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*Anyone who is engaged in mortgage services, short sales or loan modifications—or who left even a pinkie print on a subprime loan from the real estate heyday—should be prepared for the perfect storm of potential criminal liability:*

- *scrutiny by powerful, well-funded federal investigators and prosecutors*
- *public demand for punishment of housing crisis “bad guys”*
- *recent statutes enhancing criminal liability for mortgage fraud in an era of the lowest thresholds for proving criminal intent in U.S. history*

*We live and work in a post-meltdown world that is eager to lay blame. But there are things that Arizona real estate professionals can do to avoid criminal liability. Whether at the pre-indictment or post-indictment stage, taking the right steps can mean the difference between home and a prison cell.*

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BY DANIEL B. MESTAZ

## **Building a Mortgage Fraud Defense**



*"I'm shocked—shocked—  
to find that gambling is going  
on in here!"*

—CAPTAIN LOUIS RENAULT, *Casablanca*  
(Warner Bros. 1942)



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package the interest stream into mortgage-backed securities (MBS) to be resold on the open market. Home borrowers with good credit were the foundation of that MBS market.

By 2001, however, the world was flush with cash, and low interest rates on U.S. Treasury Bonds led global institutions to seek a better (but still safe) return on their trillions of dollars.<sup>2</sup> Eventually the number of credit-worthy home buyers could not fill the growing demand for AAA-rated investment-grade MBSs, so small banks such as Countrywide (and later Fannie Mae and Freddie Mac) began buying as many non-conforming subprime loans as possible from unregulated mortgage originators to resell to Wall Street. Those loans eventually included unverified “stated income” or “liar” loans and other loans that had no hope of repayment unless

### **Background: The Subprime Party**

The dynamics of the subprime market that led to the financial crisis reveal a potential strategy for fraud cases arising from pre-meltdown subprime loan documents.<sup>1</sup>

Well before the real estate boom, a few big lenders routinely bought conforming loans to resell to Wall Street, which would then

the borrower could ultimately refinance with equity on the back of a skyrocketing real estate market.

Meanwhile, Wall Street shopped its MBSs among the ratings agencies until even the riskiest received a marketable AAA rating. Everyone made lots of money until—surprise!—borrowers with terrible credit began to default, home prices fell, and a chain reac-



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tion in the credit and housing markets incinerated global wealth.

The problem, as we now know, was that until the music stopped nobody in the mortgage process got stuck with a risky loan.<sup>3</sup> The mortgage originator sold the loan to the “lender,” the lender had it sold to Wall Street before the ink was dry, and Wall Street parsed it into an investment-grade security for the global marketplace. Without a long-term stake, nobody cared about the borrower’s ability to repay.<sup>4</sup> Thus, the misrepresentations in the underlying loan documents may not have been material to a lender’s decision to fund a loan.

### The Feds Eye Arizona

“Here’s looking at you, kid.”

—RICK BLAINE, *Casablanca*

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In the wake of the housing meltdown, the federal government heeded the public outcry for new laws to prevent future disaster. Real estate professionals must now contend with the latest regulations generated by the SAFE Act,<sup>5</sup> Mortgage Disclosure Improvement Act<sup>6</sup> and Mortgage Reform Act<sup>7</sup> and with the enhanced criminal enforcement of financial misdeeds under the 2009 Fraud Enforcement and Recovery Act (FERA).<sup>8</sup> Arizona companies and people in or on the periphery of real estate lending should be wary of criminal prosecution arising from both boom-year housing loans and ongoing mortgage-related services.

The dramatic increase in mortgage fraud prosecutions over the last decade may be just the beginning. In 2009, FERA set aside approximately \$500 million for the investigation and prosecution of mortgage fraud and other financial crimes.<sup>9</sup> In March 2010, the U.S. Department of Justice launched “Operation Stolen Dreams,” the government’s “largest mortgage fraud takedown” initiative to date.<sup>10</sup> Arizona federal prosecutors recently fell in line with increased mortgage fraud prosecutions,<sup>11</sup> which should continue now that Arizona has surpassed other states to find itself at or near

the top of the mortgage fraud indices relied upon by the FBI.<sup>12</sup>

This federal attention<sup>13</sup> is worrisome for real estate professionals, no matter how “clean” they believe themselves to be. Indeed, with the deterioration of the *mens rea* requirement engendered by “tough on crime” laws, it is more difficult than ever to avoid criminal liability once in the federal government’s crosshairs.<sup>14</sup>

### Typical Mortgage Fraud Schemes

“Did you abscond with the church funds?  
Did you run off with a Senator’s wife? I like to think  
that you killed a man. It’s the romantic in me.”

—CAPTAIN LOUIS RENAULT, *Casablanca*

Generally, mortgage fraud falls into two categories: *fraud for housing* (fraudulent loan application to obtain a residence) and *fraud for profit* (fraudulently obtaining equity or loan proceeds). Law enforcement typically focuses on fraud for profit.

There is an enormous variety of fraud-for-profit schemes, including:

- **Flipping:** The fraudster may purchase the property, artificially inflate the value with a false appraisal, and then sell to an unsuspecting buyer. Or the seller will falsely inflate the value of the home, sell it to a straw buyer, pocket the loan proceeds, and let the loan default. There are numerous variations.
- **Silent Seconds:** Buyer fails to disclose that he or she also borrowed the down payment represented in the loan documents. This “silent second” lien misleads the lender as to borrower creditworthiness.
- **Cash Back/Kickback:** Seller inflates the value above the actual sale price, the lender funds the loan at the inflated value, and at closing the seller gives the buyer the difference.
- **Foreclosure Rescue/Loan Modification:** Fraudsters falsely promise to save distressed properties from foreclosure or to modify loans—sometimes in return for unearned fees, other times as part of a scheme to dupe the homeowner into surrendering title so the property can be drained of equity.
- **Other Schemes:** Loan application misrepresentations, builder bailouts (involving non-disclosed buyer incentives to offload inventory), short sale fraud, reverse mortgage fraud, home equity line of credit schemes, and investment schemes.

### The Federal Criminal Statutes

“You mustn’t underestimate American blundering.”

—CAPTAIN LOUIS RENAULT, *Casablanca*

There is no federal mortgage fraud criminal statute *per se*. Rather, prosecutors proceed under a variety of statutes, including:

- Loan and credit application (false statements/property overvalua-

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tion) – 18 U.S.C. § 1014; Conspiracy to commit Section 1014 violation. 18 U.S.C. § 371

- Mail fraud – 18 U.S.C. § 1341
- Wire fraud – 18 U.S.C. § 1343
- Bank fraud – 18 U.S.C. § 1344
- Conspiracy to commit mail, wire, or bank fraud – 18 U.S.C. § 1349
- Aiding and abetting any of the foregoing – 18 U.S.C. § 2
- Money laundering – 18 U.S.C. § 1956(a)

Under the loan and credit application statute, the criminal liability threshold for false statements is particularly low. It provides for up to a 30-year prison term for anyone who “knowingly makes any false statement ... or willfully overvalues any land, property or security, for the purpose of influencing in any way the action” of, among others, any lender or “mortgage lending business.”<sup>15</sup> Furthermore, the false statement need not be material,<sup>16</sup> nor must it deceive anyone or be intended to deceive anyone.<sup>17</sup> Thus, even slight misrepresentations regarding income, credit history, payment details, property value, and so forth, can trigger Section 1014 liability for those along the mortgage chain, including buyer, seller, agent, broker, originator, appraiser and escrow officer.

The mail fraud statutes (including mail, wire and bank fraud) also provide for up to a 30-year prison term, and they prohibit schemes to defraud or obtain money or property by false or fraudulent representations.<sup>18</sup> Although these statutes require proof of intent and materiality of representation,<sup>19</sup> proof of harm or success of the scheme is not required.<sup>20</sup>

Mortgage fraud cases typically include a conspiracy count.<sup>21</sup> Conspiracy requires proof of intent and agreement to commit the underlying offense and only a single overt act by any of the conspirators to implement the agreement.<sup>22</sup> But, rather than require an explicit agreement, “it is sufficient if the conspirators knew or had reason to know of the conspiracy and that their own benefits depended upon the success of the venture”—which can be proven by circumstantial evidence.<sup>23</sup> Thus, even a supposed wink-and-nod to a buyer’s inflated income representations can lead to conspiracy charges.

### Situation No. 1: No Forseeable Criminal Investigation

*“You give him credit for too much cleverness.”*

—MAJ. HEINRICH STRASSER, *Casablanca*

When everything seems fine is, in fact, the ideal time to implement, evaluate, revise or ensure adherence to policies regarding document retention and destruction, e-discovery and investigation response procedures.

Waiting until a criminal investigation is pending or foreseeable is too late; to avoid obstruction of justice charges, all potentially material documents must be preserved and then likely reviewed by counsel and turned over to the government.<sup>24</sup>

Companies also should have written procedures on how to respond to government investigators. For example, employees should be trained on how to respond to search warrants or ex parte government communication, and advised on their right to counsel and right to remain silent—but should not be flatly prohibited from speaking to government agents. That way, employees will know to refer questions to counsel rather than nervously stammer about important issues. And the company avoids obstruction of justice charges or claims of non-cooperation.

### Situation No. 2: Pre-Indictment Criminal Investigation

*“Major Strasser has been shot—round up the usual suspects.”*

—CAPTAIN LOUIS RENAULT, *Casablanca*

If law enforcement comes knocking, one should typically (a) invoke the right to counsel and (b) do no harm. This allows counsel to do their job, that is, to try to avoid indictment but prepare for the worst-case scenario.

First, referring government agents to an attorney and declining to answer questions is standard practice, for good reason. Even where the professional believes he or she is completely innocent of wrongdoing, attempting to “explain” can lead to misunderstandings and unwitting admissions that create the bulk of the evidence for the government’s case. Furthermore, even half-truths and white lies on seemingly minor issues can lead to false statement<sup>25</sup> or obstruction of justice<sup>26</sup> charges, which may be enough to extract a guilty plea from those who otherwise would have been exonerated. Client and attorney may decide that speaking to the government is the best choice, but only after careful consideration.

Second, doing no harm by avoiding false statement and obstruction of justice charges also may require the following:

- Clients should not discuss the investigation or the underlying facts in writing or with anyone other than counsel. Ill-advised e-mails or contacting a witness to help him or her “remember” something can lead to obstruction of justice charges or even convictions on the underlying offense.
- Companies and their counsel should implement a written preservation “hold” for all potentially material e-mails and other documents, including the suspension of e-mail auto-deletion and backup tape rotation. The computers of key players may have to be forensically imaged.

The ultimate goal is to avoid indictment. Thus, a company and its counsel may decide to conduct an internal investigation to root out any criminality or demonstrate that there is none. Or the prosecutor, inviting the client to “talk” so it can decide whether to indict, sends counsel a proffer letter regarding the parameters under which the client’s statements can be used against him or her at trial. Clients may want to explain their side of the story; however,

deciding whether or in what circumstances to agree is fraught with peril. On the one hand, it may be the only chance to avoid indictment. On the other, if the client is indicted, the “talk” may have deprived the client of a viable trial defense.<sup>27</sup>

Meanwhile, counsel should prepare for possible indictment and trial by investigating the facts, gathering evidence and exploring defenses.

### Situation No. 3: Indictment—Defenses and Strategies

*“I’m making out the report now. We haven’t quite decided whether he committed suicide or died trying to escape.”*

—CAPTAIN LOUIS RENAULT, *Casablanca*

Although available defenses and strategies depend on the “pesky details”—charges, facts and applicable law—the following should be considered in any mortgage fraud case.

First, prosecutors typically charge a “scheme to defraud” under the mail fraud statutes. Putting distance between the client and scheme is important as a liability defense and as mitigation for sentencing if convicted. Indeed, the relevant inquiry “is not whether the defendant acted knowingly in making any misstatement, but whether she did so with respect to the overarching fraudulent scheme ... charged.”<sup>28</sup>

Similarly, a conspiracy conviction may result from the acts of a co-schemer if the scheme makes those acts reasonably foreseeable.<sup>29</sup> But “foreseeability must be evaluated according to the facts that were known to the defendant”—not what was foreseeable to the co-schemers.<sup>30</sup> One may have had “such a marginal role in the conspiracy that [they] could not reasonably have foreseen the details of [their] co-conspirator’s actions.”<sup>31</sup> Thus, someone’s involvement in a single fraudulent loan application may not make it reasonably foreseeable that the true instigator had bigger plans, such as doing the same thing all over town or planning a fraudulent flip after the first loan came through.

Second, just as the government is allowed to rely on circumstantial evidence, the defense may introduce its own circumstantial evidence tending to negate scheme or intent—including (if relevant) other transactions or the honesty of the transaction from the perspective of someone else along the mortgage chain.<sup>32</sup>

Third, the government’s case often relies on expert testimony regarding the features of mortgage fraud, including the participants, the market and the loan documents. The expert witness may give the jury a mortgage fraud blueprint into which the defendant neatly fits.<sup>33</sup> Counsel should explore *Daubert/Kumbo*<sup>34</sup> challenges to the reliability of that expert testimony, as well as discovery and cross-examination on bias<sup>35</sup> arising from the expert’s relationship with the government.

Fourth, the cold, hard truth is that most federal criminal cases

result in convictions, primarily by guilty pleas. In fraud cases, punishment under the now-advisory but still applicable Sentencing Guidelines is based in large part on the loss to the victim, which in a mortgage fraud case must be reduced by (a) the fair market value of the lender–victim’s collateral real estate if not sold, or by the amount recovered if sold; and (b) any claimed interest, late fees or penalties.<sup>36</sup> This can reduce one’s sentence dramatically.

Finally, mortgage fraud defense should be front-loaded. It requires significant investigation, discovery and motion work that cannot be accomplished before trial without maximum early effort. Useful strategies include:

- early theory development to support requests for exculpatory *Brady* material<sup>37</sup>
- aggressive Rule 17 subpoenas for documents supporting defenses and the impeachment of government witnesses that one cannot necessarily rely on the prosecutor to provide<sup>38</sup>
- pinning down the government’s fraud theories, including by Motion for Bill of Particulars regarding scheme, victim and false statements, which should circumscribe what the government can offer at trial<sup>39</sup>

*“I stick my neck out for nobody.”*

—RICK BLAINE, *Casablanca*

### Moving Forward

Federal mortgage fraud investigations and prosecutions show no signs of slowing down. Real estate professionals should understand the low threshold of criminal liability under the applicable charging statutes, particularly in light of the government’s ability to prove conspiracy with circumstantial evidence. In addition, even an innocent client’s

imperfect response to federal investigators can itself lead to criminal charges for false statements or obstruction of justice.

Real estate professionals can significantly reduce their criminal liability exposure by adhering to document retention and destruction policies, having written procedures in place when government agents show up at the door, and avoiding business transactions with dishonest people. They also should document their compliance with




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the morass of new regulations, particularly those intended to verify the legitimacy of loan applications. Also, federal investigators look for red flags to determine what to investigate, such as suspiciously timed transactions or sparsely detailed documents. Mortgage industry professionals either should avoid those types of transactions or confirm and document their validity before going further.

While the ultimate goal is to avoid indictment, an aggressive front-loaded defense to prosecution can significantly reduce exposure and improve one's chances for acquittal. For example, defense

counsel can distance the client from the conspiracy, explore *Daubert/Kumho* attacks to the government's expert witness, and prove that the total "loss" to the alleged victim is far less than actually charged. If the charges arise from a boom-year loan, the defense can put the subprime industry on trial by showing that, because nobody cared about the borrower's ability to repay, the alleged misrepresentations were not material to the funding of the loan.

In the end, prudence, preparation and a little creativity can make all the difference. 



1. Kevin Tate, *Introduction to Mortgage Fraud Terms, Players, Defense Strategies, Pretrial Motions and Defenses*, at Administrative Office of the U.S. Courts Office of Defender Services Training Branch Winning Strategies Seminar (June 18, 2010).
2. See *House of Cards* (CNBC television broadcast, June 23, 2009); *The Giant Pool of Money* (This American Life and National Public Radio broadcast, May 9, 2008).
3. See James Charles Smith, *The Structural Causes of Mortgage Fraud*, 60 SYRACUSE L. REV. 473 (2010).
4. See, e.g., Tate, *supra* note 1; Andrew J. Ceresny, Gordon Eng & Sean R. Nuttall, *Regulatory Investigations and the Credit Crisis: The Search for Villains*, 46 AM. CRIM. L. REV. 225 (2009).
5. Secure and Fair Enforcement for Mortgage Licensing Act of 2008 ("SAFE Act"), Housing and Economic Recovery Act of 2008 ("HERA"), Div. A, Title V, Pub. L. No. 110-289.
6. HERA, Div. B, Title V, Pub. L. No. 110-289.
7. Mortgage Reform and Anti-Predatory Lending Act ("Mortgage Reform Act"). Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Title XIV, Pub. L. No. 111-203.
8. Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, 123 Stat. 1617 (2009); Nicholas McCann, *Federal Law Enforcement in the Home Mortgage Lending Market Enhanced by the "Fraud Enforcement and Recovery Act of 2009,"* 22 LY. CONSUMER L. REV. 354 (2010).
9. FERA, *supra* note 8 (the bulk of this funding is budgeted for fiscal years 2010 and 2011).
10. Press Release, U.S. Department of Justice, Operation Stolen Dreams—Hundreds Arrested in Mortgage Fraud Sweep (June 17, 2010).
11. Press Release, U.S. Department of Justice, Attorney General Holder, Financial Fraud Enforcement Task

- Force Announce New Funding Distribution for Enforcement Efforts at Mortgage Fraud Summit in Phoenix (Mar. 25, 2010); Press Release, U.S. Department of Justice, Arizona Financial Fraud Enforcement Task Force Announces Results of "Operation Stolen Dreams" Targeting Mortgage Fraudsters (June 17, 2010).
12. Federal Bureau of Investigation, 2009 Mortgage Fraud Report "Year in Review," at app. A (2010); Interthink, 2010 Mortgage Fraud Risk Report (2010); Mortgage Asset Research Institute, Twelfth Periodic Mortgage Fraud Case Report (April 2010).
13. The State of Arizona also prosecutes mortgage fraud. A.R.S. § 13-2330 (prohibiting mortgage fraud and a "pattern" thereof; first-time offenders are probation-eligible); Press Release, Office of Arizona Attorney General Terry Goddard, Terry Goddard Wins \$1.7 Million to Fight Mortgage Scams (Sept. 16, 2010) (with federal grants, Arizona Attorney General will devote six-person unit to "investigating and prosecuting mortgage related crimes."). Although this article focuses on federal criminal liability, the defense strategies are similar in State prosecutions.
14. See, e.g., Brian Walsh & Tiffany Joslyn (forward by Edwin Meese III and Norman L. Reimer), The Heritage Foundation and National Association of Criminal Defense Lawyers, *Without Intent: How Congress Is Eroding the Criminal Intent Requirement in Federal Law* (2010); HARVEY SILVERGATE, THREE FELONIES A DAY: HOW THE FEDS TARGET THE INNOCENT (Encounter Books 2009); *Rough Justice in America: Too Many Laws, Too Many Prisoners*, The Economist (June 22, 2010).
15. 18 U.S.C. § 1014.
16. *United States v. Wells*, 519 U.S. 482, 484 (1997).
17. *United States v. Blumenthal*, 945 F.2d 280, 282-283 (9th Cir. 1991) (intent to influence bank, but not intent to deceive, is required; actual reliance by lender also not required).
18. 18 U.S.C. §§ 1341 (requiring use of the mails), 1343 (requiring use

- of interstate wire), 1344 (bank fraud).
19. *Neder v. United States*, 527 U.S. 1, 25 (1999).
20. *United States v. Tulaner*, 512 F.3d 576, 580 (9th Cir. 2008).
21. Compare 18 U.S.C. § 371 (general conspiracy statute: five-year prison term) with 18 U.S.C. § 1349 (conspiracy to commit mail, wire, or bank fraud has same penalty as underlying offense: up to 30 years). Aiding and abetting liability provides for the same penalty as the underlying offense. 18 U.S.C. § 2.
22. *United States v. Green*, 592 F.3d 1057, 1067 (9th Cir. 2010); *United States v. Veltre*, 591 F.2d 347, 350 (5th Cir. 1979).
23. *Green*, 592 F.3d at 1067.
24. See, e.g., *Arthur Andersen LLP v. United States*, 544 U.S. 696, 707-08 (2005).
25. 18 U.S.C. § 1001 (up to five-year prison term for knowing and material false statements to government; does not require reliance upon or belief in truth of false statements).
26. See, e.g., 18 U.S.C. §§ 1503 (catch-all provision prohibits interference with "due administration of justice," including corrupt destruction of documents and influence of witnesses; pending judicial proceeding typically required), 1505 (prohibiting similar conduct as in § 1503 with respect to proceedings before federal agencies); 1512 (applies to witness tampering and destruction of documents even if proceeding not pending or about to be implemented), 1519 (destruction of documents provision under Sarbanes-Oxley Act). These statutes require a "nexus" linking the obstructive conduct to the government proceeding. See *United States v. Aguilar*, 515 U.S. 593, 599 (1995); *United States v. Reich*, 479 F.3d 179, 185-186 (2d Cir. 2007); *United States v. Russell*, 639 F. Supp. 2d 226, 233-236 (D. Conn. 2007) (but nexus need not be alleged in indictment).
27. See Barry Tarlow, *Queen for a Day—Proffer Your Life Away*, THE CHAMPION, March 2005; Jon May, *Queen for a Day From Hell: How To Handle a Troubling Proffer Letter*, THE CHAMPION, September-October 2006.

28. *United States v. Dobson*, 419 F.3d 231, 237 (3d Cir. 2005).
29. *Green*, 592 F.3d at 1070.
30. *Id.* at 1070, 1071.
31. *Id.* at 1071.
32. *United States v. Thomas*, 32 F.3d 418, 420-421 (9th Cir. 1994) (reversing conviction for failing to allow fruit broker defendant to introduce evidence of beneficial effect of pricing scheme on grower customers not named in indictment); *United States v. Coppie*, 24 F.3d 535, 545, n.16 (3d Cir. 1994) (defendant can "introduce testimony of collateral transactions that tend to negate the requisite intent" to defraud); *United States v. Garvin*, 565 F.2d 519 (8th Cir. 1977) (reversing conviction for preventing defendant from introducing evidence of intent in making false statements on insurance applications).
33. Tate, *supra* note 1.
34. *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993); *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999).
35. See *Davis v. Alaska*, 415 U.S. 308 (1974) (cross-examination regarding bias is protected by the Sixth Amendment; it is not mere collateral impeachment).
36. U.S.S.G. § 2B1.1 cmt. n.3; U.S.S.G. § 2B1.1 cmt. n.2(A); *United States v. Crandall*, 525 F.3d 907, 912 (9th Cir. 2008) (under Section 2B1.1, it is error not to reduce loss by the value of the properties).
37. *Brady v. Maryland*, 373 U.S. 83 (1963).
38. Rule 17, FED.R.CRIM.P. Although courts are often unresponsive to using Rule 17 to compel the pre-trial production of documents on the grounds that criminal defendants have no constitutional right to discovery, applicable case law actually permits it. See Peter J. Henning, *Defense Discovery in White Collar Criminal Prosecutions: Federal Rule of Criminal Procedure in Subpoenas*, THE CHAMPION, December 1999.
39. Tate, *supra* note 1. The defendant has the substantial right to be tried on the charges presented to the grand jury. *Gault v. Lewis*, 489 F.3d 993, 1003 (9th Cir. 2007).