Defending Mortgage Fraud Cases

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I. Introduction

Mortgage fraud takes many guises but can be succinctly classified as either fraud for profit or fraud for housing. In general, this article concerns fraud for profit, as the vast majority of mortgage fraud cases concern this type of fraud. Industry insiders such as real estate brokers and appraisers, lenders, loan originators, mortgage underwriters, and settlement and title company employees have all been targets of FBI investigations in the wake of the financial crisis. However, perhaps as a result of political pressure or the desire to make a big impact quickly, prosecutors and investigators also have focused on criminal charges stemming from investment banks that packaged and sold mortgage-backed securities ("MBS") in, at least in the government's view, a fraudulent manner.

This article explores two such cases and the differing results in each. It then explores strategies and tactics that can be used to defend similar cases and potentially any other type of mortgage fraud investigation—from the straightforward scammers taking advantage of the financial crisis to sophisticated investment bankers and their managers against whom it is exceedingly difficult to prove scienter.

II. Joy Jackson and Kurt Fordam versus Ralph Cioffi and Matthew Tannin

In June 2006, Joy Jackson and Kurt Fordam were married in an extravagant ceremony in Washington, D.C., at the historic Mayflower Hotel. Jackson wore a handmade oriental silk wedding gown with a 42-foot train and a tiara with Swarovski crystal rhinestones. The couple was serenaded by Patti LaBelle. Their guests dined on lobster, shrimp, and four wedding cakes, while drinking Moët and Cristal champagne. Reportedly, the couple gave select members of the wedding party a Porsche, a house, and a $10,000 check. All told, the wedding's price tag was close to $800,000.[3] All the while, Jackson's lavish lifestyle and fairytale wedding were funded by a widespread mortgage fraud scheme run by Jackson, Fordam and others through which they lured distressed homeowners with the promise of help and financial assistance and then fleeced them of their assets and what little money they had left.

Just two years later, on June 12, 2008, Jackson and her husband, along with several others, would face criminal charges. They were indicted in the District of Maryland and charged with conspiracy to commit mail and wire fraud, mail fraud, and money laundering in connection with their efforts to obtain money and property from homeowners and lenders through a "foreclosure reversal" scheme that lasted from September 2004 through June 2007.[4] The indictment alleged that the defendants used a foreclosure prevention scheme to cheat homeowners out of the remaining equity in their houses by transferring their homes to straw buyers. The defendants then defrauded lenders by inducing them to make new loans based on inflated appraisals and fraudulent credit applications.[5] Beginning in September 2008,[6] the eight named defendants began pleading guilty, with Jackson's guilty plea for conspiracy to commit mail and wire fraud finally entered on March 25, 2009.[7] Jackson was sentenced to 151 months in prison and 5 years of supervised release, and was ordered to pay restitution in the amount of $16,880,884.86 and to

forfeit residential and personal property.[8] Her husband, Fordam, was sentenced to 10 years in prison for his participation in the scheme.[9] The docket reveals little about whether, when faced with the somewhat daunting allegations in the case, the defense was able to mount much of a challenge.

At the same time that a grand jury in Maryland was issuing its indictment of Joy Jackson and Kurt Fordam, Ralph Cioffi and Matthew Tannin were being hauled out of their New York and New Jersey homes in handcuffs, accused of lying to Bear Stearns' investors about the downturn of several Bear Stearns mortgage-backed securities.[10] As former Bear Stearns hedge fund managers, Cioffi and Tannin were indicted for mail fraud and conspiracy and charged with misleading investors about the strength of two Bear Stearns hedge funds that later collapsed, allegedly initiating the subprime mortgage crisis. Cioffi was also charged with insider trading. They faced as much as 20 years in prison each if convicted of conspiracy, and Cioffi faced an additional 20 years if found guilty of insider trading.[11]

Cioffi and Tannin succeeded in convincing a jury that the concerns they expressed in a series of e-mails over the future performance of certain funds did not amount to criminal conduct. The government's argument that the e-mails clearly showed that Cioffi and Tannin knew that the funds were performing poorly, and failed to disclose this information to investors, was not persuasive to the jury. After a mere six hours of deliberation, the jury returned not guilty verdicts on all counts. Defense counsel successfully argued that the government's "silver bullet" e-mails were just the opposite—when read in their entirety, they proved that Cioffi and Tannin, at best, felt uncertain about the performance of the funds at issue in the case, but that they had not intentionally committed a crime.[12] In fact, one juror in the case later stated that she felt the market collapse could not be blamed on two people; another described Cioffi and Tannin as "scapegoats for Wall Street."[13]

Joy Jackson and Kurt Fordam stand as extreme examples of one type of mortgage fraud— predatory actions by a select group of industry insiders who took advantage of unsuspecting homeowners and defrauded countless lenders. At the other extreme, Cioffi and Tannin stand as examples of the complexities inherent in sophisticated financial fraud cases, and the pitfalls of trying to make all investment bankers scapegoats for the financial distress that resulted from the subprime mess.

How does a lawyer go about defending the charges brought against the Joy Jacksons and Kurt Fordams that walk through her door? How does a defense attorney counsel her financial institution clients to help them avoid falling victim to such schemes? What strategies will work at trial? Where are the inherent weaknesses in these types of investigations?

With 18 mortgage fraud task forces and 53 FBI working groups focused on ferreting out mortgage fraud schemes,[14] plus the hyper-vigilant SIGTARP making every effort to track and trace every dollar of taxpayer money paid out in the financial recovery,[15] mortgage fraud cases are becoming more and more prevalent. Consequently, it is increasingly important for defense counsel to have an understanding of basic mortgage fraud defenses.

III. Investigation

A. Conducting Interviews.

One of the most effective defenses to mortgage fraud cases can be challenging the government's assertion that the defendant knowingly acted in a fraudulent manner. By interviewing eyewitnesses, underwriters, bank managers, appraisers, and others, it may be possible to demonstrate that the defendant did not have the requisite intent, but rather was misled or unaware that he or she was a party to mortgage fraud.

B. Hiring the Right Experts.

Unlike more traditional white collar fraud cases where hiring a forensic accountant may be enough, additional experts may be required to investigate and defend a mortgage fraud case. For example, property valuation and ownership are likely to be critical com-

ponents of any defense. Thus, both forensic accounting experts and forensic appraisal experts may be required.[16]

C. Tracing the Documents.

A typical mortgage fraud prosecution includes certain key documents, which together may amount to critical evidence in the case. It is key that defense attorneys and their experts examine these documents for telltale signs of fraud and forgery.[17]

1. **Loan Application.** Borrowers must complete a loan application to qualify for the loan. The application will include information such as social security number, income, employment information, the purpose of the loan, debts and assets.
2. **HUD-1 Form.** Also called settlement sheets, HUD-1 Forms detail the amount of funds paid at closing, including commissions, taxes, escrow amounts, and loan fees. HUD-1 Forms are issued by the Department of Housing and Urban Development.
3. **IRS Form 4506.** Form 4506 authorizes the release of prior tax returns for income verification purposes.
4. **Appraisal.** Property valuation at the time of the purchase (or foreclosure) can be assessed by obtaining appraisal documents.
5. **Verification of Employment (VOE).** VOEs are sent to the borrower's employer to confirm his or her employment and income. It is important to compare any VOE disclosures to the information provided by the borrower on his or her loan application.
6. **Verification of Deposit.** Verifications of Deposit are sent to the borrower's bank to confirm that he or she possesses the necessary funds for the down payment.
7. **Title Opinion.** A title opinion will examine all public records, laws and court decisions to confirm that the seller has a valid claim to the property. It will include past and current facts about the property.
8. Mortgage documents and deeds, including warranty and quitclaim deeds, will demonstrate title transfers and the terms of any collateral pledged to the lender.
9. Public filings, public statements, rating agency reports, company financials, and e-mails and other correspondence are likely to be other key types of documents associated with financial institution prosecutions or regulatory actions.

IV. Pre-Trial and Trial Tactics: Suggestions for Successful Motions

A. Seeking a Bill of Particulars.

Rule 7 of the Federal Rules of Evidence may be used to seek out additional specifics concerning the alleged misstatements made or scheme charged. Furthermore, successfully obtaining a bill of particulars allows the defense to argue variations therefrom at trial and can thereby limit the government's ability to introduce an evolving theory at trial.

B. Challenging the Other Party's/Government's Experts.

In mortgage fraud prosecutions and private actions, it is important to remain vigilant in challenging the government's experts. Consider using Federal Rule of Evidence 702 to challenge conclusory statements made by the government's expert concerning the "role" or "intent" of alleged mortgage fraud participants or determinations that documents were "fraudulently" created or used for a "fraudulent" purpose. It is not proper for an expert to usurp the jury's role in determining these

ultimate issues of guilt.[18] In addition, defense counsel should be on guard for government accounting experts who also provide property valuation testimony. Not only must the government show the defendant's conduct amounted to a fraud or a conspiracy, for money laundering charges, forfeiture, sentencing and damages it must also show the amount actually lost. To do so, testimony from both a forensic accounting expert and a forensic appraiser may be necessary.

C. Moving to Prevent the Use of the Phrase "Mortgage Fraud" and Related Terms.

Mortgage fraud is not a federal offense. Defense counsel should be wary of allowing the government to characterize the alleged scheme as a "mortgage fraud." Similar terms such as "fraudulent flipping" are equally prejudicial and likely to lead to jury confusion as they are not likely to accurately characterize the alleged conduct.

D. Raising Loss Causation Issues in Civil Cases.

Loss causation is the causal connection between a defendant's material misrepresentation and a plaintiff's loss. A required element of any civil securities fraud case is that the company's share price fell significantly "after the truth became known."[19] Loss causation challenges have arisen in the myriad cases brought under both the Securities Act of 1933 and the Securities Exchange Act of 1934 against investment banks, underwriters and auditors, among others, whose firms insured, offered for sale, or audited firms that sold MBS. The argument that loss causation has not been established has been successful in a number of recent cases. Indeed, courts have reacted favorably to the argument that plaintiffs cannot hold defendants liable for the financial crises that resulted in the diminution of value of MBS, absent a specific untrue representation about the value of those assets, due to which, when the truth was revealed, the assets lost value. Most recently, in dismissing the complaint filed against ACA Capital Holdings, Inc. ("ACA"), the Southern District of New York held that the negative decline in ACA's share price was not attributable to the alleged misstatements regarding collateralized debt obligation transactions. Judge Robert W. Sweet held that the complaint and the public filings "establish[ed] that the decline in ACA's stock price was not caused by the allegedly false and misleading statements in the Prospectus." Thus, ACA's "negative causation" defense contributed to the court's decision to dismiss the complaint.[20]

E. Challenging the Search Warrant.

Often, part of the evidence that the government seeks to introduce in a mortgage fraud case involves evidence seized as a result of a search warrant for electronic records. Several cases in the past six months have addressed the appropriate scope of a search warrant for such records,[21] and have suppressed evidence resulting from overbroad warrants that did not specifically particularize the information to be searched for or seized. In fact, as commentators have pointed out,[22] at least until the Supreme Court decides to hear one of these e-records cases, this can be an effective tactic to exclude prejudicial evidence. Indeed, this strategy worked well in the Cioffi and Tannin case.[23]

V. Sentencing: Calculating Loss

The law requires that loss to investors be calculated by "determining the outstanding principal balance of the loan less the amount the victims were able to recover through liquidation of the collateral provided to secure the loan."[24] To challenge an upward departure based on a substantial loss calculation, defendants should engage a valuations expert to assist in computing the principal amount of the loans at issue, interest rates promised to investors, appraisal values of the properties at the time of the loan and at foreclosure, and actual amounts realized through the sale of the prop-

erties.[25] It may be the case that gains have been realized through a foreclosure sale, since increasing property values may have offset any loss on the interest or principal. Likewise, forensic tracing will isolate the properties tied to the alleged fraud and thereby restrict loss calculations to those properties on which fraudulent loans were in fact obtained. The amount of loss should be calculated based on the value of the loans procured through fraud, not including outstanding legitimate loans.[26] Finally, forensic appraisers and accountants will be able to assist in identifying any amounts recovered by lenders through liquidation or payments toward the loan collateral, which must be subtracted from the loss calculation.[27]

VI. Representing the Corporation

A. Lack of Knowledge or Intent by the Corporation

Much of the fraud for profit world involves acts of individuals who were incentivized by their employers to write ever more loans, regardless of the underlying risk of default. In some instances, employers might have turned a blind eye to the indicia of fraud,[28] but there may be an equal number of instances in which employers had no idea that their employees were writing bad loans. Defending corporations in this regard entails relying on traditional principles of corporate liability.

For criminal actions against corporations themselves, criminal liability may attach under principles of respondeat superior if any employees committed criminal acts within the scope of their employment for the benefit of the corporation.[29] If these two conditions are met, a corporation can be held liable for the conduct of a broad range of employees and agents: (1) executive officers and directors; (2) non-executive managers and supervisors; (3) low-level, menial employees; and (4) independent contractors.[30]

The government also may seek to prove that corporations and their executives acted criminally by demonstrating wrongdoing in the valuation of mortgage-related securities. Under federal law, those who aid, abet, counsel, command, induce or procure a crime can be found criminally liable in its commission as long as there is active participation in the crime. In the case of mortgage lenders, prosecutors may seek to demonstrate that lenders relaxed their oversight of loan applications in order to increase profits, but this would not prove that lenders or their executives were complicit in fraud. More likely that not, corporations and their employees likely will claim that independent mortgage brokers, who prepared the loan applications, were responsible for any fraudulent applications.[31] Even where prosecutors are able to establish that employees knew of widespread mortgage fraud and were complicit in approving fraudulent applications, they may still face obstacles in pursuing more high-profile actions against high-level executives and corporations.[32] In the case of criminal charges against an individual, absent the existence of explicit directives that promoted fraud, it may be difficult to show that any criminal acts were taken at the instruction of a director or officer or with their knowledge.

Defense attorneys should focus in searching for evidence indicating that employees were acting alone, perhaps in violation of compliance rules of the company. While respondeat superior liability may nonetheless pose a risk for corporations, proof of a comprehensive compliance program, including employee compliance training, is helpful evidence that rogue employees, and not the company or its officers, are the appropriate targets.

B. The Cooperation Card

If a company cannot establish lack of knowledge or responsibility for its employees' conduct, cooperation needs to be carefully

considered. On January 13, 2010, the SEC announced its expansion of the Seaboard Report,[33] through the adoption of several new policies designed to encourage individuals (and companies) to cooperate in SEC investigations.[34] Its arsenal now includes proffer, cooperation, and deferred prosecution and non-prosecution agreements, as well as the authority to submit witness immunity requests to the DOJ for witnesses "who have provided or have the potential to provide substantial assistance in the Commission's investigations and related enforcement actions."[35] The SEC intends to evaluate individual cooperation based on the following four factors: (1) the assistance provided by the cooperating individual, (2) the importance of the underlying matter in which the individual cooperated, (3) the societal interest in ensuring that the individual is held accountable for his or her misconduct, and (4) the appropriateness of cooperation credit based upon the risk profile of the cooperating individual.[36] It remains to be seen how the SEC will handle situations where a corporate executive attempts to earn individual cooperation credit by reporting possible wrongdoing at the same time that the company is seeking cooperation credit pursuant to the Seaboard Report.

An additional note of caution should be sounded. To date, the Cioffi and Tannin prosecution seems to be one of the very few brought by the government in response to the financial collapse of the MBS markets and the resulting economic crisis. The FBI continues to bemoan the lack of resources available to it to investigate and prosecute complex fraud.[37] Accordingly, defense counsel must carefully weigh whether cooperation in this context is actually valuable—in other words, if a prosecution is not inevitable, and because of the complexities of these investigations, or the success of arguments involving loss causation in the civil context, government prosecutors and regulators cannot meet their burden of proof, is confessing to misconduct the right move?

C. Don't Blame the Banks for the Housing Crisis! Case Study: *Mayor and City of Baltimore v. Wells Fargo Bank N.A.*

The City of Baltimore brought an action against Wells Fargo Bank for violations of the Fair Housing Act, 42 U.S.C. §§ 3601 *et seq.*, for alleged predatory and discriminatory lending practices that the City claimed led to economically damaging foreclosures. The City alleged that Wells Fargo engaged in "reverse redlining," which involves the marketing and sale of more expensive and risky mortgage products to low-income, primarily minority communities. The City alleged that Wells Fargo's practices had led to an increase in foreclosures in low income and predominantly African American neighborhoods which in turn resulted in decreased tax revenues, increased city expenditures for city services such as fire, police, and administrative and social services. Wells Fargo successfully argued that the City had no standing to bring such a claim because the injuries claimed by the City were a "result from 'the independent action of some third party not before the court.'"[38] In essence, the court recognized that a myriad of other factors led to the "deterioration of the inner city, such as extensive unemployment, lack of educational opportunity and choice, irresponsible parenting, disrespect for the law, widespread drug use, and violence."[39] The court also was persuaded by the low number of foreclosures that could be traced back to Wells Fargo mortgaged properties— "This fact alone demonstrates the implausibility of any alleged causal connection between Wells Fargo's alleged reverse redlining activities and the generalized type of damages claimed by the city."[40]

While the City has stated that it intends to amend its lawsuit rather than appeal the court's decision to dismiss the case, the court has made a strong statement that it is not sufficient to try to lay the economic downturn in the laps of individual banks.[41] A clear

and distinct causal connection must exist to prove that predatory lending practices in fact resulted in the economic injuries suffered.

VII. Investigations by the Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP)

Companies that applied for and received funds committed through the Troubled Asset Relief Program ("TARP") are not only feeling the watchful eye of the American people but also may feel more immediate pressure from the government itself. The scrutiny accompanying the government's decision to commit such vast amounts of money has led it to initiate a series of audits and criminal investigations of lenders who received TARP funds.[42] SIGTARP's directive is to promote transparency in TARP, through "coordinated oversight" of TARP in cooperation with other relevant oversight bodies, and by robust criminal and civil enforcement "against those, whether inside or outside of Government, who waste, steal, or abuse TARP funds."[43] To accomplish this, SIGTARP has the authority to (1) conduct, supervise, and coordinate audits and investigations; (2) subpoena documents and information from government agencies as well as non-governmental institutions and individuals; and (3) undertake law enforcement functions without first obtaining approval from the United States Attorney General.[44] SIGTARP has also been instructed to work cooperatively with other inspectors general on oversight of TARP-related activities and to regularly report to Congress on how TARP recipients have used TARP funds.[45]

In connection with its investigative efforts, SIGTARP has issued audit questionnaires, which include questions concerning internal controls and the use of TARP funds, to at least 300 institutions that received TARP money.[46] Simultaneously, SIGTARP has launched 61 criminal and civil investigations, as of September 30, 2009, including complex issues concerning mortgage fraud.[47] In light of this increased scrutiny, companies that have received or relied on TARP funds in any way should be prepared to respond quickly to SIGTARP inquiries.

Ahead of any inquiry, TARP recipients would be well advised to implement internal controls that allow for the tracking, recording, and monitoring of all TARP funds. This will allow for increased transparency in the use of the funds, should SIGTARP seek information.

If an inquiry or audit does materialize, in light of SIGTARP's commitment to proactively ferret out issues before fraud arises, companies can expect that the inquiry or audit quickly may progress to an investigation and, in turn the investigation may move more quickly than traditional DOJ, SEC or FINRA investigations.[48] As with any investigation, to stay ahead of the game, companies would be wise to set up a process in advance for responding to SIGTARP inquiries, which may include setting up an independent committee, such as an audit committee, retaining independent outside professionals, including accountants and counsel, and designating sufficient internal resources who can work collaboratively with the company's retained professionals.

VIII. Conclusion

The simultaneous occurrence of the banking crisis, the collapse of the housing market and the resulting economic downturn, has created a breeding ground for mortgage fraud. In response, there has been a definitive blip on the government's radar screen, which has led to a sharp increase in law enforcement initiatives, regulatory investigations and Congressional oversight. Within this ever evolving landscape, defense counsel must be equipped with the tools and best practices to navigate a way through for their individual and corporate clients.

Given the countless number of mortgage fraud schemes and the uniqueness of each case, mounting a successful defense can be challenging even for the most experienced white collar defense attorney. Thus, in these complex cases, counsel would be wise to engage industry experts to assist in the investigation and analysis required to effectively prepare a defense. Armed with the above strategies and assistance from qualified experts, counsel can begin to formulate a defense for individuals and corporate clients alike.

ENDNOTES:

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15. *See* discussion *infra* § VII and accompanying notes.

16. Holly A. Pierson, *Mortgage Fraud Boot Camp: Basic Training on Defending a Criminal Mortgage Fraud Case*, THE CHAMPION, September/October 2007 at 14.

17. *See generally*, *Id*.

18. *See, e.g.*, *United States v. Perkins*, 470 F.3d 150, 157–60 (4th Cir. 2006) ("conclusory testimony that a company engaged in 'discrimination,' that a landlord was 'negligent,' or that an investment house engaged in a 'fraudulent and manipulative scheme' involves the use of terms with considerable legal baggage; such testimony nearly always invades the province of the jury.")

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31. Ceresney, et al., *supra* note 29, at 241–242.

32. *Id.*

33. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969 (Oct. 23, 2001).

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37. *The Need for Increased Fraud Enforcement in the Wake of the Economic Downturn: Hearing Before the Senate Comm. on the Judiciary*, 110th Cong. (2009) (statement of John Pistole, Deputy Director of the Federal Bureau of Investigation of the United States Department of Justice).

38. *Mayor and City of Baltimore v. Wells Fargo Bank*, Civ No. JFM 1:08 CV-00062, 2010 WL 46401, at *2 (D. Md. Jan. 6, 2010).

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43. *See* Office of the Special Inspector General for the Troubled Asset Relief Program, Quarterly Report to Congress Oct. 21, 2009 (2009) [hereinafter *SIGTARP October Report*].

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45. *See Id.*

46. Schwartz, et al., *supra* note 42, at 3.

47. *SIGTARP October Report*, *supra* note 43, at 6..

48. *See SIGTARP April Report*, *supra* note 44; *SIGTARP October Report*, *supra* note 43.