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Mortgage Fraud: New Litigation Threats

Asserting and Defending Claims by FDIC and Other Federal and State Agencies

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Today's faculty features:

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Legal Counsel to the
Financial Services Industry

Resolving and Preventing Mortgage Fraud

Strafford's CLE Webinar and Teleconference: Mortgage Fraud - New Litigation Threats

January 19, 2012

Andrew L. Sandler
Chairman & Executive Partner
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Overview

- The Key Participants
  - Federal and state enforcement agencies are becoming more aggressive in their efforts to address mortgage fraud.
  - Targeting the full-spectrum of industry participants.
- Detecting and Preventing Mortgage Fraud

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Mortgage Fraud: a Costly and Growing Problem

- Mortgage loan fraud imposes significant costs on lenders as well as borrowers.

  - Litigation, enforcement, and reputation risks.

  - Frequently, investors require lenders to buy back fraudulent loans, forcing the lender to service or sell at a loss.

  - Borrowers are harmed as lenders indirectly transfer the costs of fraud to them.

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Mortgage Fraud: a Costly and Growing Problem – *cont.*

- In the second quarter of 2011, FinCen reported over 29,000 mortgage loan fraud Suspicious Activity Reports (SARs), an 88% increase over the previous year.
  - A majority of these reported fraudulent activities took place between 2006 and 2008.
  - The elapsed time from the activity date to reporting date is unsurprising—loan reviews have led to the discovery of suspicious activity.

Department of Justice Combating Mortgage Fraud

- Mortgage fraud enforcement is a stated priority of Attorney General Holder.

- In November 2009, President Obama established the Inter-agency Financial Fraud Enforcement Task Force, led by DOJ.
  - Broad coalition of agencies aimed at improving and coordinating investigations of mortgage fraud.
  - Comprised of federal agencies, including SEC, Treasury, Commerce, HUD, USAOs, and state and local partners.
  - On December 7, Attorney General Holder announced the appointment of Michael J. Bresnick, who previously worked in the DOJ's Criminal Division, to serve as executive director of the Financial Fraud Enforcement Task Force.

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Department of Justice on the March

- DOJ requested $178 million in FY 2011 budget to fight mortgage fraud, an increase of more than $18.4 million.

- June 17, 2010: Task Force announced results from "Operation Stolen Dreams."

  - Largest ever collective enforcement effort targeting mortgage fraud.
  - Targeted 1,517 criminal defendants nationwide, included 525 arrests, and involved an estimated loss of more than $3 billion.
  - 191 civil enforcement actions and the recovery of more than $196 million.

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Other Federal Agencies Pursuing Similar Aggressive Efforts

- FBI investigating over 2,800 cases, 72 percent of which involve losses of more than $1 million.

- FDIC
  - As the receiver of a failed bank, the FDIC assumes the task of selling and collecting the assets of the failed bank and settling its debts.
  - FDIC may pursue mortgage fraud claims against appraisers, attorneys and/or closing agents, title companies and title insurance companies, and mortgage loan brokers.
  - 189 residential mortgage malpractice and fraud lawsuits are pending, consisting of lawsuits filed and inherited.

The Evolving State Approach: Fraud Task Forces and New Joint Efforts

- Mirroring the creation of the Inter-agency Financial Fraud Enforcement Task Force, states have created their own task forces.
  - California's Attorney General announced the creation of the "Mortgage Fraud Strike Force" in May.
- State AGs also creating joint task forces.
  - On December 6, the Attorneys General for California and Nevada announced a joint effort to pursue mortgage-related civil and criminal investigations.
  - Agreed to share resources, information, evidence, subpoena power, and litigation strategies.
  - The new "joint investigative alliance" aims to accelerate the states' investigations.

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The Evolving State Approach – *cont.*

- AG's also seeking additional funding to pursue mortgage fraud.
  - Arizona AG pledged to wage a broad and intensified fight to prevent, prosecute, and punish mortgage fraud, aided by an additional $1.7 million in federal funding.

- States also shifting toward criminalization of mortgage fraud.
  - Recent amendments increasing mortgage fraud criminal penalties in Florida and Michigan.

Targeted Defendants and Mortgage Fraud Schemes

- The FBI estimates that industry insiders are involved in 80% of all reported mortgage fraud.

- The common participants involved in these schemes include:
  - Appraisers
  - Borrowers
  - Closing/Settlement Agents
  - Loan Servicers
  - Originators
  - Loan Processors
  - Real Estate Agents
  - Title Agents
  - Underwriters

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Common Schemes: Fraud for Property

- Individual borrowers often involved in “fraud for property” schemes.
  - Borrowers attempt to defraud a lender to purchase a house for their own use.
  - Done through overstating income or misstating expenses and providing false or forged documents.

- Often involves complicit third parties, like brokers, appraisers, or others.

Common Schemes: Fraud for profit

- Fraud for profit schemes center around a plan to inflate property values and then repeatedly flip the properties.

- This scheme employs a variety of mechanisms:
  - Issuing loans on fictitious properties
  - Misrepresenting investment property as owner-occupied property
  - Misrepresenting personal identifications
  - Falsifying documents
  - Using “straw buyers” to obtain loans
  - Creating fictitious or nonexistent payees on monetary instruments

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Mortgage Fraud and Lenders

- Although they are often the victim of fraud, banks and financial institutions may become defendants in litigation or involved in government inquiries.

- May occur where they were active participants in the fraud or lacked adequate policy and procedures to prevent it.

  – In 2005, Option One Mortgage entered into a joint agreement with the U.S. Attorney's Office for the Eastern District of Pennsylvania.
    - Investigation revealed, among other things, that independent mortgage brokers had submitted to Option One fraudulent loans in the form of inflated appraisals.
    - In response, Option One established new anti-fraud policies, performed broker reviews, created a fraud hotline, and instituted fraud prevention committees.

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Mortgage Fraud: New Litigation Threats

Asserting and Defending Claims by the FDIC and Other Federal and State Agencies

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Hughes Hubbard

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Theories of Liability – Negligence/Gross Negligence

- Typically brought against directors and officers
- General elements of Negligence
  - Duty and Standard of Care
    - Directors and officers typically owe a duty of care. *See FDIC v. Bierman*, 2 F.3d 1424, 1432 (7th Cir. 1993) (owe a duty to keep "abreast of the bank's business and exercising reasonable supervision and control over the activities of the bank.") (citations omitted).
    - Under 12 U.S.C. § 1821(k), the default standard of care is **gross negligence**. However, the FDIC may also sue for **simple negligence** if state law permits. *Atherton v. FDIC*, 519 U.S. 213 (1997).

Theories of Liability – Negligence/Gross Negligence

- Elements (continued)
  - Breach
    - Fact-specific inquiry
    - Red flags that could lead to D&O liability:
      - Negligently approving specific transactions
      - Failure to supervise/establish adequate internal controls
      - Failure to recognize and appropriately respond to a pattern of suspicious behavior

Theories of Liability – Negligence/Gross Negligence

- Elements (continued)
  - Causation and Damages
    - In order to hold a director or officer liable for losses to a corporation, a plaintiff must show that the defendant's acts or omissions proximately caused the subsequent losses. *FDIC v. Bierman*, 2 F.3d 1424, 1434 (7th Cir. 1993) (citing cases).
    - Injury must be **foreseeable** from defendant's conduct
    - Defendant's conduct may not have to be the sole cause of the injury as long as it was a **substantial** cause. *See Maiz v. Virani*, 253 F.3d 641, 675 (11th Cir. 2001).

Theories of Liability – Breach of Fiduciary Duties

- Under common law, directors owe two basic duties:
  - Duty of Care
    - Typically requires that directors act (1) in **good faith** and (2) with the **care of an ordinarily prudent person** in a like position under similar circumstances and (3) in a manner the director believes to be in the **best interests of the bank**
  - Duty of Loyalty
    - Typically requires directors to **act on behalf of the corporation**, **refrain from self-dealing**, **usurpation** of corporate opportunity, or any acts that would give an **improper personal benefit**

Theories of Liability – Breach of Fiduciary Duties

- Non-director officers typically owe the same or substantially similar duties as the directors
  - For example, Model Business Corporation Act § 8.42 provides:
    - An officer with discretionary authority shall discharge his duties under that authority: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation.

Theories of Liability – Professional Negligence/Malpractice

- Elements of professional negligence are generally the same as ordinary negligence.
  - Requires (1) duty, (2) breach, (3) causation, and (4) damages.
  - Sometimes also a privity requirement.
  - Check state law for exact elements.
- Contract theory?

Theories of Liability – Professional Negligence/Malpractice

- Standard of Care – usually that of a professional of ordinary care and prudence in the same or similar circumstances
- Proving causation may be an issue
  - Courts may reject claims if too speculative or attenuated. *See FDIC v. Ernst & Young*, 967 F.2d 166, 171-72 (5th Cir. 1992); *RTC v. Stroock & Stroock & Lavan*, 853 F. Supp. 1422, 1427 (S.D. Fla. 1994).

Theories of Liability – Professional Negligence/Malpractice

- Duty to Investigate?
  - *FDIC v. Clark*, 978 F.2d 1541 (10th Cir. 1992) – attorneys held liable for failing to uncover and prevent a "fraudulent scheme" perpetrated by the bank officers
  - *FDIC v. O'Melveny & Myers*, 969 F.2d 744 (9th Cir. 1992) – held that the presence of a client's fraud did not negate an attorney's duty of care, and that attorney could be held liable for financial loss suffered by third parties who relied on attorney's misinformation

Theories of Liability – Aiding and Abetting in Breach of Fiduciary Duty

- If a third party knowingly and actively participates in the breach of fiduciary duties of another, liability may attach for aiding and abetting the principal actor's breach
  - Can be used to reach culpable persons who are neither directors nor officers (e.g., attorneys, accountants, etc.)
  - Courts split on whether it is a valid cause of action
  - Elements vary, but typically require high level of scienter and substantial assistance

Theories of Liability – Criminal Liability

- Bank fraud - 18 U.S.C. § 1344
- Wire fraud - 18 U.S.C. § 1343
- Mail fraud - 18 U.S.C. § 1341
- False statements - 18 U.S.C. § 1014
- Money laundering - 18 U.S.C. § 1957
- Conspiracy - 18 U.S.C. § 1349, 18 U.S.C. § 371

Defenses – Business Judgment Rule

- Director or officer not held liable unless:
  - Action was not in **good faith**; or
  - Acted without **due care** (duty of care); or
  - Did not reasonably believe action to be in the **best interest of the company** (duty of loyalty).
- Applies to directors, may also apply to officers.
  - *See, e.g., Brandt v. Bassett (In re Southeast Banking Corp.)*, 827 F. Supp. 742, 748 (S.D. Fla. 1993) ("Florida also arguably applies the Business Judgment Rule to officers").

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Defenses – State Insulating Statute

- Most states have some form of insulating statute protecting directors and officers from liability for simple negligence.
- Typically, do not apply to officers, however, and do not limit liability for breach of the duty of loyalty.
- 12 U.S.C. § 1821(k) preempts state statutes so that they do not insulate for conduct that is grossly negligent or worse.

Defenses – Superseding Causation

- Arises in the context of the bad economy/bad housing market as a superseding cause of the bank's failure.
- Superseding cause must be a highly improbable and extraordinary event that was not a reasonably foreseeable danger from the defendant's negligence.
- Can be overcome if in jurisdiction where defendant's conduct need not be the sole cause of the injury, but only a substantial cause (*e.g.*, in Florida).

Defenses – Comparative Fault By Bank Regulators

- Based on an argument that OTS or another regulatory agency failed to adequately detect the poor lending practices that led to the bank's failure
- ***Not a valid defense against the FDIC.*** "The federal regulatory agencies have no duty to warn financial institutions of improprieties its examinations reveal in order to protect the institutions from losses." *Resolution Trust Corp. v. Greenwood*, 798 F. Supp. 1391, 1397 (D. Minn. 1992).

Defenses – Scope of Employment

- Typically arises in a legal malpractice action
  - Argument is that the attorney was hired for specific task or tasks and that the attorney's failure to act, which constitutes the alleged malpractice, is outside the scope of the engagement
  - Requires a close reading of the engagement letter
  - Duty to investigate?

Defenses – Statute of Limitations

- For tort claims, the FDIC has the longer of three years or the applicable state statute of limitations. *See* 12 U.S.C. § 1821(d)(14).
- For contract claims, the FDIC has the longer of either six years or the applicable state statute of limitations. *Id.*
- Begins to run at the later of when the FDIC becomes receiver, or when the cause of action accrues.

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Red Flags for Detecting Fraud

- Fraud schemes continue to evolve and become more innovative.
- Developing strong internal controls reduces the opportunity for mortgage fraud.
- While a fraudulent scheme is not always apparent, there are many warning signs.
- The presence of one "red flag" may not be significant by itself; however, many may indicate the presence of fraud.

Red Flags for Detecting Fraud – *cont.*

- A few red flags include:
  - Unsigned or undated loan applications.
  - Signatures on application documents that do not match.
  - An abnormal volume of loan applications from the same individual borrower.
  - Borrower's income is inconsistent with his/her type of employment.
  - The borrower's years of education appear inconsistent with the borrower's stated occupation.
  - Items on the borrower's credit report do not match those listed on the application.
  - Large amount of cash out in a refinance.
  - Significant increases in the borrower's housing expenses.
  - Erratic increases in the property's appraised value.

Preventative Steps to Mitigate Fraud

- Make an institutional commitment to deter and detect fraud.
  - Provide training so employees may stay on top of and detect the latest fraudulent schemes.
  - Ensure that training is routine and updated following revisions to anti-fraud policies or procedures.
  - Institute fraud committees and place senior management in key positions in order to monitor fraud.
  - Provide clear internal reporting procedures for employees to follow once fraudulent activity has been detected.
  - Require employees to certify that they have completed fraud training.
  - Create a fraud hotline.

Preventative Steps to Mitigate Fraud – *cont.*

- Perform targeted monitoring of key participants.
  - Monitor brokers and appraisers by creating objective score cards or placing brokers or appraisers on watch lists.
  - Review appraisals to assess whether they are appropriate.
- Monitor the actions of the parties during closing.
  - Require closing agents to verify the identifications of the parties to the transaction.
  - Document closing funds, verify the source of closing funds, and only accept certified funds from a verified depository institution.

Preventative Steps to Mitigate Fraud – *cont.*

- Separate fraud detection functions from the lines of businesses responsible for originations.

- Create a policy addressing source and seasoning of funds used for down payment.

- Implement targeted reviews based on geography and loan performance.
  - Law enforcement and industry data indicates that the top states for known or suspected mortgage fraud activity during 2010 were Arizona, California, Georgia, Florida, Illinois, Maryland, Michigan, New Jersey, and New York, and Texas.

Preventative Steps to Mitigate Fraud – *cont.*

- Review samples of loan losses and then identify patterns of common participant names used during loan origination or processing.

- Utilize services that pool information and data to identify possible perpetrators of mortgage fraud.

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