

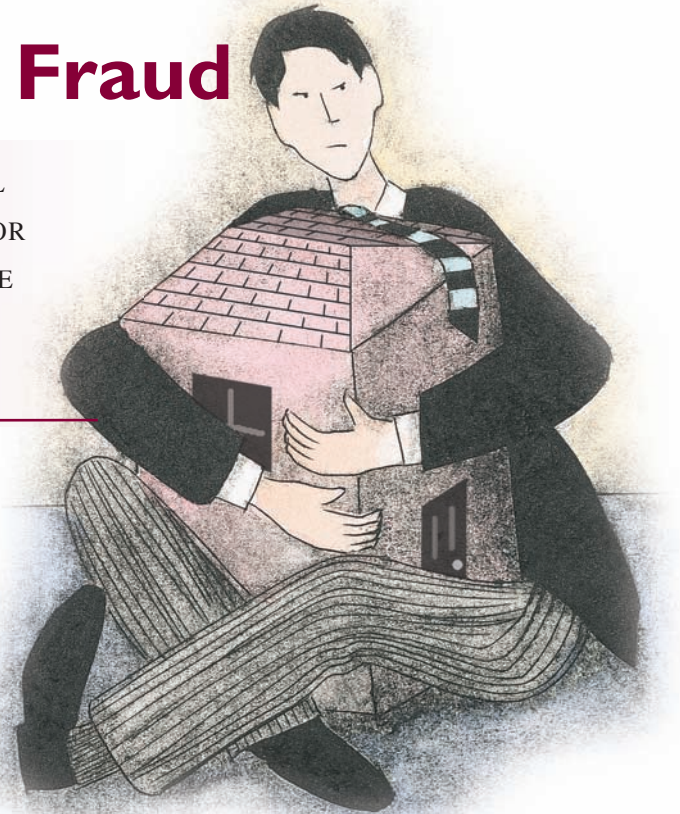
Update on Mortgage Fraud

DESPITE A CONCERTED EFFORT TO COMBAT IT, REAL ESTATE FRAUD CONTINUES TO POSE CHALLENGES FOR THE NUMEROUS STAKEHOLDERS IN THE REAL ESTATE AND FINANCIAL SERVICES INDUSTRIES, AS WELL AS THE LAW SOCIETY.

As has been noted in past issues of the *Gazette*, real estate lawyers should be vigilant for indicators of fraud whenever they are retained in real estate and/or mortgage transactions.

While **title fraud** – the fraudulent transfer of title from a true registered owner – is a serious concern, the far more prevalent manifestation of real estate fraud as observed by the Law Society is mortgage fraud.

Mortgage fraud (sometimes referred to as “value fraud”) is the act of borrowing money from a lender in a mortgage transaction under false pretenses, usually with respect to the purchase price of a property. It is common in a fraudulent mortgage transaction for a lender to be misled about the true purchase price of the property that is being offered as security for the loan.



Mortgage fraud usually involves tricking a mortgage lender into advancing more funds than a property is worth, typically to the detriment of the lender. It is not unusual in a fraudulent mortgage transaction for the purported borrower to be a straw person using false, and sometimes stolen, identification.

Applying your professional judgment

Lawyers are retained by the parties to a real estate transaction to apply their professional judgment to all aspects of the retainer as it may affect their clients. This includes the lender client. Lawyers should familiarize themselves with the possible indicators of mortgage fraud and adopt measures to ensure that they do not become the tools or dupes of unscrupulous clients or third parties associated with their clients.

Subject to certain exceptions, the Law Society's *Rules of Professional Conduct* now prohibit lawyers from acting for both the vendor and the purchaser on a transfer of title to real property. Where the exceptions apply, or where the lawyer is acting for a purchaser and a mortgage

lender, the lawyer must be particularly vigilant not to favour the interests of one client over others.

If a lawyer has suspicions about whether he or she may be assisting the client in fraud or illegal conduct, the lawyer cannot disregard these suspicions. The lawyer must make reasonable inquiries to obtain information about the client and the subject matter and purpose of the retainer. The lawyer should make a record of these inquiries.

There will be situations where, in order to meet ethical obligations, the lawyer will have no option but to withdraw from representing the client.

Avoid being duped by unscrupulous clients – watch for red flags!

Here are some obvious red flags that should prompt questions and due diligence in real estate transactions. The fact that one or more of the following appears in any transaction does not necessarily mean that the transaction is improper, or that a fraud is being perpetrated. However, when a real estate and/or mortgage transaction exhibits one or more of these (or other) red flags, a lawyer should apply extra diligence.

- ▶ The mortgage advance exceeds the balance due on closing.
- ▶ Credits which are not referenced in the purchase agreement or in amendments to the purchase agreement are granted to the purchaser for purported reasons including the following:
 - ▶ additional deposit
 - ▶ gift
 - ▶ promissory note
 - ▶ renovations and repairs
 - ▶ vendor take-back mortgage
 - ▶ rebate for legal fees or land transfer tax
 - ▶ rebate for real estate commission.
- ▶ Credits are granted to the purchaser in an amendment to the purchase agreement that have not clearly been disclosed to the lender.
- ▶ The purchase price of the property has escalated substantially over a relatively short period of time.
- ▶ The lender is effectively advancing more than 95 per cent of the purchase price where the mortgage is insured.
- ▶ The purchaser provides no or minimal funds on closing, such that only the mortgage advance is required to complete or substantially complete the purchase.
- ▶ Closing funds come in the form of a cheque or bank draft drawn from a source that indicates that the source may not be the purchaser.
- ▶ The purchase agreement (and any amendments to the agreement) indicate that the deposit is payable directly to the vendor rather than to the vendor's real estate broker or lawyer.
- ▶ There is third-party involvement including instructions, directions, client identification and information coming from a third party, or alternatively, directions to report to or pay excess mortgage proceeds to a third party.
- ▶ The same purchasers, vendors, real estate agency or mortgage broker are present in multiple transactions.
- ▶ The lawyer is asked to make a last-minute registration under a power of attorney.
- ▶ The lawyer is asked to complete a transaction in a short period of time.
- ▶ The lawyer is offered higher than usual legal fees for acting on the transaction.

Lessons for lawyers: some sample mortgage fraud scenarios

SCENARIO #1: RESALE AND ADDITIONAL DEPOSIT

On December 8, a purchase agreement is entered into between a purchaser and vendor providing for a purchase price of \$389,900 and a deposit of \$500 payable to the vendor's solicitor. The same real estate broker represents both the vendor and the purchaser.

Lawyer A acts for the vendor. Lawyer B acts for the purchaser and lender.

A mortgage loan is arranged for \$370,405 and the lender agrees to make a net advance (after deducting fees and insurance) of \$360,405.

A title search conducted by Lawyer B indicates that the vendor had originally purchased the property on November 17 of the same year for \$256,000.

Lawyer B does not advise the lender that the property was purchased less than one month earlier for \$256,000.

On December 20, the parties sign an amendment to the purchase agreement, which is not prepared by either lawyer and which provides that the purchaser will pay a further deposit of \$18,500 directly to the vendor on or before December 25.

On December 30, Lawyer B receives a facsimile transmission containing two receipts. The first indicates that the purchaser paid a further deposit of \$14,000 directly to the vendor on December 20. The second receipt indicates that the purchaser paid a further deposit of \$18,500 to the vendor on December 24.

Lawyer B does not advise the lender that deposits are being paid to the vendor instead of to the broker. Lawyer B also neglects to advise the lender that

additional deposits (\$14,000 and \$18,500) are being paid.

The balance due on closing according to the Statement of Adjustments is \$356,900. The purchaser is credited with deposits totalling \$33,000 (\$500 + \$14,000 + \$18,500).

On closing, the lender advances \$360,405 to Lawyer B in trust.

The mortgage advance of \$360,405 is greater than the \$356,900 balance due on closing. The purchaser does not pay any funds on closing.

Lawyer B closes the transaction on January 4 and registers a transfer from the vendor to the purchaser indicating consideration of \$389,900. Lawyer B also registers a mortgage in favour of the lender in the principal amount of \$370,405.

The mortgage goes into default on April 1 and the property is later sold under power of sale for \$260,000.

SUSPICIOUS FEATURES OF THIS TRANSACTION

- The initial deposit of \$500 was extremely low.
 - The purchase agreement was amended to provide for further deposits payable directly to the vendor rather than to the real estate broker or the vendor's lawyer.
 - The property was purchased less than one month earlier for a sum substantially less than the sale price in this transaction.
 - The purchaser was not required to pay any funds on closing.
 - The mortgage advance exceeded the balance due on closing and the purchaser was paid excess monies on closing.
- Lawyer B had a duty to act in the best interests of both clients in the retainer, and to disclose all information that might be reasonably considered
- material to the lender's decision to lend or not. In this scenario, Lawyer B failed to advise the lender that:
- The mortgage advance of the lender was greater than the balance due on closing.
 - The property had increased in value by \$133,900 in approximately one month.
 - The lender's \$370,405 loan to the purchaser was being secured against a property that, one month earlier, was worth \$256,000.
 - The purchase agreement had been amended.
 - Further deposits were being paid prior to closing, directly to the vendor.
 - The \$370,405 mortgage registered on title for the lender represented almost 104 per cent of the \$356,900 balance due on closing.

SCENARIO #2: PROPERTY FLIP

On January 20, a purchase agreement is entered into between Vendor A and Purchaser A which provides for a purchase price of \$315,000, with a deposit of \$1,000 payable to Vendor A. Lawyer A acts for Purchaser A. The closing date is set for February 6.

On January 20, a second purchase agreement is entered into by Purchaser A (acting as Vendor B) and Purchaser B. The purchase price of the property according to the second agreement is \$493,000, with a deposit of \$10,000 made payable to Vendor B. Lawyer A acts for Vendor B and Lawyer B acts for Purchaser B and the lender. The closing date for the second transaction is set for February 6, like the first transaction.

A mortgage loan is arranged for \$478,350 and the lender makes a net advance (after deducting fees and insurance) of \$468,350.

Lawyer A electronically signs the first transfer on behalf of Purchaser A indicating consideration of \$315,000, and submits it for electronic registration on February 6 at 11:15 a.m.

Lawyer A and Lawyer B sign the second transfer on behalf of Vendor B and Purchaser B indicating a consideration of \$493,000

and submit it for electronic registration on February 6 at 3:30 p.m. Lawyer B signs the mortgage on behalf of Purchaser B and submits it for electronic registration on February 6 at 3:30 p.m. The proceeds of sale from the second transaction, on the direction of Vendor B, are paid to various parties, who are not parties to the transaction.

SUSPICIOUS FEATURES OF THIS TRANSACTION

- The Lawyer for Vendor B is instructed to make the proceeds of the sale payable to third parties with no apparent relationship to the transaction or entitlement to the funds.
- There was a substantial escalation in the purchase price of the property over a very short period of time.
- Deposits were paid directly to the vendors.

continues on page 16

Scenario #2: Property Flip

Continued from page 15

Lawyer A had a duty, in the face of the red flags, to investigate whether the transaction was *bona fide* and to withdraw if necessary. Lawyer B, who was representing the lender in the transaction, had a further duty to inform the lender of the facts that were material to its interests, including the following:

- In the purchase agreement governing the second transaction, which was disclosed to the lender, the vendor (Vendor B) was not the owner of the property at the time of execution.
- The property had increased in value by \$178,000 in approximately one month.
- The lender's \$478,350 loan to the purchaser was being secured against a property that, a few hours earlier, was transferred for a consideration of \$315,000.

SCENARIO #3: CLOSING FUNDS IN THE FORM OF A "DAYLIGHT LOAN"

A purchase agreement is entered into between a purchaser and a vendor regarding a property for a purchase price of \$500,000. The agreement provides for a deposit of \$10,000 payable to the vendor's real estate broker.

Lawyer A represents the vendor, and Lawyer B represents the purchaser and lender.

The lender agrees to loan \$475,000 toward the transaction and (after deducting fees and insurance) advances \$465,000 on closing. The balance due on closing, which the lender expects to be paid from the personal funds of the purchaser, is \$25,000.

Lawyer A sends a direction re: funds to Lawyer B directing that the balance due on closing – \$25,000 – be paid by certified cheque to a person who is not a party to the transaction.

The day before closing, Lawyer B meets with the purchaser and receives a bank draft in the amount of \$25,000 representing the balance due on closing. There is a notation on the bank draft indicating that the source of the funds is the same person to whom Lawyer B has been directed to pay closing funds by Lawyer A.

The deal closes and Lawyer B sends a cheque to Lawyer A for \$25,000, made to the order of the named payee.

SUSPICIOUS FEATURES OF THIS TRANSACTION

- The \$25,000 was a "daylight loan," loaned over a period of 24 hours, by the third party to the participants in the real estate transaction.
- The third party receiving the closing funds was the same third party who was the source of the closing funds.
- The purchaser, in effect, took title with no personal equity contribution other than the deposit, assuming that the deposit was real.
- The actual consideration in the transaction does not include the \$25,000 that was loaned and repaid within 24 hours.

Lawyer B had a duty to inform the lender of the facts that were material to its interests, including the following:

- The purchaser was using funds to close the transaction from a non-personal source.
- There appeared to be a \$25,000 'in-and-out' amount that may not have formed part of the consideration for the transaction and, if not, then the actual purchase price was \$475,000 (\$500,000 less \$25,000), assuming the deposit to have been real.
- The lender's \$475,000 loan to the purchaser represented 100 per cent of the actual purchase price.

SCENARIO #4: DISGUISED REFINANCING BY CHURNING

A vendor has bad credit and needs to pay off a mortgage of \$200,000. Many prospective lenders have refused applications to refinance.

The vendor enters into a purchase agreement with a purchaser, who is the child of the vendor but does not share the same surname as the vendor, in which a purchase price of \$350,000 is agreed. The agreement provides for a \$50,000 deposit directly to the vendor.

The vendor and purchaser retain the same lawyer, which is permitted under the Two-Lawyer Rule because of the “related persons” exception set out in Rule 2.04.1(3) of the *Rules of Professional Conduct*.

The lawyer also represents the lender in the transaction, who agrees to advance \$300,000 to the purchaser.

The lawyer is directed to prepare a trust agreement providing that the purchaser will only be holding title to the property

as a trustee for the vendor who is to remain, at all times, the beneficial owner.

On closing, the lawyer is directed to prepare a transfer from the beneficial owner (vendor) to the trustee (purchaser).

After deducting fees and insurance, the lender advances \$290,000 on closing. The balance due on closing taking into account the advance of \$290,000 and the deposit of \$50,000 is \$10,000. The lawyer is advised by the parties that the balance due on closing was paid directly by the purchaser to the vendor.

The lawyer receives the \$290,000 mortgage advance and is instructed to use it to pay the \$200,000 mortgage on title. The lawyer does so and is directed to pay the remaining \$90,000 to the vendor.

A month after registering the transfer and the mortgage, the lawyer is instructed to register a transfer from the trustee (purchaser) to the beneficial owner (vendor) for nil consideration. The

vendor at all times remains in the property and takes over the mortgage payments to the lender using the \$90,000 generated through the churning of the property.

SUSPICIOUS FEATURES OF THIS TRANSACTION

- The deposit was high and paid directly by the purchaser to the vendor.
- The transaction was not at arm’s length.
- The closing funds were paid directly by the purchaser to the vendor.
- The trust agreement provided that the vendor would remain the owner of the property, whereas the lender was led to believe that the purchaser was acquiring title.

The lawyer had a duty to inform the lender of the facts that were material to their interests, including the following:

- The transaction was not at arm’s length and the lawyer was directed to transfer title in accordance with a trust agreement.
- The lawyer was acting for all parties to the transaction.
- The property was being “churned” without the vendor losing title in an effort to obtain mortgage funds from the lender, who was misled into believing that the property was being sold to an arm’s length purchaser at fair market value.

The importance of checking identification

Lawyers should always remember the importance of obtaining and keeping photo identification of their clients. The Law Society has observed the use of false identification in many mortgage fraud investigations. Lawyers must comply with the client identification and verification rules set out in By-Law 7.1 and should use care in following the instructions of lender clients.

If a lawyer is concerned about the identity of another lawyer acting in a real estate transaction, then the lawyer should check that the address and phone number of the other lawyer matches the information on file with the Law Society. Simply go to the Law Society’s online member directory at: www.lsuc.on.ca.

Lawyers may also contact the Law Society at 416-947-3315 or 1-800-668-7380, ext 3315.