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Foreclosure rescue scams

Separating the victims from the culprits

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The national credit crisis has exacerbated the nationwide epidemic of foreclosures. The vast number of foreclosures has proven to be fertile soil for con-artists profiting from fraudulent foreclosure rescue schemes. Consider the recent indictment of Charles Head in California. Head, along with 19 other individuals, was indicted on 13 counts involving suspicion of mail fraud, conspiracy to commit mail fraud, conspiracy to commit money laundering and other related charges. Head and the other individuals are accused of netting approximately $6.7 million from 47 homeowners as part of a foreclosure rescue scam. Although most of the homeowners resided in California, several resided in New Jersey.[1]

The foreclosure rescue scam works something like this: A homeowner, who, by reason of financial difficulties, finds the family's home subject to foreclosure, has exhausted all other options, including refinance, bankruptcy (often involving multiple filings), and borrowing from friends and family in an effort to save the family home. The homeowner receives an advertisement in the mail or comes upon a Web site which promises to save the family home. A call is placed and a meeting is scheduled. The foreclosure rescue entity (FRE) proposes that the owner sell the property to the FRE, and then to a related entity or to straw buyer who will then lease the property back to the homeowner. Normally, the FRE will finance the purchase of the property through an unwitting lender which usually has no reason to suspect the transaction is anything but an arms length purchase. In theory, the homeowner will pay rent for a set period of time (usually one or two years), during which time the FRE will make mortgage payments to the lender while the homeowner works to restore his credit. Once the homeowner's credit has been restored, the property will be sold back to the homeowner for a pre-established price.

Although the plan seems plausible, the practice usually includes one or more individuals who are intent on defrauding the homeowner out of the equity in the property. Often the FRE will charge the homeowner "fees" for arranging the purchase/lease back. The fees typically equal all the equity in the property above the existing liens. In some instances, the FRE will accept the homeowner's lease payments and pay the mortgage. More often than not, however, the FRE will make few or no mortgage payments. The homeowner discovers he has been scammed when the lender forecloses. At this point, the homeowner generally retains counsel and files suit against the FRE and the lender, even though the lender, in most instances, is at least as much a victim as the homeowner.

The distinction between predator and victim in these rescue scams is not always easily discernable. It is easy to identify the FRE, who arranged the scam and stripped the equity from the property, as the bad guy. Nonetheless, other participants may be seen as falling in a grey area when assessing culpability. The Mortgage Broker may be charged with turning a blind eye, so that brokerage fees can be churned from the transaction. Often, it is the Mortgage Broker who has the most contact with the borrower (which could be the FRE, an affiliated entity or a straw buyer) and may have insight as to the true purpose of the transaction.

Straw buyers, who are recruited because of their good credit and may receive small payments for purchasing the property and signing the loan documents, are likely to claim ignorance of this scam. Although the straw buyer may have been "duped," he cannot claim innocence, since the most cursory reading of the loan documents would alert the signor that he becomes obligated to repay the mortgage note. Additionally, lenders often require the signor to reside in the property as a condition of the loan. The straw buyer certainly knows that he will not be residing at the property.

Title agents might also be implicated in the scam. A title agent would normally close the sale and would have personal knowledge of the communications between the parties at the closing. The title agent, although not involved in the fraud, might have liability if he does not disperse the sale proceeds in accordance with the settlement statement. Typically, the settlement statements in these scams reflect that the sale proceeds are being paid to the seller/homeowner, but the funds are instead taken by the FRE. In other instances, the settlement statement might notate "fees" going to the FRE or a related entity. In those cases, the title agent would not normally have a duty to investigate the appropriateness of those fees since the seller/homeowner has signed the settlement statement authorizing the disbursement.

On the other end of the spectrum are the least culpable—the homeowners and the lenders. Desperate homeowners may feel obligated to accept harsh terms from a FRE to prevent losing their home in a foreclosure. The lender, however, will have no knowledge of the fraud and would, therefore, have the right to insist that its mortgage lien be enforced. Many of the lawsuits require a court to consider the right of the lenders to enforce the mortgage liens—often in the context of a foreclosure action. The legal determination is made that much more difficult when the most culpable party, the FRE, cannot be located or is judgment-proof. Often, the FRE's principals have already been indicted. The straw buyers may be judgment-proof as well. Additionally, with the depressed real estate market, the title agencies and Mortgage Brokers may no longer be in business. At the end of the day, the lender may be the only one standing. It is for this reason that the lender must be vigilant to avoid the foreclosure rescue scam.

Foreclosure scams commonly involve lenders who are not aware of the underlying plan to squeeze equity from a borrower caught in financial difficulties. When litigation is commenced, the plaintiff (often the homeowner) attempts to characterize the lender as just another bad guy seeking to capitalize on the homeowner's misfortune. As counsel for the lender, it is important to focus the judge and/or jury on the limited role and responsibilities of the lender, and to clarify that the risk that the lender chooses to accept is distinct from the efforts to defraud the homeowner.

The best strategy is to avoid any suspicious transactions. If the lender has implemented a procedure designed to identify suspicious loans and concludes that no questionable circumstances exist, then there is no legal basis to rescind the mortgage transaction or find the lender liable. If the lender has undertaken a diligent investigation, but despite such efforts still finds itself the subject of litigation, a number of arguments are available to defend itself from liability:

The New Jersey Recording Act

The New Jersey Recording Act grants the lender priority over any interest, equitable

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or otherwise, of the homeowner, provided the lender is a bona fide lender. Priorities between parties holding an interest in real property is governed by the New Jersey Recording Act. New Jersey Statutes Annotated (N.J.S.A.) 46:16-2 provides that properly acknowledged instruments which affect real property may be recorded in the County Recorder's Office in the county in which the property is located. N.J.S.A. 46:21-1 provides that when an instrument of the type identified in N.J.S.A. 46:16-2 is properly acknowledged and recorded, such recording shall be deemed "notice to all subsequent judgment creditors, purchasers and mortgagees of the execution of the deed or instrument so recorded, and of the contents thereof." N.J.S.A. 46:22-1 provides that until an instrument is properly recorded it shall "be void and of no effect against subsequent judgment creditors without notice ... and against bona fide purchasers and mortgagees ..." who do not have actual knowledge of the prior unrecorded interest and who record first.

A lender's first notice of the homeowner's interest may occur only when it is served with a "summons and complaint" or when it obtains a foreclosure title search which reveals the presence of a "notice of lis pendens" filed in accordance with N.J.S.A. 2A:15-6. A lender must review title for any potential claim prior to committing to a loan.[2] Provided the lender's mortgage is recorded before the lis pendens and the lender is a bona fide lender, the mortgage should retain priority over any claimed interest of the homeowner. Contrary to an argument commonly raised by homeowners, no case law exists requiring a lender to inspect the property to ascertain who is in possession. Notwithstanding a body of case law supporting the lender, it must be prepared to defend against the homeowner's allegations that certain facts should have alerted the lender of the scam had it undertaken a diligent inquiry. In light of such allegations, the lender must remind the court that the threshold by which a lender is deemed bona fide is a low one.

A lender's bona fide position is not conditioned on an extraordinary investigation designed to uncover potential claims. The court, in Scult v. Bergen Builders Inc.[3], describes the obligations of a purchaser or mortgagee: "The obligation imposed upon a prospective purchaser to make a reasonable and diligent inquiry in connection to claims or rights in and to real estate—or be charged with facts of such an inquiry would uncover—arises only where facts are brought to the knowledge of that person which are sufficient to apprise him of the existence of an outstanding title or claim, or the surrounding circumstances are suspicious and the party purposely or knowingly avoids further inquiry."[4]

Absent the lender having information relating to the scam or suspicious circumstances which require further inquiry, there should be no basis to charge the lender with knowledge. The lender, however, must be ever mindful of the circumstances suggesting that the mortgage transaction is a disguised lease-to-buy arrangement. Certainly, a lease provided by the purchaser should be reviewed. If a lease provides for the previous owner to occupy the property, the lender should be concerned.

No duty owed by lender of homeowner

No duty is owed by the lender to the homeowner, absent a special relationship. In New Jersey, the question of whether a duty exists from a lender to a borrower is a matter of law to be decided by the court.[5] It is an inquiry that ultimately involves a weighing of the relationship of the parties, the nature of the risk and the public interest in the proposed situation.[6] Historically, courts have recognized a tort liability of a financial institution where a special relationship has been established from which a duty can be deemed to flow. The mere relationship of a customer of a bank is not enough to be considered a "special relationship," and the common law of negligence does not impose a duty of care on banks upon which customers may hinge their negligence claims.[7]

The Appellate Division, in United Jersey Bank v. Kensey[8], addressed whether a lender owes a duty to the buyer of real estate. In Kensey, the lender, which had an existing relationship with the seller, agreed to finance the buyer's purchase of the seller's property. A real estate broker directed the buyer to the lender for financing. The broker also advised the buyer that the seller was in default on loans with the lender and, therefore, the lender was willing to assist in buyer's financing.[9] After the purchase and finance of the property, the buyer/borrower defaulted on his loan with the lender.[10] The lender's assignee filed suit to foreclose the mortgage and the buyer counterclaimed, alleging that he was fraudulently induced to purchase the property. The buyer had learned that the lender had obtained an appraisal which indicated that the property was worth less than the purchase price.[11] The buyer claimed that lender had a duty to disclose the financial status of the seller and also the value of the property.

The trial court granted summary judgment to the lender. On appeal, the Appellate Division held that the bank owed no duty to disclose information relating to the value of the property, as there was no fiduciary relationship between the parties. Moreover, the lender had no duty to volunteer information that was readily accessible to the buyer/borrower. The court was reluctant to find a fiduciary relationship between a lender and a borrower, but did identify circumstances where such a relationship may exist.

A relationship will be found when the lender engages in gross acts of misconduct and deceit, or where the lender knows or had reason to know that the customer is placing his trust and confidence in it and relying on the lender to counsel and inform him.[12] The court was circumspect in its application, however, and found that a fiduciary duty exists only where the lender "actively encouraged the borrower to rely upon its advice and concealed its self-interest in promoting the transaction involved."[13] The court specifically distinguished the case where a lender failed to disclose information it might have concerning the financial viability of the transaction. In those circumstances, the court determined no fiduciary duty existed.[14] In short, a lender does not owe a duty to the borrower to disclose information as to the financial status of the seller so that the borrower can consider the viability of the transaction. It follows that if the lender does not owe a fiduciary duty to the borrower, a customer of the lender, then it does not owe a duty to the seller/homeowner.

Homeowner suffers the consequence

Since the homeowner is in the first position to avoid the fraud, he then must suffer the consequence as between the two innocent parties. In the contest between the homeowner and the lender, the court must be reminded of the time-honored equitable principal "that where a loss must fall on one or more of a number of innocent parties, the loss shall fall on the one or ones among them who, by his or her conduct, created the circumstances that led to the perpetrator causing the loss."[15]

The point is not to make the homeowner appear to be the perpetrator as much as it is to remind the court that the lender is a victim as well. The homeowner is at the closing and signs documents, which reflect his understanding of the transaction. Indeed, the homeowner fully appreciates the fact that he is selling his home and will become a tenant. The selling homeowner will sign a settlement sheet, which will reflect that fees are being paid to the FRE. The homeowner also is aware that the FRE is financing the purchase through a loan secured by a mortgage on the home. In short, it is the homeowner who is in the first position to avoid the fraud. For this reason, as between the two innocent parties, it is the homeowner who must suffer the consequences.

Conclusion

The homeowner's counsel will seek to present the lender in the worst light by introducing evidence designed to "suggest" fraud. The lender's counsel must direct the court's attention to the "bona fide" lender principle and the absence of a fiduciary duty owed to the homeowner. The court must be reminded that the lender is the more innocent of the two victims. If the courts are guided by the current case law, the lender should not have to suffer the consequences of the unscrupulous FRE.

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Footnotes

1. "19 Accused of Mortgage Scheme" at www.kcra.com/news/15693205/detail.html.
2. Scult v. Bergen Valley Builders Inc., 76 N.J. Super. 124, 135 (Ch. Div. 1962).
3. The Scult case involves the knowledge of a purchaser. There is no legitimate distinction between a purchaser and a mortgagee when discussing whether a party is "bona fide."
4. Id. at 135. Real Estate-Land, etc., Company v. Stout, 117 N.J. Eq. 37, 44-45, 175 A. 128 (E. & A. 1934); Todd v. Exeter Land Company, 104 N.J. Eq. 431, 434, 146 A. 303 (E. & A. 1929); Raritan Water-Power Company v. Veghte, 21 N.J. Eq. 463, 478-479 (E. & A. 1869); Hoy v. Bramhall, 19 N.J. Eq. 563, 572 (E. & A. 1868); Shoyer v. Mermelstein, 93 N.J. Eq. 57, 60, 114 A. 788 (Ch. 1921); Schwoebel v. Storrie, 76 N.J. Eq. 466, 469, 74 A. 969 (Ch. 1909); and Smallwood v. Lewin, 15 N.J. Eq. 60, 63 (Ch. 1862). Id. at 135, 136. (Emphasis added.)
5. See Check Cashing Inc. v. Manufacturers Hanover Trust Company, 166 N.J. 49 (2001) (external citations omitted).
6. Id. at 59. (Citations omitted.)
7. Check Cashing, supra. at 59-62.
8. 306 N.J. Super. 540 (App. Div. 1997).
9. Id. at 545.
10. Id. at 549.
11. Id. at 549.
12. Id. at 554.
13. Id. at 557 .
14. Id. at 557.
15. Sears Mortgage Corporation v. Rose, 257 N.J. Super. 33, 45-46 (App. Div. 1992) certification granted. 130 N.J. 393 reversed on other grounds 134 N.J. 326 (1993). See also Tumber, Inc. v. Automation Design & Manufacturer Corp., 130 N.J. Super. 5, 13 (Law Div [date].) ("as between two innocent victims of fraud, the one whose circumstances which made the wrongful act possible must suffer the loss." (Citations omitted.).

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