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White Collar and Financial Services Litigation Flash

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KEY INFORMATION YOU NEED TO KNOW REGARDING LOAN FRAUD

The real estate market collapse exponentially increased the need to be alert to loan fraud trends and be equipped to litigate loan fraud claims. How can those in the mortgage lending industry avoid liability and minimize risk associated with loan fraud? While there is no ironclad protection, adhering to best practices and developing an awareness of recent trends can minimize exposure.

Common Loan Fraud Schemes and Trends

Loan fraud schemes very often involve fraudulent representations in the borrower’s loan application. Common examples include the borrower falsifying intent to occupy the property as the borrower’s primary residence (rather than merely purchasing the property as an investment, which may be easier to abandon); the borrower overstating assets or income to qualify for a higher loan; the borrower misrepresenting the source of a down payment as personal savings when the funds are actually supplied by an undisclosed third-party or by way of a loan; or the borrower listed on the loan application is a “straw buyer” assisting a real estate investor or developer that does not want to be disclosed as the property purchaser, or assisting a party who does not qualify for the loan.

Fraud also occurs when an appraiser inflates the value of the property to obtain a higher loan amount. Appraisal fraud results in the lender having less collateral than was understood during underwriting and exposes the lender to potentially severe losses upon a borrower’s default.

“Reverse staging” is another growing trend. Reverse stating occurs when a real-estate professional buys a property for a low amount by way of a “short-sale” and then flips the property. The real estate professional takes steps to depress the value of a property in order to obtain a low appraisal, which translates to the bank approving a low value short sale. In turn, this means a high profit when the property is later sold for its true fair market value.

Warning Signs

Irregularities in underwriting may be strong indicators of fraud, particularly where the irregularities appear to follow a pattern or are specific to certain individuals or cannot be explained. Incomplete records contrary to internal practices and procedures are themselves red flags. Moreover, misleading HUD closing statements may reflect an intent to deceive the lender about an array of prior representations regarding the buyers, including the manner in which the loan is funded and the parties who are receiving money as a result of the loan. Other red flags include “double-escrow” loan closings conducted on the same day, a large number of property transfers close in time, closings that involve a number of the same parties or related entities, sale of the same property for substantially different prices close in time, substantially different appraised values close in time, and statements by an alleged borrower inconsistent with prior comments regarding matters applicable to the loan application.

Investigating Loan Fraud

An internal investigation can provide relief if it reveals that allegations of fraud are unfounded. However, if fraud has occurred, work product from an internal investigation can potentially provide adversaries a virtual roadmap that outlines wrongdoing. Accordingly, if there is a risk of fraud, and the need for an internal investigation, a critical first step in the investigation is to involve counsel and establish privilege. Non-lawyers, such as human resources staff, corporate security personnel, internal auditors, or other internal investigative staff may be trained to conduct an initial assessment of allegations. There is a risk their investigative work is not privileged if it is not directed or conducted by counsel. Conversely, work product created by non-attorneys can be covered by attorney-client privilege. The key question is whether the non-attorney was acting at the bequest of counsel. Other important rules and best practices to follow when conducting an internal investigation involving potential loan fraud include the following:

- *Gather Critical Documents.* Gather the entire loan file, including the loan application, HUD settlement statement, appraisal, note, mortgage or deed of trust, and documents provided in support of the loan application. Also obtain any separate loan origination file, any separate closing file, and the applicable underwriting notes or file. If fraud is deemed likely, the closing agent's files will also be key, as they will provide insight about what happened during the fraud, including who was likely involved.

- *Conduct Interviews Promptly.* Talk to witnesses at the outset, before they can confer with other potentially culpable employees. Include mental impressions, legal theories or potential strategies in notes of interviews to afford those documents the extensive protection of attorney opinion work product.

- *Identify the Scope.* An immediate goal is to determine whether the fraud was a discrete incident of wrongdoing or, instead, was a mere example of fraud from what might be a substantial pool of fraudulent loans. If the fraud relates to the actions of a particular person, such as a bank officer or a closing agent or an appraiser, identify all of the loans in which that person was involved and then look for trends. Look for geographic trends as well. Loan fraud by a developer, for example, may involve properties situated near each other. Finally, look for personal and other relationships amongst those involved in the fraudulent transactions.

- *Regulate the flow of information.* Disclose information about the investigation on a "need to know" basis only and regulate the internal flow of information. Fact witnesses should never be given access to investigation materials such as notes, reports, privileged databases, chronologies or discussion.

- *Limit disclosure.* Disclosure of any part of the investigation to any third party jeopardizes attorney-client privilege and work-product immunity. Disclosure to the company's own directors, officers and auditors risks waiver of a privilege. Disclosure to a government agency generally waives privilege.

- *Counsel should oversee outside consultants.* To protect outside consultants' work product and the confidentiality of communications between counsel and consultants, outside counsel, rather than the client, should retain and direct the consultants' activities.

Identifying Potentially Responsible Parties

Complex loan fraud often involves multiple parties working together. When internally investigating loan fraud, or preparing to seek recourse for fraud, identify whether the following persons are responsible, along with the borrower:

- *Bank employees.* A bank employee aware of underwriting requirements may inform others about criteria necessary to obtain loans. Involvement of a bank employee may preclude a bank's ability to seek recourse against others and should be thoroughly evaluated at the outset whenever there is suspicion of mortgage fraud.

- *Loan brokers.* A loan broker's employees have direct contact with potential borrowers, may be the source of straw buyers, are aware of lending terms and requirements, and profit from loan origination. The loan broker also may have a relationship with a lender that is necessary to carry out the fraud.

- *Closing agents.* An employee of the closing agent is a key, often necessary, conspirator in many large-scale mortgage fraud schemes. The closing agent may participate in the fraud by, among other things, forging documents, completing inaccurate HUDs, conveying to the lender that straw buyers who are not at closing are in fact present, disregarding closing instructions, or facilitating undisclosed money transfers.

- *Appraisers.* Appraisers may knowingly inflate an appraised value in order to procure a loan from the bank that will satisfy loan to value ratios.

The Benefits of Criminal Proceedings to Civil Litigation

Parties pursuing recourse can benefit from a criminal prosecution that has already been completed against persons involved in mortgage fraud. Subpoenaing the criminal defendants may result in disclosure of the materials disclosed to them during the criminal case, including the prosecutor's investigatory file, witness interview records, and financial records that trace funds associated with the fraud. Such materials can substantially lessen discovery costs that would otherwise be necessary to investigate and prove fraud. Further, if criminal defendants have plead guilty to fraud, the transcript from the criminal sentencing and plea hearing will include statements by the culpable party admitting to, and explaining the fraud. Finally, a criminal court may order the convicted defendants pay restitution to victims of the fraud. Pursuing a restitution award may be worthwhile if the criminal defendants have substantial assets, or are likely to have substantial assets in the future.

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