



# **How Commercial Mortgage Lenders are Deceived**

## **Common Techniques of Deception**

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# Commercial Mortgage Lending Today

- Many lenders operate nationwide.
- Intermediation of due diligence as a result.
- Increasing proportion of third party originations.
- Collateral is sometimes not seen by an impartial employee of the lending institution.
- As a result, fraud has become more difficult to prevent.



# Mortgage Fraud

- Nationwide in scope. Examples today will include Oklahoma, Texas, Colorado, California, Illinois, Michigan, New York, and Utah.
- FBI mortgage fraud investigations have increased 623% since 2001.
- Collusion between industry insiders (mortgage brokers, appraisers, loan officers, realtors).
- Often goes undetected by victims.

## Residential Trends Become Commercial Trends

- Adjustable rate financing
- Securitization
- Increasing distance between borrowers and lenders
- Third party originators
- Fraud



# Recent Residential Lending Trends

- The “New Skepticism” paradigm:
  - In-house appraisal reviewers pull new comps.
  - Appraised values reduced without consulting appraisers.
  - AVMs used as objective second opinions.
- Vigorous litigation against fraudsters and those who abet them.

# Catalog of Tricks

- Misleading purchase agreements
- "Pocket-to-pocket" leases
- Missing or phantom tenants / Straw tenants
- Inaccurate operating statements
- Undisclosed or misrepresented property conditions
- Phantom renovations
- Bogus construction plans
- Bogus offers to purchase
- Illegal improvements
- Extraordinary appraisal assumptions
- Borrower-provided comparable data
- Unrealistic cash flow projections

## Case study: Oklahoma MF refinance

- 56 units built in 1970. Purchased for \$1,400,000 six months previously, with occupancy alleged to be 50% at time of sale.
- Current occupancy was 97%.
- Original HUD-1 settlement statement indicated \$350,000 repair allowance and \$50,000 in seller financing.
- Local brokers had judged the effective sales price to be \$1,000,000.
- Inspection indicated no updating of units.
- Borrower couldn't produce receipts documenting \$350K in repairs.
- Over 50% of new tenants were not paying their rent, exposing the practice of foregoing credit checks in order to fill all units.
- Nevertheless, an independent, approved appraiser was fooled into appraising for \$1,575,000.

# Misleading purchase agreements

- Intend to mislead lenders and appraisers into thinking that the purchase price is higher.
- Often characterized by:
  - Missing addenda
  - Seller financing
  - Repair allowances
  - Related parties

## How to guard against deceptive purchase contracts

- Ask to see the most recent listing.
- Check LoopNet or commercial realtor websites for the listing.
- Ask how the buyer and seller found each other.
- Ask to see all addenda to the contract.
- Pull comps at the outset. Public records, First American, DataQuick, SiteX are affordable.
- Document images can reveal names of individuals representing special purpose entities (LLCs, LPs, etc.).

# Pocket-to-pocket Leases

- The owner leases from himself, either openly or clandestinely.
- Sometimes accomplished through special-purpose entities.
- The tenant may also be a related party, such as a partner or a close family member.
- The best defense is to inspect the space, verify occupancy, and get comparable rental data from brokers or LoopNet. Above-market leases should be scrutinized.

# Missing or Phantom Tenants

- Tenants listed on rent rolls may have already vacated.
- When in doubt, ask to see copies of rent checks or ask for estoppel certificates.
- Developers' claims of pre-leasing should be verified with signed leases or letters of intent on company letterhead from known enterprises.

# Straw Tenants

- Apartments with vacancies can quickly be filled with deadbeat tenants.
- Undocumented rent holidays or reductions can be given to struggling commercial tenants.
- When in doubt, ask to see copies of rent checks.
- Be suspicious when monthly income statements include numerous late fees.

# Inaccurate Operating Statements

- Beware of non-income sources of cash inflow, such as “capital infusion” or “partner contributions” or “management fees”.
- Beware of nonrealty revenues being counted as property revenue, such as:
  - Legal awards, tax refunds, insurance refunds
  - Retail sales
  - Unrelated services (businesses or properties elsewhere)
  - Rents from unrelated properties.
- Compare operating statements with tax returns. Discrepancies need to be reconciled. If the borrower is evading taxes, also consider the consequences of a tax lien.

## Undisclosed/Misrepresented Conditions

- Environmental contamination. Trailer park in Michigan was an unremediated Superfund site. Can be inexpensively found with environmental hazards study (Property Data Services, National Hazard) or check [www.epa.gov/superfund](http://www.epa.gov/superfund).
- Special assessments/Bonded indebtedness. \$2 million loss on a Utah subdivision because the appraiser was not given a preliminary title report.
- Extent of completion of construction. Have qualified, non-commissioned employee verify this.

# Phantom Renovations

- Claims of renovations that have not actually happened.
- Independent appraisers can and have been deceived.
- Appraisers and property inspectors need detailed instructions on what to look for.
- Random unit selection for inspection should be done by the inspector or appraiser, not the borrower.

## Bogus Construction Plans

- New York – planned conversion of rent-controlled apartments into MRI space. No permits, incompatible zoning, immediate loan default.
- California -- \$30 million acquisition and development loan funded despite no drawings, plans & specifications or requests for permits. The only thing built was a surface parking lot.

## Bogus Offers to Purchase

- In Refi applications, written purchase offers are usually misleading and should be considered irrelevant to the valuation of the collateral.
- In Refi applications, expired sales contracts should be viewed suspiciously.

# Illegal Improvements

- Appraisers often forget to check for building permits for all improvements.
- Be particularly careful about billboards and cell phone towers, which are easy to erect and can generate substantial revenues until their forced removal.

# Extraordinary Appraisal Assumptions

- “Look at the what the loan agent is making me do!”
- Assuming existence of things that don’t exist—streets, utilities, etc.
- Assuming non-existence of things that do exist—contamination, etc.
- Assuming events have occurred when such events may not occur.
- Assuming immediate demand for unoccupied space without measuring or validating such demand.
- Assuming that the client’s statements are correct.
- Look for these in the *Assumptions and Limiting Conditions* section.
- The term “hypothetical appraisal” should always be a red flag.

## Borrower-provided Comp Data

- May not be closed transactions.
- May require adjustments for concessions or cash equivalency.
- May not be arm's length transactions.

# Cash Flow Projections

- Over the long term, expenses always increase faster than revenues, as proven by higher operating expense ratios for older buildings.
- Escalation or expense pass-through income increases much less in buildings with gross leases.
- Percentage rent income increases much less than rental revenues.
- Discount rates should be taken from properties with similar risk.
- Terminal cap rates should be higher than initial stabilized rates.
- Be able to recognize the difference between a lease-by-lease DCF analysis and DCF models which don't consider lease terms.

# Weak Links

- Appraisers are not usually given effective instructions.
- Appraisals ordered by commissioned salespeople.
- Commissioned loan agents interfere with objectivity.
- Bait and switch in appraisal shops—Hire the MAI, get the trainee.
- Appraisers may not be verifying the facts.
- Lack of comp searching.
- Appraisals should be field-reviewed whenever possible.
- The larger deals come with more pressure to make the deal work.
- In-house rules get ignored or superseded.

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