

**MORTGAGE FRAUD PROSECUTIONS IN MINNESOTA**

**26<sup>TH</sup> ANNUAL REAL ESTATE INSTITUTE**

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## MORTGAGE FRAUD PROSECUTIONS IN MINNESOTA

### **I. INTRODUCTION.**

While the wave of questionable lending practices which helped trigger the current mortgage lending crisis has largely dissipated, transactions which occurred over the past several years remain subject to prosecution. Individuals should remain diligent in avoid transactions which violate state and/or federal law.

### **II. CONTROLLING LAW.**

#### **A. Federal Law.**

1. RESPA. This discussion of the Real Estate Settlement Procedures Act (“RESPA”) is not intended to be an exhaustive presentation. RESPA (12 U.S.C. § 2601-17) may be one of the least understood and most commonly violated real estate laws. While the law is strict, the ambiguities in RESPA result in misunderstandings and substantial violations by many individuals. Although RESPA was not aggressively enforced for many years (further exacerbating lapses in good judgment), it does provide for substantial criminal and civil penalties in the event of violations. Penalties include fines of up to \$10,000 for each offense, imprisonment of up to one year, or both. Recent rampant predatory lending and the subsequent mortgage banking crisis has energized federal agencies in other jurisdictions, including the FBI and the Criminal Division of the IRS, to prosecute RESPA violations.

RESPA was enacted in December 1974 as a consumer disclosure and anti-kickback statute. RESPA seeks to protect borrowers by prohibiting individuals who provide services from paying one another for kickbacks or referral fees. Additionally, the statute protects lenders by insuring that the value of the loan is not lessened by kickbacks or other “hidden” transactions. See National Association of Realtors, RESPA: Guide to Complying with the Real Estate Settlement Procedures Act (2005).

a. Two Basic Rules. While there are certainly many complex aspects to understanding RESPA, there are essentially two basic rules to follow in order to avoid violations:

- i. All transactions must be disclosed to a lender; and
- ii. All fees or services must be earned.

b. Prohibitions/Violations.

i. Section 8(a) – Improper Referrals. Section 8 of RESPA provides two basic prohibitions. First, Section 8(a) prohibits a person from giving or receiving any fee, kickback or thing of value pursuant to an understanding that business will be referred:

“Business referrals. No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person.”

12 U.S.C. § 2607(a). There are four basic elements required for a Section 8(a) violation:

1. A settlement service involving a federally related mortgage loan;
2. A referral of business incident to or part of a settlement service pursuant to an agreement or understanding (the referral agreement does not need to be in writing);
3. A payment or receipt of thing of value; and
4. A referral of settlement service business.

In 1993, RESPA was amended to permit settlement service providers to own other settlement service providers or enter into joint venture operations, so long as the parties’ Affiliated Business Arrangement (AfBA) adheres strictly to RESPA requirements and guidelines. Generally, this exception permits AfBA owners to receive a financial return on their ownership interest in a AfBA, and these payments are not considered a referral fee as long as: (i) this referral arrangement is disclosed to the customer on a separate sheet of paper identifying the business relationship, along with the written estimate of the charge imposed by the affiliated entity; (ii) the person being referred must not be required to use any particular provider of services; and (iii) no payments other than a return on ownership interest, or payments otherwise, are permitted under the arrangement. 12 U.S.C. § 1607(c).

ii. Section 8(b) Kickbacks and Fee Splitting. Section 8(b) prohibits splitting of any charge made or received for performance of settlement services, except for services actually performed:

“Splitting charges. No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed.”

12 U.S.C. § 2607(b). A “settlement service” is broadly defined to include most, if not all, services that are performed prior to or in connection with a real estate closing transaction. “Settlement service providers” include real estate brokers, salespersons, insurance companies, attorneys, appraisers, surveyors, credit reporting agencies, mortgage bankers, home inspectors and title insurance companies. This is the oft cited provision requiring fees be “earned” as part of real estate transactions.

iii. Section 8(c). While the language of RESPA is very broad and appears to limit many payments, the provisions also contain specific exceptions. The following do not violate RESPA:

- Payment to an attorney for services actually rendered;
- Payment of a fee to a duly appointed agent of a title company, by the company itself, for services actually performed in issuing a title policy;
- Payment of a fee to a duly appointed agent of a lender, by the lender itself, for services actually performed in making the loan;
- Payment of a bona fide salary for services actually performed; or
- Payment of any compensation for goods or facilities actually furnished.

In addition to these exclusions, no violations of Sections 8(a) or (b) will be deemed to have occurred by giving a “thing of value” if the thing of value:

- Is normally a promotional or educational activity;
- Is not directly a condition for referral of business; or
- Does not involve significant expense that otherwise would not be incurred by the referring party in the real estate transaction.

See A. Arnold, Real Estate Investor’s Deskbook, § 13:5 (3d Ed. January 2007) citing 12 U.S.C. § 2607(c).

iv. RESPA Enforcement. The primary focus of RESPA enforcement looks at kickbacks and unearned fees. As discussed below, the exact nature of the transactions have evolved over time, but the

fundamental principle in a “kickback” transaction involves a payment by a buyer of an amount in excess of the actual value of a property with monies being “kicked back” to the buyer, or some other third party. The approach is usually made by the buyer or its agent offering to purchase a distressed property at or above its asking price. As part of the sales transaction, the seller is asked to “kickback” to the buyer, the buyer’s agent, a “deal facilitator” or into a sham escrow some amount of the closing proceeds.

For a desperate seller, this offers an extremely appealing temptation. The property is being sold, even with the “kickback,” still represents an attractive opportunity to remove an unwanted property from the seller’s balance sheet. However, the reason these transactions constitute a RESPA violation is the “kickback” constitutes a charge for which no actual value is rendered. The conspiracy<sup>1</sup> and fraud in the transaction is, in the final instance, perpetrated on the lender. That is, the buyer and seller are representing that the property being sold is worth the full purchase price when, in fact, the value rendered is far less when the “kickback” is remove. Thus, the lender is lending money predicated upon an illusory “full” purchase price when monies are being siphoned off through a kickback as part of the settlement service. See H. Gunnarsson, 92 Ill. B. J. 337 “Watch Out For (Un)real Estate Deals” (July 2004).

The most significant unearned fee and fee splitting case in Minnesota was the memorialized recent Consent Order between First American Title Company, the Minnesota Commissioner of Commerce and the U.S. Department of Housing and Urban Development signed on January 20, 2007. While the factual background is extensive, First American was found to have engaged in improper affiliated business relationships which directed customers for title insurance work to its related AfBAs that was not adequately disclosed in violation of 24 C.F.R. Part 3500.10 and Section 8 of RESPA. HUD found that little or no title work was provided by the title agencies themselves and settlement services purported to be provided by the title agencies were essentially provided by First American. Applying the factors in HUD’s policy statement on sham and affiliated transactions, HUD determined the title agencies were not independent business entities, but rather sham businesses controlled through arrangements in order to make referral payments back to other parties. As part of the settlement, nine builders agreed to cease their business activities with First American and agreed to pay \$225,000 in additional fines. See D.Slifer and P. Schieber, “Beware of Kickbacks: HUD’s Recent RESPA Enforcement Actions,” *Banking Law Journal* (June 2006).

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<sup>1</sup> Many of the federal indictments also include a conspiracy claim under 18 U.S.C. § 371.

Significantly, there appears to be a dispute between HUD, the 8th and 7th Circuits, and several state courts, whether the imposition of an “unearned fee” requires a transaction with a third party in order to trigger the statutory prohibition. The 8th Circuit in Haug v. Bank of America, 317 F.3d 832 (8th Cir. 2003) relied upon Echevarria v. Chicago Title and Trust Co., 256 F.3d 623 (7th Cir. 2001) in ruling that even though a bank charged more than it paid for services to a customer, because the “overcharge” was not shared with a third party, the fee splitting prohibition in Section 8(b) was inapplicable. In response to the Echevarria decision, HUD promulgated a Statement of Policy which implies that Section 8(b) prohibits all unearned fees, whether or not the transaction involves a third party. Real Estate Settlement Procedures Act Statement of Policy 2001-1, 66 Fed. Reg. 53,052 (October 18, 2001). The 8th Circuit specifically ruled that deference to the HUD Policy Statement was not warranted and that to demonstrate a violation of Section 8(b) a plaintiff must make a “showing that the defendant illegally shared fees with a third party.” Haug, 317 F.3d at 840.<sup>2</sup>

In contrast, fees or kickbacks have been found illegal where a “facilitator” or broker is paid an excessive fee for facilitating a transaction. For example, a broker or “deal facilitator” will receive a 25% undisclosed commission or “finders fee” as a cash back payment after closing. Again, this involves the typical situation where the home value is already inflated and the “kickback” is not reflected in either the HUD or the loan documents.

2. Other Federal Violations. Recent indictments for lender fraud have not included claims for violation of RESPA. Indeed, claims have turned on other federal violations, including income tax evasion (26 U.S.C. § 7201, et al), money laundering (18 U.S.C. § 1957), wire fraud (18 U.S.C. § 1343) and conspiracy (18 U.S.C. § 371).

The local office of the Department of Justice confirms that it has not focused on bringing RESPA claims per se, as claims of lender fraud inevitably involve clear misdeeds which, in and of themselves, present significant violations of other federal laws. Put simply, the Department of Justice has not found it necessary to add RESPA violations when conspiracy, money laundering or fraud claims already exist.

## **B. Minnesota Law Violations.**

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<sup>2</sup> The courts have repeatedly held that mortgage brokers and lenders may have arrangements where the lender pays a “yield spread premium” to the broker for referral of the mortgage. Such transactions fall within the loan-specific liability tests promulgated by HUD that, if properly disclosed, these fee arrangements do not violate RESPA. Glover v. Standard Federal Bank, 283 F.3d 953 (8<sup>th</sup> Cir. 2002); Brancheau v. Residential Mortgage, 187 F.R.D. 591 (D. Minn. 1999).

There are far fewer published or available Minnesota cases regarding lender fraud enforcement. Extensive discussions with the Department of Commerce and Department of Labor & Industry reveal that most lender fraud violations have been handled through administrative enforcement, investigations and proceedings, and are not available for public review. A notable exception is the joint action by the Commissioner of Commerce and HUD against First American Title. In that case, in addition to RESPA violations, First American was charged with violations of Minn. Stat. §§ 60K.43 (Insurance License Revocation) 72A.08 (Prohibited Rebates Under Regulation of Trade Practices), 72A.20, subd. 18 (Improper Business Practices), and Minn. R. 2795.0800 (Department of Commerce – Insurance Agent). In the Matter of First American Title, “Consent” (January 20, 2007) at p. 4. Additionally, actions involving lender fraud typically involve claims relying upon the Minnesota Consumer Fraud Act (Minn. Stat. § 325F.68-70) and Minnesota Uniform Deceptive Trade Practice Act (Minn. Stat. § 325D.43-48). See generally Blair v. Source One Mortgage Services Corporation, 925 F.Supp. 617, 619 (D. Minn. 1996).

### **III. CURRENT DEPARTMENT OF COMMERCE CASES.**

It is crucial to note that while many of these transactions, especially those involving “stated income” borrowers, occurred several years ago, the passage of time offers builders and developers little comfort. There is certainly a statute of limitations for breach of contract between individuals (six years under Minn. Stat. § 541.05), and a statute of limitations for criminal complaints under RESPA (one year under 12 U.S.C. § 2614), but no such parallel statutes exist as to licensure violations by builders or other professionals including realtors and appraisers. In fact, the Department of Commerce has asserted there is no applicable statute of limitations which bars enforcement, even after traditional statutes of limitation have expired.

While many of the problems with “stated income” borrowers have been addressed through substantial amendments to Chapter 58, there remains the problem that past transactions could make builders vulnerable. Additionally, while there are far fewer creditless borrowers who would qualify for a loan since the onset of the current credit crisis and amendments to Chapter 58, there are still ways to purchase properties in violation of the statutes, even with otherwise qualified borrowers.

**A. Primary Focus of State of Minnesota – Department of Commerce and Department of Labor & Industry.** The State of Minnesota, through the Department of Commerce, the Department of Labor & Industry, and the Attorney General’s office, has received complaints relating to the financing of transactions through multiple sources, including lenders, brokers, appraisers, and other parties participating in “questionable” transactions. The Department of Commerce has indicated that one of the major indicators of fraud currently being examined by investigating officers is whether the loan made is greater than the actual demonstrable value of the home. Regardless of the byzantine intricacies of the transaction, the key point is whether the purchase price and loan exceed the intrinsic value of the property being sold. If this is the case, there is a “fraud” on the lender and the transaction is inherently improper.

**B. Evolution of Fraudulent Transactions<sup>3</sup>.**

1. Example:

a. Transactions Not Reflected on HUD. The initial *modus operandi* for parties engaging in fraudulent transactions was to simply not reflect the increased price for an “improvement” (a/k/a the kickback to the buyer) on the HUD statement and have a check issued following the closing.

Initially, the property listed for \$279,900, but later decreased in value. See Exhibit 1A. On May 20, 2005, the property received an offer of \$302,000, with \$57,000 going back to finish the basement. Shortly thereafter, the MLS listing was increased to \$310,000. This is important because it created the illusion that the ultimate purchase price was less than the requested offer.

b. Appraiser. Crucial in many of these transactions is an incompetent/sloppy appraiser, or an individual who is aware of the improper actions contemplated in the transaction. In this case, the Department of Commerce is investigating the appraiser, because the appraiser testified that the \$47,100 “improvement” to the basement (a/k/a the “kickback”) represented a 5% reduction in the value of home. Obviously, this is either an incredibly basic math error (5% of \$302,000 = \$15,100), or the product of fraud.

The closing ultimately occurred with a check of \$57,000 to the buyer. This payment was not reflected in the HUD.

c. Phantom Escrow. Fraudulent transactions often involve a phantom “escrow agreement.” In the typical escrow arrangement, a title company acts as the escrow agent between the buyer and the seller to permit outstanding issue to be resolved following the closing. What is different in fraudulent transactions, is the escrow is often between the buyer and seller and does not constitute a real “escrow.” Rather, the transaction is merely a vehicle to transfer money from the seller to the buyer. For example, in this case, the amount the buyer and seller were placing into “escrow” was subject to continual negotiation. While the document reflects an escrow of \$57,000, the actual amount was \$55,800. See Exhibit 1B.

d. Fraudulent Statements in Loan Documents. Not only is fraud perpetrated against the lenders, but the multiple representations by the buyers and sellers, where they are affirming the accuracy of their documents, and, in particular, the accuracy of pay stubs, W2s and 1040s, constitute grounds for the

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<sup>3</sup> The documents and charts presented during the presentation of this topic were received from the Department of Commerce for illustrative and educational purposes only, and while the author has engaged in extensive research and conversation with various public officials, these materials, and the documents presented, should not be viewed as reflecting an official position by the Minnesota Department of Commerce.

Department of Commerce, the IRS and the FBI to impose liability. See Exhibits 1C and 1D In many cases, information provided by borrowers to lenders has been false.

e. “Stated Income” Borrowers. “Stated Income” transactions often involve individuals with minimal or no income. Borrowers would receive “stated income” financing with no real prospect of qualifying. Borrowers normally would provide fraudulent or misrepresented information in their certifications. Likewise, despite providing a “Certificate of Occupancy,” the borrower had no real intent to ever occupy the premises. See Exhibit 1E. In this example, the appraiser, builder, loan officers, closer and agents are all under investigation. The closer, in particular, indicated the transaction was permitted to go head, despite reservations, because of the closer’s long-term relationship with the builder and the desire to see this unproductive property sold.