Michigan Association of REALTORS7
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Disappearing second mortgages and other similar "creative" financing devices

Several years ago, our legal seminar discussed what was then a fairly new practice which we then referred to as "disappearing second mortgages." This practice B and similar devices designed to inflate the loan amount for a home B continue to flourish in Michigan and around the country. According to a recent article in the *Wall Street Journal*, there is currently a pending case filed by the Pennsylvania attorney general against an appraiser and a builder alleging that they colluded to sell inflated Poconos' property to 170 different families. According to the Pennsylvania attorney general, in return for a steady stream of work, the appraiser simply accepted, without question, the builder's property valuation figures. When, years later, these home buyers went to refinance and/or sell their homes, they were startled to find that their homes were worth significantly less than they paid for it. Many of these buyers simply walked away from their home leaving the lender with an asset worth significantly less than the loan amount.

It is important that REALTORS7 recognize mortgage fraud scenarios and avoid them at all costs. For those of you unfamiliar with "disappearing second mortgages," the scenario is typically something like this:

> Seller lists home for $50,000. The home sits on the market for several months without an offer. A Buyer presents an offer at $49,000 which is contingent upon financing. Seller accepts this offer. At some point, Listing Broker receives a call from a mortgage broker who indicates that in order for the Buyer to obtain financing, the purchase agreement must be amended to provide for a $60,000 purchase price. The Seller is to agree to take back a second mortgage for the difference which will be

> forgiven by Seller immediately after closing upon payment of $1 by the Buyer. Buyer is to obtain 90% financing, that amount being $54,000. An out of town appraiser, using comparables from another area, has appraised the home at $60,000. Listing Broker is assured that this arrangement is "done all the time." Seller wants to sell his home and tells Listing Broker that he does not care what the paperwork looks like -- as long as he gets $49,000 for his home. Listing Broker is concerned that if he does not assist Seller in restructuring this transaction, Seller will proceed forward without him and he will not get his commission.

As we stated several years ago, under no circumstances should REALTORS7 participate in these types of arrangements. The stated purchase price of $60,000 is clearly fraudulent and designed to cause a lender to believe that it is providing 90% financing on a $60,000 home B when in fact it is providing 108% financing on a $50,000 home.

Based upon recent calls that we have received, there are any number of variations on this technique. It was once proposed to this author, for example, that the parties amend the purchase agreement to increase the purchase price by $16,000 and then provide in an addendum that at closing, the seller will pay off the buyer's $16,000 car loan. Other times, the inflated purchase price amount is to be offset by a "remodeling credit" back to the buyer. In the Pennsylvania case, it is alleged that the builder, in essence, secretly paid the buyer's down payment and was reimbursed through an inflated sales price (financed through an inflated loan amount). Whatever the specifics, the purpose of these "creative" financing devices is the same. They are designed to defraud the ultimate lender.

These financing devices are often used in the types of transactions where a future default is fairly likely. When and if the lender discovers that it has been defrauded, presumably it will sue everyone involved in the transaction, including the real estate broker. Not only will the broker be subject to a common law fraud claim, but also, as will be discussed below, the broker may be subject to various criminal sanctions.

A. Federal Criminal Provisions

Federal law provides extremely severe criminal penalties for fraud or misrepresentations committed by anyone involved in a loan transaction that is in any way funded or subsidized by any federally insured financial institution or government agency (such as the FHA). According to 18 U.S.C. ' 1014:

> [w]hoever knowingly makes any false statement or report, or willfully overvalues any land, property or security, for the purpose of influencing in any way the action of [a federally-insured institution or agency] . . . upon any application, advance, discount, purchase, purchase agreement, repurchase agreement, commitment, or loan, or any change or extension of any of the same, by renewal, deferment of action, or otherwise, or the acceptance, release, or substitution of security therefor, shall be fined not more than one million dollars or imprisoned not more than thirty years, or both. (Emphasis added.)

B. Michigan Criminal Provisions

In addition to the draconian penalties imposed by Federal law, the use of disappearing second mortgages and other "creative" financing devices may run afoul of several provisions of the Michigan Penal Code. Specifically, MCL 750.218(1); MSA 28.415(1), the "false pretenses" statute, provides the following:

> A person who, with intent to defraud or cheat and by color of a false token or writing, by a false or bogus check or other written, printed, or engraved instrument, by counterfeit coin or metal that is intended to simulate a coin, or by any other false pretense . . . causes a person to grant, convey, assign, demise, lease, or mortgage land or an interest in land . . . is guilty of a crime punishable as provided in this section. (Emphasis added.)

Where the land or intangible interest in land involved in the transaction is valued at $20,000 or more, the crime is considered a felony, punishable by ten years imprisonment and a fine of $15,000 or three times the value of the property, whichever is greater. MCL 750.218(5)(a); MSA 28.415(5)(a). Like Federal law, Michigan also specifically criminalizes false statements made to lenders or banking institutions for the purpose of obtaining a loan or extension of credit, with violations punishable by one year imprisonment or a $500 fine. MCL 750.219; MSA 28.416.

C. Recognizing the "Red Flags"

Obviously, not every transaction where a seller takes back a second mortgage is fraudulent. Likewise, it is certainly permissible for a seller to give the buyer a remodeling credit or to pay some of the buyer's closing costs. How then does a REALTOR7 differentiate between a legitimate transaction and a fraudulent one?

There are a number of red flags. A call from a buyer's agent or mortgage broker after a purchase agreement is signed indicating that the purchase price needs to be increased is certainly a red flag. An appraisal by an out of town appraiser using out of area comparables is another red flag. But perhaps the most telling "red flag" of all is where the purchase agreement says one thing, and an addendum or side agreement says something else. REALTORS7 should keep in mind that fraud does not necessarily require the presentation of false information, but can also involve simply withholding relevant information.

In fact, the United States Supreme Court has expressly upheld the conviction of a borrower who simply withheld a secret side agreement from its lender. US v Wells, 519 US 482; 117 S Ct 921; 137 LEd2d 107 (1997). In Wells, a copy machine lessor obtained a loan from a bank by using the income stream from its copy machine leases as collateral. When it applied for the loan, it provided the bank with copies of the lease contracts which showed that the customers were responsible for service costs. In actuality, there were secret side agreements that made the copy machine lessor responsible for servicing the copy machines at no cost to its customers. The copy machine lessor did not show these side agreements to its bank because it was afraid that the bank would then require it to tie up some of the loan proceeds in a reserve account. As a result, the copy machine vendor found itself convicted of a crime by a federal court jury.

C. Who is the "Lender"?

Often times, REALTORS7 will argue that the transaction cannot be fraudulent because it was structured at the direction of the lender or an employee of the lender. This is simply incorrect. REALTORS7 should be aware that federal courts have consistently held that a borrower is still guilty of a crime even if the fraud was committed with the knowledge and consent of one of the bank's loan officers.

Moreover, REALTORS7 should also keep in mind that the nature of residential loans has changed significantly in recent years. Years ago, when local bankers made residential mortgage loans directly and held them, they had a strong incentive to make certain that the value of the property supported the loan amount. Today, loans are often arranged by mortgage brokers or by a lender who intends to immediately sell the loan B neither of whom have a concern over the long term health of the loan. It is criminal to knowingly defraud the ultimate purchaser of a loan, even if the lending "middleman" is actively involved B or even initiates B the scheme. In these criminal prosecutions, the question is not whether the defendant made the false statement directly to the ultimate lender, but whether he should have had a "reasonable expectation" that the false statement would reach that lender.

For example, in US v Smith, 29 F3d 914 (CA 4, 1994), Smith formed a corporation to develop and sell residential townhouses, which he had difficulty selling. To raise needed capital, Smith recruited his brother and a friend to sign multiple purchase agreements for the townhouses, with the assurance that they would not be required to pay the down payment at closing or to make any payments on the properties. Smith then used the signed purchase agreements to obtain financing from a bank, through its real estate sales subsidiary.

In appealing his conviction for false statements made to a financial institution, Smith argued that since the loans were arranged through a realty company, not a bank, he did not make false statements to a bank as required for criminal liability. The court rejected this argument, noting that while the realty company was not a bank, Smith knew that his statements would influence the action of a bank, as the bank was the ultimate purchaser of the loans originated by the realty company.

D. Inflated Appraisals

At the heart of almost all these creative financing schemes is an inflated appraisal. Federal regulations require some form of appraisal for virtually every residential real estate loan. Appraisers complain that as a result of the changes in the residential real estate industry, there is increasing pressure on them to inflate their appraisals. Many appraisers are pushing for state and federal regulations that would prohibit mortgage brokers and lenders from coercing or intimidating appraisers or from tying payment for an appraisal to a desired property value.

According to a recent article in the *Wall Street Journal*, the United States Department of Justice says that it has made fighting mortgage fraud a priority. According to that same article, the amount of mortgage fraud reported by federally chartered banks has nearly doubled over the last two years to $293 million annually.

These fraud claims are being pursued not only by the government in criminal cases, but also by the lenders themselves in civil cases. For example, several lenders have filed a lawsuit in Georgia alleging that a developer and an appraiser conspired together using inflated appraisals to defraud the lender out of tens of millions of dollars in losses on more than 600 properties. REALTORS7 should keep in mind that lenders bringing these suits will not only sue the borrower and mortgage broker who came up with the scheme, but also the appraiser and anyone else who participated in the scheme, including the real estate licensee.

E. Conclusion

The statutes and cases discussed above clearly indicate the seriousness with which federal and Michigan law regard the falsification of mortgage or loan documents, applications, statements and paperwork. Given the drastic consequences B i.e., damages, penalties, fines and imprisonment B REALTORS7 must simply refuse to participate in such a transaction. If the buyer later defaults B which is not an unlikely event under these circumstances B all persons that knowingly participated in the fraudulent transaction are subject to possible prosecution. The fact that the REALTOR7 was instructed by a mortgage broker or a loan officer as to how to structure the transaction – or the fact that the REALTOR7 was told that "these types of transactions are done all the time" B will not be of much help to the REALTOR'S7 attorney in keeping his client out of jail.