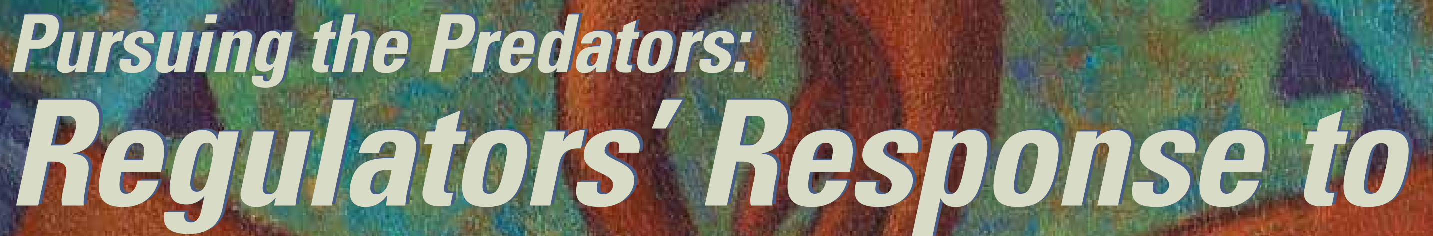

Pursuing the Predators: Regulators' Response to

A weakening housing market has shed light on excesses that were easily overlooked when the market was strong. Both state and federal authorities are responding vigorously with legislation to clean up the mortgage industry, but the risk is that even honest practitioners may suffer the costs and trauma of investigation.

By Dulce J. Foster

Mortgage Fraud

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For many people, becoming a homeowner is what the great American dream is all about. Like the three little pigs in the fairy tale, we grow up, leave our families and venture out into the world, aspiring to obtain a beautiful home where we can raise our children. During the first half of the decade that dream became approachable for many families as interest rates plummeted. Subprime lenders and mortgage brokers devised creative strategies to enable people with lower incomes and bad credit histories to obtain mortgages. As the more recent slump in the housing market reflects, however, many of those creative (and risky) strategies have failed and contributed to a sharp spike in foreclosure rates nationwide. A growing number of consumers are discovering they might lose their homes, unable to sustain their obligations as interest and property tax rates increase and introductory teaser rates on adjustable-rate mortgages vanish.

According to RealtyTrac, Inc., foreclosure rates nationally rose 27 percent in the first quarter of 2007 over the previous quarter and were up 35 percent from the same period in 2006. Foreclosure rate increases in Minnesota were even more startling, reflecting a 35 percent increase over the previous quarter and as much as a 130 percent increase over the first quarter of 2006. The spike in foreclosures and a related downturn in the housing market have sent ripple effects throughout the national economy, causing regulators and consumer advocacy groups to stand up and take notice. Everyone is pointing a finger at someone and asking, "Who is to blame?"

No Single Villain

In actuality there is no single "big bad wolf" who is responsible for the crisis in the housing market, but rather, many players are involved. The one thing that regulators all appear to agree upon, however, is that fixing the problem demands clamping down on predatory lending practices and ramping up enforcement actions against mortgage fraud.

Mortgage fraud can take many different forms, and may be perpetrated by a variety of players. Mortgage fraud investigations frequently target mortgage brokers, who process mortgage applications, act as intermediaries between buyers and lenders, and are at the center of many transactions. Because they are typically paid commissions for their services based on loan amounts, mortgage brokers are strongly motivated to obtain lenders' approval for buyers' applications. Brokers who become overzealous in seeking such approval may find themselves on the wrong side of a civil or even criminal fraud investigation. A typical example is the broker who is alleged to have intentionally overstated the buyer's income or assets on an application in order to dupe the lender into approving it.

This kind of approval became easier to obtain with the advent of "no-documentation" or "stated-income" loan transactions. In these transactions, a borrower pays a higher interest rate and the lender, in exchange, relies on the income representations made on the application without demanding supporting documentation or making substantial efforts to verify those representations. Minnesota Attorney General Lori Swanson argued for regulations against stated-income loans in testimony before the Board of Governors of the Federal Reserve System on June 14, 2007. According to Attorney General Swanson, the intended purpose of stated-income loans is to provide an avenue of approval for self-employed individuals and others whose income is not derived from a regular paycheck subject to verification. Instead, she says, they have become an avenue for unscrupulous brokers who have falsified applications "to claim that octogenarians hauled in cash by making bird houses they didn't make or cleaning houses they didn't clean, that a gardener in his early 20s made $6,000 per month as a 'landscape engineer,' or that a suburban couple earned money renting out a nonexistent apartment in their home."

A mortgage broker who intentionally inflates a buyer's income may feel morally justified in doing so, on the ground that he is helping the buyer obtain a home that otherwise she would not be able to afford. The broker may point out that many such transactions are successful: When the buyers are able to meet their obligations everyone wins, including the lender. Such is not the case, however, when the buyer finds herself overextended and cannot make the required payments. Then the buyer loses the home and the lender typically sustains substantial losses when the outstanding balance is not recovered in the foreclosure sale.

Fraud Takes Many Forms

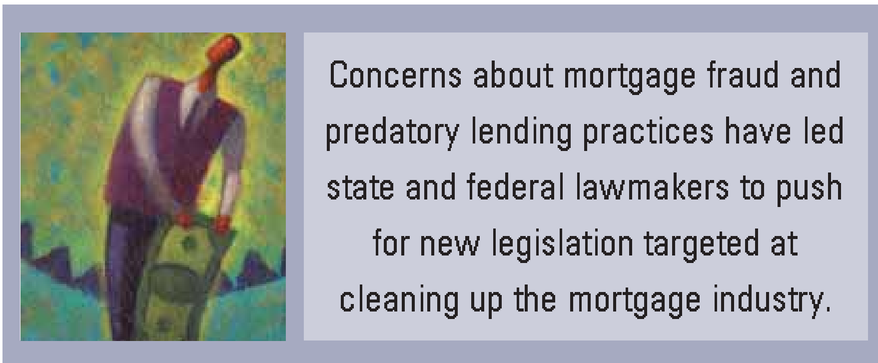
Although mortgage brokers are easy political targets for state and federal regulators attempting to assign blame, it should be acknowledged that the buyers themselves are often at fault. Buyers may intentionally inflate their own incomes, with or without the brokers' knowledge, and place themselves in the precarious position of assuming obligations they cannot afford. To view the problem solely as an issue of mortgage industry opportunists taking advantage of poor, unsophisticated consumers is to ignore the responsibility that some buyers share for making their own bad decisions. After all, the moral of the fairy tale is not simply that wolves are bad, but rather, that smart pigs will not build their houses out of straw.

Buyers may become embroiled in mortgage fraud investigations in other ways, as well. Take, for example, the case of Isadore Stewart and Jill Lehn. In December 2006, Stewart, a real estate buyer, and Lehn, a closing agent, pleaded guilty in federal court in Minnesota to criminal wire fraud charges arising from mortgage transactions. According to court documents filed in the case, Lehn prepared closing documents related to over 60 real estate transactions that deliberately overstated the true purchase price for the properties. Lehn allegedly concealed from lenders the fact that a portion of the loan proceeds would be redistributed to buyers, such as Stewart, and other parties. The government alleges that buyers obtained a total of over $3 million in concealed payments in these transactions, and that Stewart personally derived over $271,000 from three separate real estate purchases. Neither Stewart nor Lehn has yet been sentenced, but both face maximum potential penalties of up to 20 years in prison and $250,000 fines.

As the case of Stewart and Lehn suggests, mortgage fraud investigations tend to focus not on individuals acting alone, but rather, on an alleged conspiracy of individuals, each of whom may play a different role in the transactions at issue. Such is the case in a typical "flipping" scheme. Flipping occurs when a real estate investor purchases a home and then resells it within a short period of time for a higher price. Usually there is nothing illegal about these transactions and, when the buyer makes improvements to the home before reselling it, the practice can be beneficial to a community by raising property values. Flipping becomes fraudulent, however, when the investor colludes with a dishonest appraiser, who intentionally overstates the appraised value of the home so that the investor can resell it for a grossly inflated profit. A flipping scheme can take advantage of an unsuspecting buyer or, when the buyer himself is a participant in the conspiracy, leave the lender holding substantial losses when the buyer allows the home to go into foreclosure and the lender is unable to recover the outstanding balance of the loan.

"Equity stripping" is another practice that has raised concerns among regulators. Equity stripping typically targets homeowners who are experiencing financial distress, have fallen behind in their mortgage payments, and are facing a risk of foreclosure. Usually a homeowner attempts to refinance and is turned down by the lender. A foreclosure notice is published in the local newspaper and is read by a "foreclosure rescue" firm, which approaches the troubled homeowner offering help. The foreclosure rescuer pays off the balance owed in foreclosure, acquires title to the home, and agrees to reconvey the property to the homeowner under the terms of a lease or contract for deed. This kind of arrangement may be considered predatory if the terms of the lease or contract are unreasonably high, resulting in the homeowner's inability to pay and ultimate eviction from the home, while the "rescue" firm retains ownership and the homeowner's equity in it. It becomes fraudulent if the firm knowingly misleads the homeowner about any of the terms of the arrangement.

In June of this year, the Minnesota Office of the United States Attorney led a grand jury to indict a former mortgage broker and his assistant in an alleged equity-stripping scheme that went a step further. According to the indictment, they encouraged distressed homeowners to refinance and then used physical intimidation to force the homeowners to endorse the equity checks produced in the refinancing process over to themselves. The two now face charges carrying a maximum potential penalty of 20 years in prison.



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Such bold schemes are not uncommon. The United States Attorney's Office also had the president of a title and escrow company indicted this past June. The indictment alleges that she opened an escrow account to deposit funds from lenders for real estate closings, but then transferred the money to her own personal account and used it to pay about $2.5 million in personal expenses.

Not all problems in the housing market can be attributed to blatant misconduct. Commentators are also raising concerns about lending practices that are not illegal, but nevertheless may be viewed as predatory. They point to insufficient disclosures to consumers, overly ambitious prepayment penalties, and exorbitant closing costs. Brokers are not the only parties implicated by these concerns. Commentators also point to lawyers who fail to properly advise their clients of the risks associated with transactions, lenders who fail to apply sufficiently rigorous underwriting standards, and even secondary market investors — who some argue should be liable to homebuyers for failing to conduct proper due diligence before taking assignment of questionable loans.

Regulatory Response: Minnesota

Concerns about mortgage fraud and predatory lending practices have led state and federal lawmakers to push for new legislation targeted at cleaning up the mortgage industry. On May 14 of this year, Governor Tim Pawlenty signed a predatory lending practices law (S.F. No. 988) that — for the first time in Minnesota — specifically defines residential mortgage fraud as a criminal offense. Under the terms of the new law, which went into effect on August 1, "residential mortgage fraud" is defined as knowingly making or using any misstatement, misrepresentation or omission that is both "deliberate" and "material" during the "mortgage lending process" with the intent that any party to the mortgage lending process rely upon it. The "mortgage lending process" includes virtually every step in a mortgage transaction, including solicitation, application or origination, negotiation of terms, third-party provider services, underwriting, signing and closing, and funding of the loan. Documents involved in this process include required disclosures, loan applications, appraisal reports, HUD-1 settlement statements, and supporting personal documentation for income verification, such as W-2 forms, bank statements, tax returns and payroll stubs. Violating the law can lead to a felony conviction with a maximum term of imprisonment of two years, and mandatory restitution to any identified victims. In addition to enacting new criminal penalties, the law also contains provisions prohibiting prepayment penalties for subprime loans and creates a private civil right of action for borrowers injured by violations of the affected statutes and other state mortgage laws.

This new law joins another new predatory lending practices law approved by Governor Pawlenty on April 20 (H.F. No. 1004), which also became effective August

Even honest practitioners may find themselves under investigation for alleged crimes in which they were no more than unwitting participants.

1. Although the new law establishes no new criminal penalties, H.F. No. 1004 included a number of provisions targeted at predatory lending practices, including: a prohibition against stated-income loans; a requirement that mortgage originators verify borrowers' ability to make scheduled payments; a prohibition against "churning" (arranging a refinance that provides no tangible benefit to the buyer); a requirement that originators make disclosures to buyers about anticipated property taxes and hazard insurance costs; a prohibition against mortgage repayment options resulting in negative amortization; and a provision establishing fiduciary duties owed by mortgage brokers to borrowers as their agents.

These new laws complement Minnesota's equity-stripping statute, which was enacted in 2004 and codified at Minn. Stat. ch. 325N. That law imposes strict disclosure and other requirements on any investor who purchases a home in foreclosure and subsequently reconveys or promises to reconvey continuing rights to the homeowner to possess the property. The equity-stripping statute creates criminal penalties against any such investor who defrauds a homeowner, including imprisonment of up to one year and fines of up to $50,000 (Minn. Stat. §325N.18).

Regulatory Response - Federal

Federal regulators are similarly working to strengthen legislation against mortgage fraud and predatory lending practices. On July 12, Rep. Spencer Bachus and several other representatives introduced a 71-page bill to establish the "Fair Mortgage Practices Act of 2007" (H.R. 3012). Many of the provisions of the bill would explicitly preempt state law on the same subject, including certain applications of Minnesota's new predatory lending laws. The proposed legislation addresses mortgage fraud and predatory lending practices on multiple substantive and procedural fronts. Its requirements are too voluminous and complex to describe here in exhaustive detail, but some of its more innovative provisions are worth noting.

The bill seeks to establish a national registry and licensing system for residential mortgage originators which would, among other things, require registrants to undergo background checks and provide fingerprints and would deny licensure to applicants with felony convictions during the prior seven-year period. The bill also mandates consumer-counseling referrals and the use of escrow accounts in connection with subprime mortgages. The proposed legislation imposes additional duties on the Department of Housing and Urban Development (HUD), creating a separate "Office of Housing Counseling" within HUD, and requiring HUD to conduct a study into the root causes of foreclosures. The proposal places limits on the assessment of prepayment penalties for certain hybrid fixed-rate/adjustable-rate mortgages, and contains an antiflipping provision that mandates a second appraisal for homes resold within the first six months after purchase. Finally, if this bill is passed, the federal government will appropriate an additional $20 million for fiscal years 2008-2012 "for the purpose of enhancing the efforts of the Department of Justice and the Federal Bureau of Investigation to prevent, investigate, and prosecute mortgage fraud."

A Strong Message

The new legislation mushrooming at both the state and federal levels in response to the housing crisis sends a strong message to professionals operating in the residential housing market that unscrupulous conduct will not be tolerated. With increased legislation and heightened scrutiny comes increased enforcement. Attorney General Lori Swanson has made clear in statements to the public that ending mortgage abuse is a high enforcement priority for the state of Minnesota. In addition to addressing the Federal Reserve last June, she made a presentation to the U.S. House of Representatives Financial Services Committee on August 9, in which she forcefully advocated for stronger federal legislation against predatory lending practices. This issue has also become a high enforcement priority for the federal government. In its Financial Crimes Report to the Public for fiscal year 2006, the Federal Bureau of Investigation reported an increase in pending cases related to mortgage fraud from 436 in 2003 to 818 in 2006 — an increase of over 87 percent in just three years. If Congress appropriates an additional $20 million for these investigations over the next five years, those numbers are likely to increase even more dramatically.

When law enforcement agencies put an entire industry under the microscope everyone involved feels the impact, because with increased enforcement comes a substantial risk of over-enforcement. Wide traps set for the big, bad wolf are likely to catch a lot of innocent parties, too. Even honest practitioners may find themselves under investigation for alleged crimes in which they were no more than unwitting participants. Although these unfortunate companies and individuals will have strong defenses to any criminal charges levied against them, the emotional toll on individuals and the costs of defense — in legal fees, lost productivity and lost business — may be devastating. For these reasons, anyone working in the residential mortgage industry should tread very carefully. It is important to exercise caution and avoid even the appearance of wrongdoing, so that the propriety of any transaction under scrutiny is indisputable. ▲

Dulce Foster is a shareholder in Fredrikson & Byron's White Collar & Regulatory Defense and Commercial Litigation groups. Her practice focuses on white collar criminal defense, administrative, and regulatory matters.