

# Going “Cocoanuts”: Looking at Modern Mortgage Fraud

*Groucho Marx meets mortgage fraud. A look at modern mortgage fraud, the law, a little of the law of unintended consequences, and, perhaps, a reminder that those who forget the past are doomed to repeat it.*

**By Thomas N. Palermo**

In 1929, the Marx Brothers released their first feature-length film, “The Cocoanuts.” Groucho Marx played Mr. Hammer, the owner of the Cocoanuts Hotel, during the Florida real estate boom in the 1920s. In one scene, Groucho, as a land developer auctioning Florida land of nebulous value, tries to sell the land based on the price of homes that have not yet been built. He informs his potential buyers: “You can have any kind of a home you want to; you can even get stucco! Oh, how you can get stuck-oh!” During the auction itself, Chico Marx disastrously rigs the bids and outbids everyone, including himself: “I go higher! Higher! I have plenty of numbers left!” As in the film, the most recent real estate boom saw no end to the bidding, but the numbers ended up being just as real as Chico’s.

Today, such a plot would end with a slew of prosecutions related to mortgage fraud, because the purchase of the homes would have been financed fraudulently through mortgage lenders. Prosecuting mortgage fraud has become a major priority of the U.S. Department of Justice, and these criminal cases are percolating in ever greater numbers throughout the district courts around the United States. To that end, background information regarding mortgage fraud, some examples of current schemes, and a brief discussion regarding sentencing may be of value to anyone involved with or interested in these cases.

## **Mort Gage: French for Dead Pledge**

To understand mortgage fraud, it is useful to look at a common definition of the term: mortgage fraud involves a “material misstatement, misrepresentation or omission relied upon by an underwriter or lender to fund, purchase or insure a loan.” As a practical matter, such fraud, which is usually found on mortgage-related paperwork, is committed to get money.

Usually, mortgage fraud cases start with a house, which someone (for example, a builder or a homeowner) wants to sell and someone else wants to buy (for a residence or as an investment). Once upon a time, a buyer might have gone to his or her bank directly to borrow the money from a lender, who would have loaned money deposited into the bank’s various accounts. Over the last decade, however, buyers have turned to mortgage brokers to originate such mortgage loans.

A mortgage broker’s job consists of, in part, pairing qualified borrowers with appropriate lending programs. Brokers are then paid by commission when a loan closes. Mortgage brokers are supposed to collect information from borrowers, including their income, employment, assets, liabilities,



and intent regarding occupancy of the property (for example, primary residence or investment property). This information is usually reduced to writing on a Uniform Residential Loan Application (Freddie Mac Form 1003), which the borrower and the broker then sign—usually under penalties that include federal prosecution for making a false statement.

Once the borrower has secured financing, he or she would eventually attend a closing of the loan, in which the sale is completed. In Florida, for instance, the closing is customarily done by a title agent or by an attorney acting as a title agent. The title agent is supposed to be paid a commission upon the closing of the loan. At the closing, the parties and the title agent sign all the final documents, including the HUD-1 Settlement Statement, which the title agent prepares and which ostensibly describes the money going into and out of the transaction.

The HUD-1s in the title and lender files should match, as opposed to the “dueling” HUD-1s that appear in some cases involving criminal conduct by title agents. In cases involving such dueling statements, a relatively truthful one may appear in the title file but a false statement will be

submitted to the lender or, when two or more lenders are involved, fundamentally different HUD-1s will be submitted to each of the lenders.

### **Criminal Statutes**

The use of the HUD-1 Statement is mandated by the Real Estate Settlement Procedures Act of 1974, 12 U.S.C. § 2603. Even though the form is never submitted to the U.S. Department of Housing and Urban Development (HUD), the form is within HUD's jurisdiction and, therefore, falsity on it can lead to a distinct charge: a violation of Title 18, U.S. Code, § 1001, which is a deliberate false statement within the jurisdiction of a branch of the federal government. See, for example, *United States v. Wilkins*, 308 F. App'x 920 (6th Cir. 2009), *cert. denied*, *Wilkins v. U.S.*, 129 S. Ct. 2805 (2009).

When the closing agent closes the loan, documents are mailed to the lender, and the money is wired—usually across state lines—from the lender's bank account to the closing agent's bank account. The closing agent should disburse the money in accordance with the lender's instructions. This process explains why schemes related to mortgage fraud are prosecuted using a distinct set of charges. These frauds are not prosecuted under a federal "mortgage fraud" statute; no such statute exists. Instead, the mortgage loan process lends itself to prosecution under the traditional tools used by a prosecutor who deals with federal white-collar crimes: mail fraud (18 U.S.C. § 1341), wire fraud (18 U.S.C. § 1343), conspiracy (18 U.S.C. §§ 371 and 1349), and false statements (18 U.S.C. § 1001).

It is interesting to note that most mortgage fraud cases that were prosecuted before 2009 affected financial institutions, which ended up holding the bad mortgages; but, under 18 U.S.C. § 1344, the cases could not be prosecuted as bank frauds themselves. The statute relating to bank fraud does not define financial institutions, 18 U.S.C. § 20 does, and it does not include most fraud committed by common mortgage lenders, such as the Mortgage Warehouse of Clearwater, Fla. See 18 U.S.C. § 20 (2008). On May 20, 2009, a tenth subsection to the definition of financial institutions took effect and added the following: "a mortgage lending business (as defined in section 27 of this title) or any person or entity that makes in whole or part a federally related mortgage loan as defined in Section 3 of the Real Estate Settlement Procedures Act of 1974." 18 U.S.C. § 20 (2010). However, the Ex Post Facto clause of the U.S. Constitution prohibits retroactive application of penal legislation. U.S. Const. Art. I, § 9, cl. 3. The irony is, of course, that many of the lenders that are now included in the statute are out of business or have been consumed by lenders that would have already qualified.

### **Liars' Loans and Industry Insiders**

In the now infamous stated income loans (also known as liars' loans), lenders allowed borrowers simply to tell the lenders how much money they earned, rather than requiring a verification of income from the borrower's employer. But the borrowers still used the same universe of documents common to all mortgage loans. Thus, borrow-

ers who lied did so in the face of explicit and dire warnings of criminal and civil penalties regarding untruthfulness.

When a lender relied on the truthfulness of the borrower, the borrower's lies were all the more material to the fraud. Much of this fraud could perhaps have been avoided had lenders simply assumed that, after being warned that borrowers would be prosecuted for lying, borrowers simply still could not be trusted to tell the truth on their applications for mortgage loans. However, except for the most vanilla mortgage origination fraud—a borrower who lies to a lender to get the lender to authorize a loan—there may be complicity on the part of an industry insider, invariably to get a lender to fund a particular loan that, had the truth been properly disclosed, would never have been funded.

### **Current Schemes**

#### ***Rescue from Mortgage Foreclosures***

In the recent and ongoing sagging real estate market, the current schemes appear to have shifted away from investments and basic mortgage origination fraud. Instead, schemes designed to rescue borrowers from mortgage foreclosures seem to be on the rise. In these schemes, a third party preys on people who can no longer afford to pay their mortgages. These schemers recruit individuals with good credit, usually paying them some amount of money (for example, \$5,000 per house) to become straw purchasers, who then buy the homes from the homeowners who cannot afford their mortgages.

The straw purchasers are usually told that the original homeowners will be the tenants in the property, and the original homeowners are told that they will lease back their property at a rate that is less than the current mortgage rate and will be able to buy back their property in a few years. With original homeowners losing their houses, there is a measure of desperation preyed upon by the mortgage foreclosure rescue fraud schemers. Unfortunately for the homeowners, these schemes are generally doomed to failure: the new mortgage that is taken out by the straw purchaser is invariably larger than the original mortgage was.

With the straw purchasers, the appeal of such a scheme is simply to their greed—the age-old illusory promise of money for nothing. But, of course, in life there is no such thing. When the straw purchasers do not go the extra step of bringing a false check to the closing or letting their conspirators put money into their bank accounts to bring to the closing, the title agent, when not complicit, may catch the money coming from someone other than the borrower. If it is not caught or the title agent is involved, misrepresentations are then made to the lender about money being put into the transaction by a person who is, instead, getting money out of it.

Moreover, sometimes title agents do not even require someone to bring money on behalf of the buyer but merely net out of the deal the difference between what the borrower should have put into the deal and what the seller should have gotten out of it. When the true settlement of the money is done, the majority of the difference between the first mortgage and the second mortgage (that is, the equity, real or fake), less the supposed money from the

straw purchaser, invariably ends up in the hands of the foreclosure rescue schemers.

### **Down Payment “Assistance”**

The renewed rise of down payment assistance programs follows a similar pattern. On their face, these programs are not necessarily fraudulent; they become so when there is no fully and completely truthful disclosure to the lender that the borrower is being given money to purchase the property. These schemes operate in much the same way that straw purchaser-type schemes do, with lenders being told that borrowers are putting money into the deals when, in reality, the borrowers have no “skin in the game.”

Furthermore, when the person or entity providing the assistance recoups the money, the “assistance” is really a loan, which is not disclosed to the lender. To get the money back, these schemes often involve an inflated sales price for the home, hidden fees, or false debts to collect the money back from the buyer—often from the seller or through money diverted from the seller. When these schemes, in all their various iterations, are not completely disclosed, they are fraudulent and therefore totally illegal. Material misrepresentations to others to induce them to lend money are at the heart of prosecutions of cases involving wire fraud and mail fraud.

### **Short Sale Fraud**

Another scheme that has become more common in the current down market involves short sale fraud. Short sales involve the lender, who would otherwise be foreclosing on the property, agreeing to a sale of a property in which it will realize a substantial loss. These frauds often involve a realtor falsely telling the original lender that the sales price is the best price the homeowner can get and are often followed by a simultaneous or near-simultaneous sale (or even simulated sale) that might look like the following:

Homeowner owes to original lender:	\$200,000
Lender approves sale at “best” price:	\$100,000
Sale “occurs” with immediate resale:	\$150,000

The original homeowner, the person behind the simultaneous sale, and often the homeowner’s realtor (behind the false short sale package sent to the lender) split the \$50,000 difference.

## **Sentencing Issues**

### **Finding the Victim for Sentencing**

In the majority of indictments related to mortgage fraud, the victims are frequently the lenders. However, by virtue of the nature of the mortgage market, the original lender, who is the victim at trial, is rarely the victim at sentencing under the U.S. Sentencing Guidelines, which require the victim to have suffered a pecuniary loss. U.S. SENTENCING GUIDELINES MANUAL § 2B1.1, cmt. n.1 (defining victim as any person who sustained any part of the actual loss). As a result of the realities of the mortgage and real estate markets, many sentences for those convicted of mortgage fraud can be tricky.

Often the key is to find the final holder of the debt. Loans are resold on the secondary market many times. Some victims involve a collectivized but disparate group of bondholders who held mortgage-backed securities. Sometimes the victims are just individuals who invested in assignments of mortgages. In other instances, the victim is the bank that bought the bank that bought the imploded last lender that held the debt. As a practical matter, the best friend of someone trying to identify the victim is the Mortgage Electronic Registration System and its online search feature ([www.mers-servicerid.org/sis/](http://www.mers-servicerid.org/sis/)).

### **Definition of Financial Institutions and Reality**

The expansion of the definition of financial institutions can have an impact in sentencing those convicted of mortgage fraud. If a defendant in a case involving mortgage fraud derives more than a million dollars in gross receipts from a financial institution, he or she will be subject to a two-level increase to his or her total offense level and, therefore, increased punishment under the guidelines. U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(b)(14)(A) (Nov. 2009). The definition of financial institutions given in the guidelines includes the definition found in 18 U.S.C. § 20, which has now been expanded to cover mortgage lending businesses. U.S. SENTENCING GUIDELINES MANUAL § 2B1.1, cmt. n.1. (Nov. 2009). As a result of the *Booker* ruling, the increased penalty does not necessarily lead to an ex post facto issue. See, generally, *United States v. Matbis*, 239 F. App’x 513, 517 n.2 (11th Cir. 2007).

However, much of the fraud, at least that done by industry insiders, does not appear to have been committed for amounts that were anywhere near a million dollars. Rather, the payment structure for industry insiders created a system of perverse incentives. Often the mortgage broker and the title agent, who had a legal duty to stop vast swathes of the mortgage fraud that ran rampant through the industry, got paid only if they found a way to push the loans through to closing. The shock is how few of the industry participants (such as brokers and title agents) appear to have committed mortgage fraud for anything more than their normal commission upon the closing of the loans.

### **Determination of Losses and the Collateral Offset Rule**

Calculation of a sentence for a mortgage fraud-related offense usually falls under U.S. Sentencing Guideline § 2B1.1, which is driven heavily by one important factor: the size of the losses. U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(b)(1). When the lender has not yet resold the property after foreclosure or has not completed a short sale, there is no perfected loss; fortunately, according to this provision, “the court need only make a reasonable estimate of the loss.” U.S. SENTENCING GUIDELINES MANUAL § 2B1.1, cmt. n.3(C).

Calculation of the estimates when the property has not yet been resold usually starts with a basic number: the original amount of the loan. If the collateral has not been disposed of by time of sentencing, the loss—that is, the loan amount—is reduced by “the fair market value of the collateral at the time of sentencing.” U.S. SENTENCING GUIDELINES MANUAL § 2B1.1, cmt. n.3(E)(ii). There are endless ways to find the value of the collateral—the property—at the time

of sentencing. See, for example, *United States v. Greene*, 279 F. App'x 902, 908 (11th Cir. 2008). As a practical matter, for example, in Florida, the common technique for estimating the value of the collateral is to make use of the property appraiser's estimate of value for each county's property tax assessment, which is usually publicly available on the appraiser's Web site ([www.hcpafl.org](http://www.hcpafl.org), for example).

As a result of the collateral offset rule, the Sentencing Guidelines call for greater sentences as the local real estate market plummets further, which is perhaps appropriate given the harm wrought upon the country. The rule also had the unintended result of limiting prosecutions during the real estate boom itself: as any practitioner involved in federal white-collar prosecutions can tell you, cases without losses are not prosecuted frequently. The effect of the collateral loss rule as applied in offenses related to mortgage fraud is perhaps an example of the law of unintended consequences.

### **Restitution**

The last thorny issue in sentencing those convicted of mortgage fraud is calculating restitution, which involves something of a formula: the unpaid balance on the loan, minus the value of the collateral on the date the victim bank gained control of the collateral, plus the bank's expenses prior to that same date. See *United States v. Catherine*, 55 F.3d 1462, 1465 (9th Cir. 1995). When the bank

has not yet taken control of the property, a process may be made available: ordering restitution of the full amount of the loan, without subtracting the value of the collateral, with an understanding that, in the future, the value of the collateral will be offset when the property is sold through the state civil proceeding. See 18 U.S.C. § 3664(j)(2)(A) (2010).

If the amounts ordered for restitution could actually be collected, much of the financial losses inflicted upon the American economy from mortgage fraud could be restored. Unfortunately, many of the defendants will never be in a position to make good on the enormous harm they have wrought. Robert Sarnoff described finance as "the art of passing money from hand to hand until it finally disappears." It is from these orders and the orders that have yet to be written from prosecutions still to commence that we will know how much actually disappeared in what was the last decade's version of "The Cocoonuts." **TFL**

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## *Sarah T. Hughes Civil Rights Award*



Named after the renowned federal district judge from Dallas, Texas, the Sarah T. Hughes Civil Rights Award was created to honor that man or woman who promotes the advancement of civil and human rights amongst us, and who exemplifies Judge Hughes' spirit and legacy of devoted service and leadership in the cause of equality. Judge Hughes was a pioneer in the fight for civil rights, due process, equal protection, and the rights of women.

### **CRITERIA AND PROCESS:**

The award will be presented at the Presidential Installation Banquet to an attorney or judge whose career achievements have made a difference in advancing the causes that were important to Judge Hughes. Such work may include either ground-breaking achievement or a body of sustained and dedicated work in the area of civil rights, due process, and equal protection.

The nominee should: have at least ten years of practice; either be a member in good standing of a state bar association or retired; demonstrate sustained and verifiable excellence in the legal profession; and be of good character.

The nomination package should have the following:

1. A resume and biography of the nominee.
2. A two- to three-page description of the career achievements of the nominee as a lawyer or a jurist in the area of civil rights, due process, and equal protection.
3. No more than three testimonials or letters of recommendation.
4. No more than three articles about the nominee. Any such articles must be primarily focused on the nominee's work in civil rights, due process, and equal protection.
5. A list of the other awards the nominee has received.

**All nomination materials must be received at FBA Headquarters by close of business on July 30, 2010.** The award recipient will be expected to attend the Presidential Installation Banquet in New Orleans to accept the award in person on Sept. 25, 2010. The FBA will reimburse the award recipient's reasonable travel and hotel expenses in connection therewith.

**The nomination deadline is July 30, 2010.**