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Real Estate Fraud: Detection, Prevention & Recovery©

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Almost everyone has heard the old saying, “The pen is mightier than the sword.” For real estate lenders and, for that matter, sellers and buyers of real property, the saying “It is easier to steal a million dollars with a pen than with a sword” reflects a day-to-day reality of doing business, and a danger against which they must take precautions.

This article surveys (1) the distinction, in terms of the potential for fraud, between commercial and residential transactions; (2) a variety of common real estate fraud schemes; (3) approaches one may take to prevent/detect fraud at the outset; and, (4) ways in which to maximize recovery of loan funds or property if fraud has occurred in your transaction.

Commercial Versus Residential Real Estate Fraud. Fraud in commercial real estate transactions is uncommon. A commercial transaction is typically conducted with the active assistance of counsel for the seller, buyer, lender, title insurer and, at times, others. Each attorney is charged with protecting his or her client’s interests *zealously*. In a residential transaction, attorneys rarely participate, except in those states which utilize attorneys as closing agents. Even in those transactions, however, the attorney as closing agent does not generally owe the seller, buyer or lender the same degree of zealous loyalty as counsel engaged by the parties.

Residential transactions give the criminally inclined person an ideal environment in which to operate. The following aspects of many residential transactions help to create and nourish that environment, and also distinguish residential from commercial transactions:

1. A substantial amount of residential lending is brokered, with most employees of mortgage brokers operating on commission income structures.
2. Often the lender or mortgage broker never meets the borrower.
3. Loan documents are often delivered to the borrower at his or her home by a “loan signer”, whose sole job it is to obtain and notarize the borrower’s signature.

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4. Unlike commercial transactions, where the parties and their counsel may be working on no more than a handful of deals at any one time, residential lenders count on loan volume to generate fees, commissions and income. Thus, it is not uncommon for loan processors to be handling more than thirty loan applications at once.
5. In a slow real estate economy, the residential lender/broker may have fewer applications to process, but without the loan volume to generate income, loans that would ordinarily be considered sub-par may be pushed through the system. Of course, when the real estate market is booming, as it has been for more than a year in most parts of the country, loan processors have less time to conduct the due diligence required to assure quality loans. In both circumstances, individuals with a fraudulent intent will be waiting.

Common Fraud Schemes. What follows is a description of various types of schemes utilized to defraud lenders, buyers and sellers:

Incomplete Public Property Records. In some counties, particularly in California, criminals have seized upon the fact that the recording of property records has become backlogged, as has the computerization of those records used by title insurers.

In one case, a homeowner sought to refinance her home and utilize some of the equity she had accumulated to perform home improvements. What the homeowner did not disclose was that she had simultaneously applied for the same loan to approximately six (6) different lenders, mostly through loan brokers.

The homeowner explained the numerous inquiries on her credit report by saying that she had been “loan shopping.” Each lender approved the loan and, as the homeowner had anticipated, each deed of trust was recorded within two to three days of the others. Each loan was disbursed and the homeowner’s fraud brought her hundreds of thousands of dollars

The fraud was able to be perpetrated because the county did not “index”, *i.e.*, make public, the recorded deeds of trust until several days after they had actually been recorded. Exacerbating the situation was the fact that the title insurers for each of the lenders utilized a computerized “title plant”, not the hall of records, for determining the state of title prior to funding the loans. Whereas the hall of records was two to three days backlogged, the title plant was two to three weeks behind.

As a result, when the lenders’ title insurers investigated title just prior to recording and funding, the records available to them failed to disclose the existence of other deeds of trust.

Forged Vesting Deeds. One of the most common, and troubling, real estate fraud schemes involves the transfer of title to property, through a forged deed, to the person who will perpetrate the fraud.

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For example, Homer Homeowner owns his home with only a few thousand dollars remaining to be paid on the mortgage. Unbeknownst to Homer, Freddie the Forger signs Homer's name on a deed conveying the house to Freddie.

Freddie then applies for a home equity loan, utilizing Homer's house as security. The lender feels secure to make the loan because of the large equity cushion, fails to conduct much due diligence, and disburses the loan to Freddie, who then disappears into the shadows from whence he came.

Stolen Identity / Stolen Credit. This type of fraud has become much publicized in recent months. One version of this scheme experienced in Southern California a few years ago involved 80 separate properties and drew the attention of the FBI. In the scheme, an individual acquired the credit and personal history of a creditworthy borrower, impersonated that individual and obtained loans to purchase properties. Thereafter, the impostor either leased the properties or sold them using an All Inclusive Trust Deed ("AITD"), skimming the rents or absconding with the down payment in the case of an AITD sale.

Improper Disbursement of Loan Funds. In this situation, more commonly found in commercial than residential transactions, the owner of the property is a business entity (e.g., corporation, partnership, joint venture, limited liability company, etc.). A person affiliated with the owner, usually a control person, will then pursue a loan utilizing the business entity's property as security. Either at this point, or at loan disbursement, the control person will falsify company resolutions authorizing the borrowing and / or direct that loan proceeds be disbursed to an entity he or she controls other than the owner of the property.

For example, if the owner of the property is Blackacre Investments, Inc., how difficult might it be for the President and CEO of Blackacre Investments, Inc. to create a new entity, Blackacre Investments Co., Inc. and utilize that corporate entity to obtain a loan against real property owned by Blackacre Investments, Inc?

Erroneous Property Description. In this unique scheme (amazingly on the rise), the person intending to commit the fraud will know how title insurer's operate, and will have discovered real property encumbered by a security instrument which does not accurately describe the real property.

In one scenario, the property is encumbered by a first and second deed of trust. The loans have fallen into default and the holder of the second deed of trust has begun to foreclose. The first deed of trust incorrectly describes the real property (e.g., Tract 5096, Lot 97, *instead* of the correct description, Tract 5097, Lot 96).

The person intent on fraud will purchase the property at the foreclosure sale and immediately thereafter obtain preliminary reports from as many title agents as possible for the sole purpose of locating a title company which fails to detect the first trust deed on the property because of its incorrect legal description.

Having found the target title company, the person will market the property competitively and, as part of the escrow instructions, commit himself to provide the title insurance.

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When the lender makes its loan to the purchaser of the property, utilizing the title insurer pre-screened by the defrauder, the first trust deed will be missed, resulting in a huge windfall to the seller/defrauder.

It is only when the new owner fails to make payments on the unknown first deed of trust, causing foreclosure proceedings to commence, that the homeowner and the lender learn of the elaborate scheme to which they have fallen prey.

Prevention/Detection of Fraud. At the outset it must be understood that it is impossible to eliminate completely the risk of real estate fraud. Rather, by taking the following precautions, among others, the risk of fraud may be substantially reduced:

Know Your Borrower, Buyer and Seller. All too often, real estate transactions take place without the personal interaction of the parties or their counsel. There is no better way to protect a real estate transaction against fraud than to look the other parties or their counsel in the eye or, at a minimum, to speak directly with them.

In many transactions, sales agents, loan brokers and document signers conduct the actual business of the transaction. While these persons certainly owe a duty to their principals, their involvement can never replace the insight and instinct brought to the table by the parties themselves. To be sure, a sales agent's or loan broker's duty does not rise to the level of zealous loyalty that an attorney owes his or her client. Therefore, if the parties themselves cannot participate in the transaction at some level, they should employ counsel to do so on their behalf.

Demand Precision in Due Diligence. Every party involved in a real estate transaction has, or should have, a thorough due diligence checklist. These checklists include, but are not limited to, income and deposit verifications, identity verifications, preliminary reports concerning the title to the property in question, and environmental investigations.

It is critical that whatever due diligence procedure is in place be followed precisely. That means looking for and questioning every inconsistency, to the point of being on the alert for fraud. In the first example of a fraud scheme, above (*Incomplete Public Property Records*), questioning more closely the multiple credit inquiries could have revealed the scheme that was underway.

Avoid a False Sense of Urgency. No doubt many transactions are time sensitive; however, it is important to understand which transactions are subject to real or concocted time constraints. A person intent on fraud will typically attempt to create a frenzied or excited atmosphere for the transaction in an attempt to disrupt due diligence efforts, or dissuade a party from the type of critical analysis which is necessary to detect fraudulent schemes.

Avoid Last Minute Deal Changes. Part and parcel of the defrauder's bag of tricks is the effort to change terms of the transaction at the last minute. There should be no exception to the rule that due diligence is required concerning new terms, especially those arising at the last minute. To do otherwise is to increase substantially the risk of fraud.

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In a commercial transaction, a last minute change in a business entity's structure, no matter how minor, could prove to be disastrous. For example, the risk of loan fund diversion to someone other than the owner of the real property security is made a real by a borrower's last minute change in name, capacity or loan disbursement instructions (*e.g.*, Blackacre Investments, Inc. *vs.* Blackacre Investments Co., Inc.)

Beware The Prolific Letter Writer. Real estate transactions usually follow a fairly predictable pattern. When that pattern is disrupted, by numerous letters, telephone calls or other communications, especially from counsel, an alarm should sound.

It is not at all uncommon for a borrower to attempt to obtain, in the guise of informal communications, agreements or concessions from a lender or seller. This is especially true in the case of loan work-out discussions. Invariably, a flurry or correspondence is designed solely to create a record of communications for a party later to argue that it was promised something, lulled into a false sense of security, or otherwise caused to alter its position.

When a transaction falls out of the normal pattern, or begins to become adversarial, it is time to call upon counsel to assist. For example, in loan work-out transactions, it is important for the parties to understand their rights and obligations while conducting negotiations. In such circumstances, a pre-negotiation agreement may be called for. Counsel will be in a position to protect a borrower's (or lender's) interests in crafting the agreement and conducting further communications concerning the transaction.

Recovery of Property/Loan Funds. The preliminary precaution of title insurance, as well as immediate action following detection of fraud, is required to maximize recovery of property and loan funds.

Title Insurance. No real estate loan should ever be made, and no one should buy real estate, without obtaining title insurance. While there are certain exclusions that will relieve a title insurer of its obligation to cover certain losses resulting from loan fraud, the benefits of title insurance cannot be overstated. For example, the risks associated with forged instruments, incomplete public property records, and erroneous property descriptions are the types of risks for which title insurance affords protection. Without insurance, even a victory in the courts can prove pyrrhic once attorneys' fees and costs are factored in.

The intricacies of what type of title insurance policy to obtain, how an insured's conduct can affect its rights under the policy, and the myriad other issues involved with pursuing recovery for real estate fraud under a title insurance policy are beyond the scope of this article. Suffice it to say, however, that obtaining title insurance is the single most important step in obtaining recovery for real estate fraud.

Immediate Action. To prevent the real property from being conveyed, and lost, to a *bona fide* purchaser or encumbrancer, it is essential to put the world on notice that a dispute exists concerning the ownership or possession of the property in question. To do so requires an immediate gathering of the relevant facts, the preparation and filing of a lawsuit seeking appropriate remedies *vis-à-vis* the property itself and those involved in

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the fraud, and the recording in the public records of notice of the existence of the dispute concerning the property.

As soon as notice of the dispute has been recorded, it should not be possible for the property to be lost to a *bona fide* purchaser or encumbrancer. Having put the world on notice of the claim, and while pursuing recovery of the property, one's focus can turn to the recovery of assets from those responsible for the fraud.

Just as it is essential to block the conveyance of the property following detection of a fraud, it is vital to locate and effectively seize any funds that have been disbursed or lost through the fraudulent scheme. This is accomplished by pursuing two parallel courses of action, as follows:

Civil Court Order (Temporary Restraining Order) Blocking Transfer of Funds. An injured party may apply to the court in which the lawsuit is pending for an order blocking the transfer of funds obtained through the fraudulent scheme. It is, of course, necessary to conduct an intense investigation and act quickly so that any order obtained from the court will prove effective. If the funds have already been disbursed or concealed, the court's order will prove worthless.

Thus, it is critical to involve counsel immediately upon the discovery of a potential fraud so that action can be commenced before even the defrauder knows he or she has been found out. For example, loan funds will almost always be on deposit - the key is discovering where so that a court order may be directed to the appropriate depository institution. Modern investigative techniques afford counsel the ability to trace assets quickly so that any court orders obtained will be effective.

Criminal Complaint and Restitution Order. In the past, the authorities have been so overwhelmed with prosecuting violent crime that virtually no resources were devoted to the investigation and prosecution of financial or real estate crimes. Indeed, until recent years, authorities in one of the country's major metropolitan areas (and "hotbed" of real estate fraud) had the resources to investigate and prosecute only ten percent (10%) of the real estate crime complaints received. Now, new real estate fraud task forces have been created in many areas, with a mandate to prosecute vigorously those involved in real estate fraud.

Although a civil litigant cannot threaten criminal prosecution to gain an advantage in that forum, it is perfectly acceptable and proper for a victim of fraud to file a complaint with the authorities. Having filed a complaint, the victim of the fraud should work closely with the authorities and encourage them to investigate and prosecute those responsible for the fraud.

The penalties imposed upon those involved in real estate fraud typically include an order that they make restitution to their victims. These orders carry with them the threat of incarceration and, therefore, are often more compelling than a money judgment obtained through civil litigation.

When all is said and done, a criminal intent on perpetrating a fraud will, from time-to-time, succeed. It is, however, possible to reduce the risk of falling prey to their schemes

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by being alert to them, establishing and following strict due diligence guidelines, and pursuing vigorously recovery immediately upon discovery of a fraud.