due diligence on packaged mortgage loan products. The problem is that just one individual represents the first line of defense against mortgage fraud—the bank mortgage officer—and as the housing market heats up and more loans are being issued because banks want to make money, bank mortgage officers tend to become a little overwhelmed, and they may miss some things they would otherwise catch. A busy loan underwriter handling several hundred mortgage loan applications

[5] See 18 U.S.C.A. § 1344.

just does not have all of the time and resources needed to conduct thorough due diligence on every loan application. The lending officer, the customer, and the brokers all want the deal to go through and the loan to close. Underwriters have to rely on the truth of some of the data in those loan applications and on the honesty and correctness of the appraisal, credit score, and other portions of the underwriting process. And loan underwriting is not a profit center for a bank or institution, typically drawing, unfortunately, lower paid, less qualified candidates to its ranks.

The biggest change that I have seen in this area can be found in the underwriting process, with respect to the types of loans that no longer are available that led to many defaults by borrowers who never should have received the loans they did. For example, "liar loans" or "no-income-verification" loans are no longer available, and the once-popular interest-only loans are virtually gone, as well, along with balloon mortgages and teaser rates on mortgages. Banks are trying to change the products that were leading to the highest amount of defaults and abuse—the kinds of products that allowed people to purchase a property by making a low monthly payment upfront that would inevitably go up over time. Properties purchased with such financing products would often wind up in foreclosure. Simply put, many people found that they could not afford the increased payments that went along with teaser rates, balloon mortgages, and mortgages with a lifespan of more than thirty years. Those products are now gone, and while I think that development has been a big help, it obviously has not eradicated mortgage fraud.

Third Parties that May Be to Blame for the Perpetuation of Mortgage Fraud

Third parties that may be to blame for the perpetuation of mortgage fraud include some real estate brokers and appraisers. Typically, a dishonest mortgage broker works with a dishonest appraiser—someone who is willing to write an appraisal that is not accurate. In the case of a government-insured mortgage, the government often winds up picking up the pieces in these types of schemes.

In fact, the government recently arrested more than 30 people who were involved in a mortgage fraud ring that involved inspectors who were hired by banks to keep an eye on their inventories of foreclosed properties (known by banks as REO properties—real estate-owned). Those inspectors filed fraudulent deeds, purporting to convey the bank properties to themselves and their confederates. They then leased out the homes—which were actually bank-owned, empty, foreclosed properties—and pocketed the rent. These inspectors were supposed to be guarding the gates of empty homes, but instead they leased them out in their own names and put the money in their own pockets—and this scam went on for years. It was discovered only when an honest inspector, who was not in on the scam, realized that what were supposed to be empty, foreclosed properties had been rented to unsuspecting victims.

Unfortunately, lawyers are also often involved in popular mortgage fraud scams. A lawyer may advertise on TV or in the press with the message, "Are you facing foreclosure? We can bring a lawsuit on your behalf. We also offer credit counseling." Some lawyers take fees upfront after promising to help a borrower get her money back and refinance her mortgage—and then they either do nothing or renegotiate the borrower's mortgage on terms that are completely unacceptable to the borrower, who is in a difficult spot to begin with.

A simple example is an ad directed to desperate homeowners facing eviction. They are promised help by, often, an entity called Homeowner's Help Hotline or some similar name. They are told banks always renegotiate their loans and, for an upfront fee of several to many thousands of dollars, the hotline company can help them out of their problems by renegotiating the mortgage loan. The upfront fee is paid; no viable renegotiation takes place; and the unsuspecting homeowner is left in the same position, but with less desperately needed cash.

Sadly, I recently read an article about lawyers who are now the driving force behind mortgage scams. One law firm in Florida was signing up borrowers in default of their mortgages who each paid $3,000 to $4,000 in upfront fees, as well as monthly fees—purportedly so that the law firm would bring class actions on behalf of the homeowners to sue their banks and force them to refinance their properties. The lawyers, however, just filed stock complaints that eventually were all dismissed or withdrawn. One law firm took in more than $2 million over a twelve-month period doing this and then disappeared. These kinds of scams occur because people are desperate; their home is the biggest asset in their world, and there is so much at stake that they are ripe for being taken advantage of.

Preparing a Litigation Strategy in a Consumer Claim of Mortgage Fraud

The problem with bringing a consumer claim of mortgage fraud is that these types of claims must be brought as class actions or group actions. That is largely because the average person who has been the victim of some kind of mortgage scam and lost his house or is about to lose his house has no money to pursue a case—and the damages he may receive at the end of the case are not, in and of themselves, enough to warrant individual litigations. More important, the people he is suing are scamsters, and people like that tend to disappear. Therefore, there is not much you can do in these cases unless you can find a "deep pocket," such as a bank or a lending institution, that has somehow been complicit in the scheme. Again, these cases are usually brought as class actions because grouping them is the only way they can be handled effectively and efficiently; nobody has the money to pursue his own individual claim.

Consequently, the first step in preparing a litigation strategy in a mortgage fraud case is to identify a deep-pocket defendant who has some liability or complicity in the case—perhaps an institution that had a rogue employee or employees who assisted people in generating fraudulent mortgages, and that institution failed to see the red flags. Such warning signs might include overinflated appraisals, credit scores and assets that do not match the stated income, and other missed opportunities to catch the fraud before the loan is funded. Simply put, you have to find a deep pocket to sue because many of the people who commit mortgage fraud and engage in flipping properties and short sales without disclosing their real intent are not deep pockets. As noted, they are often people whose assets are nonexistent, or by the time you find them, their money is somewhere else, and it is very hard to track it down. So you need to ask yourself: Who is a deep pocket that is worth pursuing—i.e., someone who would be left standing at the end of the case?

Our firm has brought claims against title companies; for example, we recently brought a case against a title company on behalf of a large number of people who were victims of second mortgage fraud. This particular title company had an employee who was working with scamsters and issuing phony title insurance. He was telling people, "Yes, you now have a second mortgage," when in fact they had a third or even fourth mortgage, and they were wiped out of their investment. In this case, we went after the title company, but we were not able to get anywhere because the title company's legal defense was that it was not generating the title reports. You can see that it can be very difficult to find a deep pocket to sue in these cases.

Many of the people who have been victimized by mortgage fraud, especially in Southern California, are victimized in so-called second mortgage or second deed of trust mortgage scams, which are essentially Ponzi schemes that take in a great deal of money. For example, our firm once represented a group of more than forty investors who collectively lost $80 million by investing in what they thought were second mortgage deeds of trust—and there was either no deed of trust or the money just went to the scamsters. Unfortunately, the individual who perpetrated the fraud, with his more than forty companies, ultimately filed bankruptcy. Although assets were obtained through settlements with third parties, the administrative and legal expenses ate up what little was recovered, leaving our clients with just pennies on the dollar for their losses.

Again, we tend to get involved primarily in representing groups of people—rarely individuals—because there is no economic basis for pursuing such claims. Someone who has lost a house in foreclosure and been victimized by a mortgage scam is not the kind of person we are set up to represent—there is no money to pay for that type of lawsuit.

In one of these cases, the only deep pocket we could find was the title company; we were able to get at least some money back for our clients because the title company wanted to avoid the risk of litigation. However, in another case involving more than thirty clients, our deep-pocket defendant was someone who had a radio show in the mid-2000s, when the real estate market was booming. His pitch was that you should mortgage your home to the hilt and then put the money you get out of your home into two different investments—a real estate development deal and another deal involving second mortgage deed of trust properties. Ultimately, he raised $50 million from local San Diego investors, and most of that money paid for the cost of marketing to raise more money. We eventually found that the $50 million was all commingled into one account. We wound up putting that radio pitchman and all of his forty-five companies into bankruptcy, but there was nothing left over for our clients at the end of the day. The bankruptcy trustee brought some lawsuits, but in the end, our clients got nothing after the administrative costs of the lawsuit were paid.

Conclusion

Unfortunately, mortgage fraud is a lucrative, simple crime that, on the surface, is victimless. Few scamsters seeking quick money care whether a bank or other institution takes a loss on a mortgage loan. In the aggregate, however, given the immense size of the mortgage loan industry, even a small percentage of mortgage fraud among millions of mortgages represents a significant amount of loss, a loss that all of society must bear.

More legislation is needed in mortgage lending, starting with limits on the types of loans that can be offered in a particular jurisdiction. The worst thing that could happen, when the pendulum swings the other way and the real estate melt down of 2007–2008 is but a distant memory, is the return of the various "teaser" loans with low initial rates and payments, negative amortization loans that increase the amount of the mortgage debt over time, and a loosening of underwriting and verification standards, including a return to "liar" or no-income-verification loans. While home ownership is a dream for many, and a stable economy is helped by people who own their own homes and have a stake in their neighborhoods, the fact is that not everyone can afford a home. Many of the problems we are just climbing out of came about by a growing trend to ensure that everyone can buy a home, including those who simply could not afford to own one.

Key Takeaways

- Note that the first step in preparing a litigation strategy in a mortgage fraud case is to identify a deep-pocket defendant who has some liability or complicity in the case—perhaps an institution that had a rogue employee or employees who assisted people in generating fraudulent mortgages, and that institution failed to see the red flags.
- Keep in mind that you have to find a deep pocket to sue, because many of the people who commit mortgage fraud and engage in flipping of properties and short sales without disclosing their real intent are not deep pockets. Their assets are usually nonexistent, or by the time you find them, their money is somewhere else, and it is very hard to track it down.
- Ask yourself: Who is a deep pocket that is worth pursuing—i.e., someone who would be left standing at the end of the case?

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Mr. Shustak has practiced law for forty years and litigated hundreds of financial and securities fraud cases across the country. His firm has recovered hundreds of millions of dollars for defrauded investors over the years. Mr. Shustak has received numerous recognitions from his peers and has been selected a SuperLawyer and Best of the Bar; has been voted a Top Litigator of 2014 by AMERICAN LAWYER *and* CORPORATE COUNSEL *magazines; and has been named one of the "Top Lawyers in San Diego" and "One of the Top Lawyers and Law Firms You Need to Know" by* SAN DIEGO MAGAZINE *and featured on the cover of the 2012 edition of "Top Rated Lawyers in New York" published by* THE NATIONAL LAW JOURNAL *and* THE AMERICAN LAWYER. American Lawyer Media *and* Martindale Hubbell *also named Mr. Shustak a "2013 Top Rated Lawyer in Securities Law." He was honored as a "Top Rated Lawyer of 2013" in the field of Commercial Litigation by* CORPORATE COUNSEL *and* THE AMERICAN LAWYER *magazines published by American Legal Media. The American Society of Legal Advocates selected Mr. Shustak "One of the Top 100 Litigation Lawyers in California" in 2014 and 2015, a recognition that is awarded to fewer than 1.5 percent of lawyers nationally. He was selected by the editors of* THE SAN DIEGO DAILY TRANSCRIPT *as one of the* TRANSCRIPT'S *"Top Ten Attorneys in 2005" and was nominated by the same publication as one of the "Top Influentials in 2010." Mr. Shustak has received the highest rating—AV—from Martindale Hubbell since 1985, a testament to the fact that his peers rank him at the highest level of professional excellence.*