

# REAL ESTATE

## Mortgage Fraud now on the rise

Condo-conversion developers and related participants tend to be those indicted in recent cases.

By: Bruce Udolf, Esq. and Robert W. Barron, Esq.  
All Rights Reserved

The convergence of the extreme slowdown in the condominium-conversion market and the collapse of the subprime-mortgage market provides fertile ground for new opportunities for fraud by a new subclass of white-collar criminal defendant — the condominium-conversion developer and its construction lender, title company, real estate agent and mortgage broker.

While the past typical mortgage fraud case may have involved an individual consumer who falsified his or her financial information to obtain a home mortgage, recent market conditions are placing tremendous pressure upon the condominium-conversion developer to cut corners to satisfy mandatory principal paydown requirements and default-rate interest payments due to both senior and mezzanine lenders — not to mention payments owing to its equity investors.

Unfortunately, like a black hole threatening to draw everything into its dark core, these same market forces are also seducing the other participants in the condominium sale transaction — the construction lender, the title company, the real estate agent and the mortgage broker — and threatening to draw many of these participants into the web of the fraudulent mortgage conspiracy.

The prey in this spiraling drama are the consumer mortgage finance companies financing the

acquisition of the condominium unit; the federal government, which insures all or a portion of the mortgage; and, ultimately, the taxpayer who is left to foot the final cost of the scheme.

In response to this growing problem, the Federal Bureau of Investigation's mortgage fraud programs have recently been consolidated in its Financial Institution Fraud Unit. That unit is focusing its efforts on mortgage fraud perpetrated by industry insiders. Similarly, the U.S. attorney for the Southern District of Florida recently announced the launching of a new federal-state mortgage fraud initiative designed to marshal the resources of numerous federal and state investigative agencies to target mortgage fraud in South Florida. The trends under investigation in these types of cases generally involve equity skimming, property flipping and false representations in U.S. Department of Housing and Urban Development (HUD) documents.

In cases involving equity skimming, an investor commonly uses a straw buyer and utilizes false income documents and credit reports to obtain a loan in the straw buyer's name. After closing, the buyer quitclaims the property to the investor, who collects rent payments on the property until the property is foreclosed.

In the typical property flipping scam, property is purchased, then falsely appraised at a much



higher value and resold. Often, several successive fraudulent sales are churned, each sale further overinflating the value of the property and the amount financed. These closings similarly involve false and doctored loan documentation.

More and more, particularly in an overbuilt real estate market, buyers are enticed with hidden payments dressed up as “decorator’s allowances” or other rebate payments. These allowances or rebates are typically not disclosed on the HUD-1 forms submitted at closing. For instance, if such expenses are not disclosed on the closing statement and not used to improve the condominium unit or otherwise paid to a bona fide construction company, then they may be viewed down the road by investigators as illegal kickbacks. Such “developer incentives,” in conjunction with a falsely inflated appraisal, can allow a buyer to purchase property with virtually no money down. By contrast, the lender is placed in the position of financing a much riskier mortgage than it would have had the true facts of the transaction been disclosed.

Recent indictments illustrate this new trend of criminal activity among industry insiders and the government’s response to this state-of-the-art fraud. In March, federal prosecutors in Arizona obtained

the indictment of six individuals for conspiracy plus mail and wire fraud violations involving 65 properties in the Phoenix area in connection with HUD’s “pre-foreclosure” sale program. *U.S. v. Peters*, No. 2:07-CR-00266-PHX-NV W-1 (D. Ariz.). This program was designed to reduce foreclosure costs to the government by allowing homeowners to sell their homes for less than they owed on the mortgage, thus allowing a “short sale.” The program requires that homeowners receive counseling and that an independent appraiser establish the market value of the home.

In this case, the government alleged that the defendants conspired to purchase and sell the properties using false homeowner counseling certifications and fraudulent appraisals so that they could purchase homes for less than market value and immediately flip those homes for a substantial profit. The defendants included two employees of a mortgage company who were paid fees for referring the names of borrowers in default under their home mortgages and for replacing the mortgage company’s independent appraisals with altered appraisals. An escrow officer with a title company allegedly participated in the fraud by failing to disclose on the real estate settlement statements that second and third mortgages were encumbering the properties. The indictment alleges that HUD paid nearly \$1.9 million in claims from the Federal Housing Administration insurance fund as a direct result of this fraudulent scheme and conspiracy.

### **Sham purchases in San Diego**

In August, two individuals pleaded guilty in the U.S. District Court for the Southern District of California to a felony charge of mail fraud arising from a scheme to draw equity out of a San Diego condominium complex through a series of sham purchase transactions and refinances. *U.S. v. Norton*, nos. 3:07-CR-02260 and 02291-H-1 (S.D. Calif.). One of the defendants, an investment advisor, acquired an apartment complex through a legal entity in 1999. Through a combination of unfavorable loan terms, mismanagement, insufficient rental income and other problems, the defendant lacked the money necessary to fund the debt obligations of the complex, make payments to his investors and complete the condominium-

conversion project.

The defendants used straw purchasers and used the names and credit histories of those straw purchasers to obtain new mortgage loans on individual condominium units. The defendants, not the straw purchasers, were to pay all mortgage and tax payments. The defendants obtained mortgage financing in the straw purchaser's names without disclosing to the financial institutions the side agreements between the defendant and the straw purchasers. The defendants also transferred condominium units into the names of some individuals without informing them, and then used their names and credit histories to obtain mortgages to finance the "purchase" of the condominium unit(s). The defendants would sign the names of the unsuspecting straw purchasers to deeds and loan documents and, to avoid detection, had all escrow documents and bills sent to one of the defendants' mailing address.

Also in August, a federal grand jury sitting in the Eastern District of California returned an indictment charging two individuals with multiple counts of mail fraud in connection with a mortgage fraud scheme that involved the flipping of multiple properties in the Stockton area. *U.S. v. Ahmad*, No. 2:07-CR-00386-WB5-1 (E.D. Calif.). The indictment alleges that one defendant paid an associate to recruit straw purchasers of properties who, in turn, would be paid for posing as buyers. The defendants paid the down payment for the straw purchasers. False information regarding the straw purchaser's employment and monthly income was submitted in the loan applications. The indictment alleges that the defendants obtained in excess of \$1.5 million in loan proceeds pursuant to this scheme.

Perhaps the most troubling of these recent cases is the Phoenix case above involving six defendants and 65 properties. Here is an example of a sophisticated scheme to defraud in which the government charged seemingly disparate participants under the umbrella of a single conspiracy. In Phoenix, the alleged scheme included "inside" assistance from employees of a residential lender who, for a referral fee, substituted falsified appraisals for the real ones and a title agent who failed to disclose second and third liens

encumbering the property. Through the individual activities of aggregator, lender and title company, the mortgage fraud was allegedly implemented.

The financial condition of the San Diego condominium converter described above is perhaps more typical of situations that may arise in Florida, which has the dubious distinction of leading the nation in mortgage fraud rates in 2007. Often, the condominium converter has purchased an existing apartment complex with a "conversion" valuation — that is, the apartment complex was purchased with the assumption that the project would be renovated with granite countertops, new carpet and paint, and sold as individual condominium units within 12 to 18 months.

Because of the inflated acquisition prices payable during the go-go days of the hot real estate market, the purchase price paid for the project and the debt levels utilized to acquire the project will not support existing rental rates. Simply put, if the developer cannot sell most of the project as soon as possible, the entire deal is a failure. To finance the acquisition, the developer has utilized a combination of senior debt, mezzanine debt with high interest rates and, perhaps, equity investors demanding a preferred equity return on investment. It is not uncommon for the loan documents for the senior and mezzanine debt to provide that the failure to sell units pursuant to a certain schedule constitutes a default under the credit facilities, thereby triggering debilitating default interest rates.

### **South Florida indictments**

Against this backdrop, such a project creates a perfect storm that can lead a desperate developer to engage in the type of conduct charged in the San Diego case. For example, on Sept. 27, a South Florida grand jury returned a 70-count indictment charging 15 defendants, including mortgage brokers, appraisers and an accountant, for allegedly conspiring to obtain 12 fraudulent loans totalling \$8.3 million in *U.S. v. Quintero-Lopez*, No. 07-602070-Cr (S.D. Fla.). According to the indictment, the defendants offered sellers the full asking price for their properties and then inflated the contract price submitted to the acquisition lender. Straw buyers were lured with a promise of a "no money

down” purchase and were paid thousands of dollars to sign closing papers; accountants falsified pay stubs; appraisers inflated values; and mortgage brokers completed fraudulent loan applications. The “extra portion” of the inflated sales price was then rebated to the “team” when the loans closed.

In an unrelated South Florida case recently filed, *U.S. v. Crowder*, No. 07-20773-Cr (S.D. Fla.), a mortgage broker, a title attorney and a former Wachovia Bank loan officer were charged in a scheme to obtain \$42 million of fraudulently obtained loan proceeds for the purchase of 17 South Beach condominium units. Working with the title company’s assistance, the group allegedly obtained home equity loans for condominium units that were not yet owned by the borrowers. The equity loan proceeds were then used as the down payments to purchase the same units by the straw buyers. The sales price was inflated in order to obtain an increased acquisition loan. The defendants were allegedly able to defraud both the home equity and acquisition lenders by combining their respective skills and positions of trust as lawyer, mortgage broker, title company owner and loan officer.

As these cases demonstrate, the federal conspiracy statute offers no safe harbor to players in the real estate industry who participate in real estate deals in which they know or ought to know fraud is occurring. “Willful blindness” or “deliberate ignorance” of another’s fraudulent conduct, be it on the part of a lender, broker, developer or purchaser of another’s fraud, can result in criminal liability for any of those other, lesser participants.

The practitioner who represents or advises any participant in this condominium-conversion drama may not be familiar with white-collar criminal exposure and may be desensitized by a client who informs her that “everyone is doing this” to survive in this downmarket climate. However, the substantive offenses of mail fraud and wire fraud carry maximum penalties that are draconian — 20 years imprisonment and up to \$1 million in fines — and if a financial institution is involved, the maximum term of imprisonment goes up to 30 years.

Given such potential consequences for conduct a

client may mistakenly perceive as a minor infraction of the law, it is incumbent on the real estate practitioner to ensure that any client involved in a mortgage transaction, especially one involving a federally insured financial institution, is aware of the dangers when any party to the transaction fails to make truthful disclosures regarding the sources and flow of funds in the transaction.

If a client advises that she knows or suspects that some party to a transaction has made a false representation with respect to it, or that she has otherwise noticed some “red flag” that might indicate such a problem, the real estate practitioner should immediately seek assistance from an attorney with expertise in white-collar criminal law.



***Bruce Udolf, a shareholder in the Fort Lauderdale, Fla., office of Berger Singerman, is a former assistant U.S. attorney with significant experience in white-collar criminal matters.***



***Robert W. Barron, also a shareholder in that office, is a commercial real estate and business attorney.***