

# Mortgage Fraud and the Deliberate Ignorance Jury Instruction: THE RISK OF CRIMINAL LIABILITY FOR REAL ESTATE PROFESSIONALS INVOLVED IN CIVIL LITIGATION

By William Z. Duffy<sup>†</sup>

## I. INTRODUCTION

Current economic conditions, which began with a sharp increase in real estate foreclosures in 2007, have been described as “the worst economic crisis since the Great Depression.”<sup>1</sup> Federal and State law enforcement agencies have responded by investigating suspicious real estate transactions for evidence of fraud.<sup>2</sup> By April 2008, the FBI had received a record number of complaints of mortgage fraud, and recently warned that “as housing prices continue to fall, more financial misdeeds will no doubt come to light.”<sup>3</sup>

Mortgage fraud is defined as a materially false or misleading statement made to a lending institution for the purpose of obtaining a mortgage loan.<sup>4</sup> In many instances, the lending institution will initiate a civil lawsuit against the perpetrators of the fraud and anyone else connected to the transaction before criminal charges are brought by the Department of Justice or a similar state agency.<sup>5</sup>

Real estate professionals such as escrow agents, mortgage brokers, realtors, sellers, appraisers, and developers are vulnerable to civil lawsuits and criminal investigations because of their pivotal roles in the fraud. For example, an escrow agent might close a series of transactions despite suspicions that the borrower was lying about the source of a down payment. Likewise, a mortgage broker might issue loans to a group of individuals despite signs that they were being used as “straw borrowers” to purchase property at an inflated price only to walk away from it after the sale. Real estate professionals like these are often unaware of fraudulent activity until an investigation has uncovered wrongdoing, a lawsuit has been filed, and the relevant documents have been forwarded to the government. This article focuses on the risk of criminal liability to these individuals, who might admit their own negligence but deny knowledge of the fraud at the time of the transaction.

When evaluating a mortgage fraud case, civil counsel should be aware that government prosecutors will argue that “red flags”

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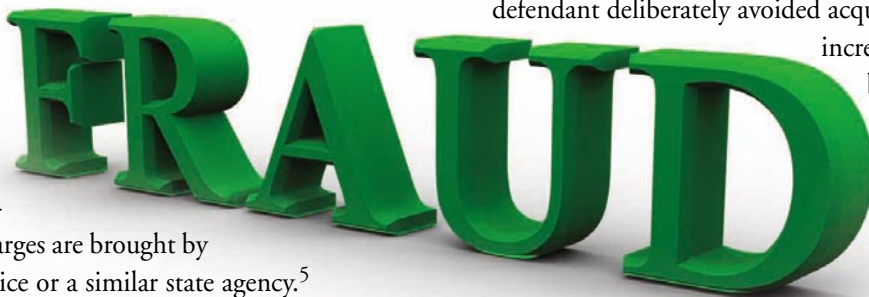
alerted the defendant to the fraud, but the defendant purposefully avoided gaining knowledge of the crime. Prosecutors will focus on these red flags when requesting a deliberate ignorance jury instruction from the court. This instruction permits the jury to find that there was a knowing violation of the law if the defendant deliberately avoided acquiring knowledge, and further increases the risk of criminal liability by negating arguments that the accused was either unaware of fraudulent misrepresentations or simply neglected to understand the fraudulent scheme.<sup>6</sup>

## II. THE GOVERNMENT'S CASE

In a typical mortgage fraud case, the indictment will contain allegations of bank fraud, money laundering, mail fraud, wire fraud, and conspiracy, each of which requires the government to prove that the defendant acted knowingly.<sup>7</sup> Federal courts define the word “knowingly” to mean that the defendant acted voluntarily and intentionally, not because of ignorance, mistake, or accident.<sup>8</sup>

### (A) Bank Fraud

Bank fraud is the core allegation in the majority of mortgage fraud cases. The burden of proof is on the government to show that the defendant knowingly executed a scheme to defraud a financial institution or obtain funds by means of false or fraudulent representations.<sup>9</sup> Federal statute prohibits the act of knowingly making any false statement or report, or willfully overvaluing any land, property, or security for the purpose of influencing the action of a federally-insured bank.<sup>10</sup>



To prove a conspiracy, the government must establish beyond a reasonable doubt that two or more people agreed to pursue an unlawful objective, that each defendant voluntarily agreed to join the conspiracy, and that at least one of the members performed an overt act to further the objectives of the conspiracy.

#### **(B) Money Laundering**

Money laundering is the practice of engaging in financial transactions to conceal the identity, source, or destination of illegally-gained funds. Federal money laundering statutes make it illegal for a person to knowingly engage in a financial transaction with proceeds derived from an unlawful activity with the intent to promote the unlawful activity or conceal the nature, location, source, ownership or control of the illegal funds.<sup>11</sup>

#### **(C) Wire and Mail Fraud**

Wire fraud and mail fraud involve knowingly using the mail service, wires, radio or television with the specific intent to defraud an individual or the government.<sup>12</sup>

#### **(D) Conspiracy**

Conspiracy requires an agreement between two or more people to defraud the United States.<sup>13</sup> To prove a conspiracy, the government must establish beyond a reasonable doubt that two or more people agreed to pursue an unlawful objective, that each defendant voluntarily agreed to join the conspiracy, and that at least one of the members performed an overt act to further the objectives of the conspiracy.<sup>14</sup> When an objective of the alleged conspiracy was to defraud a privately-owned lending institution, prosecutors can prove that the conspirators were planning to defraud the United States by presenting evidence that the lending institution was insured by the Federal Deposit Insurance Corporation (FDIC).<sup>15</sup>

### **III. DEVELOPMENT OF THE DELIBERATE IGNORANCE INSTRUCTION**

The use of deliberate ignorance as a substitute for actual knowledge can be traced to *United States v. Jewell*.<sup>16</sup> In that case, Jewell testified that he was vacationing in Tijuana when a man named Ray approached him and offered to sell him drugs.<sup>17</sup> Jewell initially declined but later accepted \$100 from Ray to drive a strange car across the border.<sup>18</sup>

When customs agents subsequently discovered a large cache of marijuana hidden in a secret compartment in the trunk, Jewell denied knowledge of the illegal cargo.<sup>19</sup> In light of these facts, the trial court instructed the jury that they could find Jewell guilty of knowingly possessing the marijuana if his ignorance was the result of a conscious decision to avoid learning the truth.<sup>20</sup> The Ninth Circuit affirmed this instruction, and every federal court of appeals except for the D.C. Circuit adopted the reasoning of that opinion.<sup>21</sup>

The Ninth Circuit recently revisited its holding from *Jewell* in *United States v. Heredia*, another narcotics transportation case.<sup>22</sup> Heredia used her aunt's vehicle to drive her mother from Nogales to Tuscon, Arizona.<sup>23</sup> Unbeknownst to Heredia, her mother and aunt stowed drugs in the vehicle and were using her to transport the cargo to Tuscon.<sup>24</sup> Heredia testified that she became suspicious when her mother seemed nervous, and she noticed that her mother was carrying a large sum of cash even though she was unemployed.<sup>25</sup> The strong smell of detergent in the car raised her suspicions further.<sup>26</sup> When asked about the scent, her aunt said she spilled Downey fabric softener in the car a few days earlier, an explanation which Heredia described to police as "incredible."<sup>27</sup>

Heredia was convicted at trial. She subsequently appealed the issuance of a deliberate ignorance instruction that allowed the jury to find that she had acted knowingly if she was aware of a high probability that drugs were in the vehicle, but deliberately avoided learning the truth about what she was transporting.<sup>28</sup> Citing *Jewell*, Heredia argued that the instruction should include a third element—that the defendant's motive in deliberately failing to learn the truth was to give herself a defense in case she should be charged with the crime.<sup>29</sup> The Court rejected this argument, holding that the requirement that the defendant deliberately avoided learning the truth sufficiently protects the accused.<sup>30</sup>



#### IV. DELIBERATE IGNORANCE INSTRUCTION IN MORTGAGE FRAUD CASES

Mortgage fraud prosecutions lend themselves to the deliberate ignorance instruction because they often involve complicated fact patterns that give real estate professionals the opportunity to deny knowledge about key misrepresentations. In *United States v. Faulkner*, for example, two real estate developers, Faulkner and Toler, were indicted for defrauding a federally-insured savings and loan in Dallas, Texas.<sup>31</sup> Faulkner, the ringleader of the scheme, began by purchasing a large tract of land upon which he located several new condominium projects.<sup>32</sup> Faulkner recruited Toler and others in a series of developments designed to capitalize on rampant speculation in the area's real estate market.<sup>33</sup>

Faulkner and Toler purchased large tracts of real estate, subdivided them, and sold them at great profit to intermediate developers.<sup>34</sup> The intermediate developers further subdivided the tracts and arranged for the financing, construction, and marketing of condominiums to be built on the various properties, which were sold in advance to individual investors.<sup>35</sup> The individual investors did not plan to live in the units, however, and were only purchasing them as investments to sell later at a higher price.<sup>36</sup>

Faulkner arranged loans for the developers and investors with several savings and loans operated by personal acquaintances upon whom he had lavished a number of expensive gifts.<sup>37</sup> These executives arranged loans that were incredibly favorable to the investors, requiring no money down and often providing them with "up-front" money (or "kickbacks") at closing.<sup>38</sup> Formann, their appraiser, consistently provided inflated appraisals that were always high enough to justify the loaned amounts.<sup>39</sup> Curiously, Faulkner and Toler were not found guilty of conspiracy to submit a false appraisal.<sup>40</sup> According to testimony, neither Faulkner nor Toler had asked Formann to provide inflated appraisals.<sup>41</sup> Rather, Formann did so because he understood that the property needed to be valuable enough for Faulkner and Toler to secure loans for the second and third sales.<sup>42</sup>

When the demand for the condominium developments proved much lower than expected, the inflated appraisals left investors with notes they could not possibly repay and properties they could not resell at a profit.<sup>43</sup> Eventually, the savings and loans failed, and the federal government had to pay huge sums to their insured depositors.<sup>44</sup>

The government accused Toler and Faulkner of fraud and analogized their dealings to a classic Ponzi scheme, with Toler and Faulkner at the top and taxpayers at the bottom.<sup>45</sup> Toler

denied knowledge of the fraud and argued that he was simply a lucky businessman who had legitimately prospered during a real estate boom not of his making.<sup>46</sup> He objected to the court's issuance of a deliberate ignorance jury instruction, which allowed the jury to credit him with knowledge of the fraud if he had "deliberately closed his eyes to what would otherwise have been obvious to him."<sup>47</sup>

Toler argued that the instruction was improper because there was no evidence that he deliberately avoided learning of the illegal conduct.<sup>48</sup> The court disagreed, holding "that in some

cases the likelihood of criminal wrongdoing is so high, and the circumstance surrounding a defendant's activities and cohorts are so suspicious, that a failure to conduct further inquiry or inspection can justify the inclusion of the deliberate ignorance instruction."<sup>49</sup>

A second case, *United States v. Nguyen*, illustrates how third party agents can

find themselves accused as conspirators in a scheme to defraud. In *Nguyen*, the defendants were two brothers employed by American Title Company as notary, escrow, and closing agents.<sup>50</sup> The Nguyens were accused of using their positions to participate in a scheme to defraud a financial institution that had been orchestrated by their cousins, the Meis.<sup>51</sup> The Meis prepared false title documents to make it appear like they owned parcels of real estate.<sup>52</sup> Before the Meis actually purchased a property, however, they sold it to a straw purchaser who had borrowed the purchase amount based on an inflated appraisal.<sup>53</sup> After the lender funded the transaction, the Meis then purchased the home at the real sales price, which was always significantly less than the price paid by the straw purchaser.<sup>54</sup> The Meis closed both transactions on the same day, kept the difference between the two loans, and rented the properties to offset the mortgage payments, which the Meis paid in the name of the straw purchasers.<sup>55</sup> The Meis used the Nguyen brothers as escrow officers to close several of the fraudulent transactions.<sup>56</sup>

On appeal of their convictions, the Fifth Circuit held that the deliberate ignorance instruction was properly provided to the jury in the Nguyens' trial because of the numerous red flags associated with the transactions.<sup>57</sup> These red flags included evidence that buyers were providing multiple affidavits to the lenders representing that they planned to occupy the residences (which allowed the Meis to obtain a more attractive mortgage), as well as evidence that the buyer was not providing the down payment as claimed in the closing documents.<sup>58</sup> Notably, the Nguyens did not share in the profits from the sham transactions outside their usual fees as escrow officers and notaries.<sup>59</sup> Moreover, like

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many who become entangled in a mortgage fraud prosecution, it is possible that they were convinced by their relatives, who were extremely successful real estate developers, that the transactions did not violate the law.

## V. LESSONS FROM FAULKNER AND NGUYEN

*Faulkner* and *Nguyen* highlight the importance of educating individuals in the real estate industry of their duty to inspect and inquire when they notice facts that indicate fraud. Escrow agents like the *Nguyens* should receive extensive training, as they are uniquely vulnerable to criminal liability for closing a suspicious transaction due to negligence or because they accepted the explanations of a real estate developer or others with whom they have a close working relationship. If a real estate professional is questioned after a transaction has already been concluded, however, actions should be taken to minimize the impact of civil litigation in a subsequent criminal trial.

In my experience, the lending institution that lost money in the transaction will begin by performing an investigation, which might be followed by a lawsuit for damages in civil court. The lending institution will probably send the Department of Justice the results of its initial investigation, copies of pertinent documents, and any deposition transcripts taken during the civil proceedings. The Department of Justice may wait until a significant record has been developed before they pursue charges against the alleged conspirators. The timing of these proceedings underscores the importance of involving competent criminal counsel as early as possible. Faced with the prospect of criminal charges, civil defendants should be advised of the risks associated with their deposition testimony and the benefits of reaching an early settlement.



## VI. CONCLUSION

Attorneys who represent individuals being investigated for alleged involvement in mortgage fraud must be aware of the risk of criminal prosecution and act appropriately before the government obtains an indictment. They can advise their clients to invoke their right against self-incrimination in civil depositions or to cooperate with the government at the earliest stage of the investigation. As illustrated by the foregoing cases, criminal defendants may have difficulty prevailing at trial if they attempt to deny knowledge or understanding of the fraud. Armed with the power of hindsight, and the likely availability of a deliberate ignorance jury instruction at trial in such matters, prosecutors will focus on suspicious facts to portray the defendants as having “buried their heads in the sand” to proceed with a lucrative transaction.<sup>60</sup> With this in mind, it is crucial to evaluate the allegedly fraudulent transactions long before the civil defendant is accused of a crime, examining each for evidence that should have alerted the client to alleged misrepresentations or other fraudulent activity. **BLB**

## ENDNOTES: *William Z. Duffy*

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<sup>1</sup> The Economist, *When fortune frowned*, available at [http://www.economist.com/specialreports/displayStory.cfm?story\\_id=12373696](http://www.economist.com/specialreports/displayStory.cfm?story_id=12373696).

<sup>2</sup> Carrie Johnson and Tomoeh Murakami Tse, *FBI to Focus on Area Mortgage Loan Fraud Agency to Host Investigators, Law Enforcement Officials*, WASHINGTON POST, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/12/05/AR2007120502612.html>.

<sup>3</sup> CnnMoney.com, *FBI: Beware of mortgage fraud*, available at [http://money.cnn.com/2008/05/13/real\\_estate/mortgage\\_fraud/index.htm](http://money.cnn.com/2008/05/13/real_estate/mortgage_fraud/index.htm).

<sup>4</sup> Texas Dept. of Banking, available at <http://www.banking.state.tx.us/dss/mortgagefrd.htm> (last visited Oct. 20, 2008).

<sup>5</sup> See, e.g., 31 C.F.R. § 103.18 (2008) (requiring a lending institution to report possible violations of the law to the Department of the Treasury by forwarding a Suspicious Activity Report); see generally FEDERAL BUREAU OF INVESTIGATION, 2007 MORTGAGE FRAUD REPORT, available at [http://www.fbi.gov/publications/fraud/mortgage\\_fraud07.htm](http://www.fbi.gov/publications/fraud/mortgage_fraud07.htm) (last visited Oct. 20, 2008) (stating that Suspicious Activity Reports related to mortgage fraud increased by 47 percent from 2005 to 2007).

<sup>6</sup> See *United States v. Griffin*, 524 F.3d 71, 78 (1st Cir. 2008); *United States v. Boesen*, 491 F.3d 852, 857-58 (8th Cir. 2007); *United States v. Carrillo*, 435 F.3d 767, 782 (7th Cir. 2006); *United States v. Ferrarini*, 219 F.3d 145, 154 (2d Cir. 2000).

<sup>7</sup> See, e.g., *United States v. Nguyen*, 493 F.3d 613, 618 (5th Cir. 2007) (enabling the government to allege that the defendant participated as a principal pursuant to 18 U.S.C. § 2 if they aided or abetted the commission of the underlying offense); see also *Indictment, United States v. Gonzalez*, (No. H0876); *Indictment, United States v. Robinson* (A08CR001SS).

<sup>8</sup> *United States v. Duval*, 496 F.3d 64, 71-72 (1st Cir. 2007).

<sup>9</sup> See, e.g., 18 U.S.C. § 1344 (2007).

<sup>10</sup> See 18 U.S.C. § 1014 (2007).

<sup>11</sup> See 18 U.S.C. § 1956; see also 18 U.S.C. § 1957 (prohibiting a individual from knowingly engaging in monetary transactions in criminally derived property of a value greater than \$10,000).

<sup>12</sup> See 18 U.S.C. §§ 1341, 1343 (2007); *United States v. Akpan*, 407 F.3d 360, 370 (5th Cir. 2005) (“[D]efendant acts with the intent to defraud when he acts knowingly with the specific intent to deceive for the purpose of causing pecuniary ‘loss to another or bringing about some financial gain to himself.’”).

<sup>13</sup> 18 U.S.C. § 371 (2007).

<sup>14</sup> *United States v. Parekh*, 926 F.2d 402, 405-6 (5th Cir. 1991).

<sup>15</sup> *United States v. McCauley*, 253 F.3d 815, 820 (5th Cir. 2001).

<sup>16</sup> *United States v. Jewell*, 532 F.2d 697, 698 (9th Cir. 1976) (en banc). The deliberate ignorance jury instruction is sometimes referred to as the “*Jewell* instruction.”

<sup>17</sup> *Id.* at n.1.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 698.

<sup>20</sup> *Id.* at 700.

<sup>21</sup> See, e.g., *United States v. Bussey*, 942 F.2d 1241, 1246 (8th Cir. 1991); *United States v. Lara-Velasquez*, 919 F.2d 946, 951 (5th Cir. 1990).

<sup>22</sup> See *United States v. Heredia*, 483 F.3d 913, 917 (9th Cir. 2007) (en banc).

<sup>23</sup> See *id.*

<sup>24</sup> See *id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 918

<sup>29</sup> See *id.* at 919-20

<sup>30</sup> *Id.* at 920.

<sup>31</sup> See *United States v. Faulkner*, 17 F.3d 745, 754 (5th Cir. 1994).

<sup>32</sup> See *id.* at 751-52.

<sup>33</sup> See *id.* at 751-54.

<sup>34</sup> See *id.* at 751-52.

<sup>35</sup> See *id.*

<sup>36</sup> See *id.* at 751-54.

<sup>37</sup> See *id.* at 767.

<sup>38</sup> See *id.* at 753.

<sup>39</sup> See *id.* at 768-69.

<sup>40</sup> See *id.* at 768.

<sup>41</sup> See *id.* at 753.

<sup>42</sup> See *id.*

<sup>43</sup> See *id.* at 754.

<sup>44</sup> *Id.*

<sup>45</sup> See *id.*

<sup>46</sup> See *id.* at 767.

<sup>47</sup> *Id.* at 765-66.

<sup>48</sup> *Id.* at 766.

<sup>49</sup> *Id.* at 766-67. The list of red flags cited by the court included the following: (1) Faulkner and Toler reaped enormous profits of tens of millions of dollars each by selling land along I-30 for a relatively brief two-year period, (2) the loans which made these profits possible were never denied and rapidly approved, (3) Faulkner and Toler were always able to dictate the price they wanted for the properties they sold, and likewise could dictate who would receive commissions or other payments at closing and in what amounts, (4) the closer, bankers and appraisers for the I-30 developments were lavished with gifts and bonuses, (5) The Savings and Loan's board members included Jane Nix, the closer on all of Faulkner's deals, and Brenda Kennedy, a close friend of Faulkner who received millions of dollars in commissions on the property sales despite a lack of any apparent effort on her part (6) even when properties were bought and sold in rapid succession, sometimes on the same day, the appraisals were always high enough to support the loans, (7) buyers would not put up any cash for a down payment, and typically walked away from the closing with cash in their pockets and a loan large enough to pay all closing costs and future interest payments for some period of time, (8) sales of properties by Faulkner and Toler never fell through due to lender concern about the creditworthiness of a borrower or the value of the property pledged as collateral, and (9) the area was being overbuilt and arms-length sales of the condominiums were far from justifying the level of loans and construction.

<sup>50</sup> *United States v. Nguyen*, 493 F.3d 613, 617-18 (5th Cir. 2007).

<sup>51</sup> See *id.*

<sup>52</sup> See *id.*

<sup>53</sup> See *id.*

<sup>54</sup> See *id.*

<sup>55</sup> See *United States v. Moncrief*, 133 Fed.Appx. 924, 926-29 (5th Cir. 2004) (per curiam) (unpublished) (referring to a more extensive set of facts pertaining to the Mei's fraudulent scheme).

<sup>56</sup> *Nguyen*, 493 F.2d at 618.

<sup>57</sup> See *id.* at 620-21.

<sup>58</sup> See *id.*

<sup>59</sup> See *Moncrief*, 133 Fed.Appx. at 929.

<sup>60</sup> See *United States v. Jaffe*, 387 F.3d 677, 681 (7th Cir. 2004) (explaining that an ‘ostrich instruction’ is appropriate “when a defendant claims a lack of guilty knowledge and there are facts and evidence that support an inference of deliberate ignorance. . . . Apart from a trial involving an actual ostrich, it’s hard to imagine a case where an ostrich instruction is more appropriate than one, as here, where the defendant acknowledges ‘sticking his head in the sand.’” (quoting *United States v. Craig*, 178 F.3d 891, 896 (7th Cir. 1999))).