Mortgage Fraud: Assessing and Avoiding Liability

It starts out simply. A borrower goes to a loan officer to obtain a mortgage. The loan officer works for a mortgage broker, which contracts with a bank to fund the mortgage. Then it gets complicated. The first bank sells the mortgage to a second bank as part of a loan portfolio; the second bank transfers the mortgage, along with a pool of many others, into a trust, where the mortgages are securitized and sold to investors as mortgage-backed bonds.

What Happens When It Is Discovered That the Mortgage Was Obtained by Fraud?

During the past two years, a large number of lawsuits and a far greater number of arbitrations have been initiated by and against financial institutions over losses caused by mortgage fraud. These include claims between banks that bought and sold fraudulent mortgages, as well as claims against brokers, appraisers, underwriters and title companies for their role in originating these loans.

What can financial institutions and others do when faced with potential claims due to mortgage fraud? What can they do to protect themselves going forward? Our Firm's experience working on these issues reveals a number of points that mortgage lenders should keep in mind.

What Is Mortgage Fraud and How Can It Be Avoided?

Financial institutions increasingly are facing repurchase demands, and lawsuits or arbitrations, because mortgage loans they sold involved borrower or broker fraud.

There are two basic categories of fraud - fraud for housing and fraud for profit. Fraud for housing involves a borrower (often with the loan officer's help or indifference) providing false information regarding income, assets or debts in order to obtain the financing needed to purchase a home. Such fraud also includes loans where the borrower was required to make a down payment or pay certain closing costs, but the funds actually were paid by the seller or broker.

Fraud for profit is where the purported "borrower" provides the false information in order to obtain loan proceeds rather than to acquire a residence. This can

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involve the use of false or stolen identifications or of straw borrowers who are paid to provide their name and credit information to the application. Another common fraudulent scheme is the practice of taking out multiple mortgages on a single property so that the different banks are unable to learn about the other loans before extending their own. In other schemes the borrower takes out mortgages on several properties, representing that each will be "owner occupied."

Determining the type of fraud is important to ascertain whether the financial institution, title company or broker ultimately bears the liability for any loss. Going forward, it is also important for financial institutions to develop practices to prevent the funding of such fraudulent loans.

Repurchase Agreements

Agreements between financial institutions for the resale of mortgages commonly contain repurchase agreements, which require sellers to buy back any mortgage later discovered to have been obtained by fraud or other material error. Many such agreements also require the seller to indemnify the buyer against any damages resulting from either the fraudulently obtained loans or the seller's refusal to repurchase. Many of them require repurchase even where some other party—a homeowner, a broker, or a lender earlier in the chain—was responsible for the fraud or error. >[?]In the past year, several courts in various states have enforced strict repurchase provisions even where the buyer had long-since resold the mortgage loan to a third party. We have seen exceptions where the repurchase or indemnity agreement was found to be ambiguous as to whether it included fraud by the borrower only. Therefore, it is important that repurchase and indemnity provisions make clear that the selling entity assumes the risk of any false or fraudulent information contained in the loan documents, including false statements by the borrower.

Verify the Broker's Insurance Coverage

Many cases against mortgage brokers end not with victory or defeat, but with the brokers going out of business or filing for bankruptcy protection. Potential claimants can ensure that court judgments or arbitration awards against bankrupt brokers are collectible by requiring proof of insurance before dealing with a broker.

Many banks already require their brokers to have insurance. However, very few

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routinely verify that the insurance is in place and coverage is sufficient. Many brokers go without errors and omissions insurance. Others have minimal term insurance that will only cover claims if both the claim and the breach occur in the same policy year—a rare occurrence since the fraud may be difficult to uncover. As a result, banks should not only verify that brokers have insurance, but should also require adequate insurance so that if problems arise, they will find more than an empty broker's office from which to seek recovery.

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