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Prosecution of Subprime-Mortgage Fraud *Will Congress Pay for It?*

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With the meltdown of the U.S. housing market, many players in mortgage lending now face the triple threat of criminal, civil, and administrative legal action. Potential targets include financial institutions, borrowers, mortgage brokers, lenders, securities dealers, and auditors. Popular pressure to hold someone accountable will increase now that taxpayers have been asked to pay for various bailouts. But the scope of federal action against questionable lending practices will depend on the answer to a key question: What funding will be made available to law enforcement agencies?

Current Investigations

Countrywide Financial Corp.'s recent woes may foreshadow what awaits other players in the subprime-mortgage industry. Countrywide faces concurrent criminal, civil, and administrative investigations or lawsuits in multiple jurisdictions. The U.S. Attorney's Office for the Central District of California reportedly is investigating alleged fraud in Countrywide's origination of loans, including what prosecutors assert was willful blindness by company executives to many borrowers' inflated income figures. The U.S. Attorney's Office for the Southern District of New York is investigating whether Countrywide's executives committed securities fraud by understating the risks of buying securities backed by mortgage loans to subprime borrowers. Countrywide and its executives also face SEC and FTC investigations, shareholder lawsuits, consumer-protection lawsuits brought by the Attorneys General of Illinois and California, and claims by the U.S. Trustee that Countrywide's loan servicing practices represent an abuse of the bankruptcy system.

According to published reports, federal criminal investigations into the subprime-mortgage industry have gained intensity in recent weeks. A federal grand jury is investigating Countrywide, New Century Financial Corp., and IndyMac Bancorp Inc. The FBI is investigating at least 19 major corporate-fraud cases related to the mortgage industry and hundreds of smaller investigations. The Department of Justice (DOJ) recently announced the results of "Operation Malicious Mortgage," a 3½-month joint operation among the FBI, Postal Inspection Service, IRS, and other federal agencies that was designed to identify, arrest, and prosecute mortgage-fraud violators throughout the United States. From March through mid-June 2008, the Operation resulted in 144 mortgage fraud cases, in which 406 defendants were charged. The DOJ told *The Los Angeles Times* that it intends to continue its investigation into each segment of the subprime-mortgage industry and that a variety of firms could be investigated, including securities firms, hedge fund operators, credit rating agencies, and mortgage brokers and lenders. *See* Richard B. Schmitt, "Federal Grand Jury Investigating Countrywide, IndyMac, New Century" (July 23, 2008).

So far, the DOJ has rejected calls to create a national task force to investigate mortgage fraud, relying instead on local U.S. Attorney's Offices to supervise the FBI's investigations. The Office for the Eastern District of New York has formed a task force of federal, state, and local agencies to probe mortgage fraud, securities fraud, accounting fraud, and other crimes. The FBI has instructed 26 of its 56 field offices to stop opening other financial-crimes investigations so that they can focus on the subprime-mortgage crisis and is working to identify "large-scale industry insiders."

For its part, the SEC has launched an agency-wide task force to investigate the subprime-mortgage industry. It has more

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than 50 open investigations — a 40% increase since January 2008 — related to the subprime-mortgage industry, which are looking into mortgage origination, accounting, sale of securities, insider trading, and other relevant business practices. The SEC is also sharing information with the DOJ and FBI, including, for example, information that led to the indictment of two former Bear Stearns hedge-fund managers.

Types of Business Practices Under Scrutiny

The DOJ has stated that it is investigating a variety of business practices related to the subprime-mortgage industry, from fraud involving individual mortgages to mortgage-related securities fraud. Targeted practices include:

Lending fraud. Mortgage lenders that issued loans based on information from borrowers that the lenders knew was a misrepresentation of the borrower's true financial status, including overstating the borrower's income or assets, using false employment records, or overstating property values.

Foreclosure rescue scams. Individuals who fraudulently collect fees for foreclosure prevention services from homeowners who are in financial trouble.

Bankruptcy schemes. Bankruptcy petitions used to stay foreclosure proceedings. The DOJ believes that mortgage-related bankruptcy is being used to further lending fraud and foreclosure rescue scams.

Securities. Fraud and related crimes in connection with mortgage-backed securities and other financial instruments. DOJ reports that it is looking at whether sellers of packaged subprime mortgages misrepresented the value of the packaged debt or engaged in insider trading when they sold stock knowing that it was about to lose value.

The Government's Arsenal

Besides the mainstay statutes of white-collar prosecution such as Conspiracy (18 U.S.C. § 371), False Statements (18 U.S.C. § 1001), Mail/Wire Fraud (18 U.S.C. §§ 1341 & 1343), Bank Fraud (18 U.S.C. § 1344), and Securities Fraud (18 U.S.C. § 1348), federal prosecutors may be investigating violations of:

The Continuing Financial Crimes Enterprise Act (18 U.S.C. § 225), which prohibits organizing, managing, or supervising a continuing financial crimes enterprise, or receiving $5 million or more in gross receipts from such an enterprise during any 24-month period. A continuing financial crime is defined as a series of certain criminal violations, including Bank Fraud and Mail/Wire Fraud, affecting a financial institution, committed by at least four persons acting in concert.

The False Entries statute (18 U.S.C. § 1005), which prohibits false entries in any book, report, or statement of an insured institution, with intent to injure or defraud such institution or any other company, or to deceive any officer of such institution or its regulators.

The Credit Institution Fraud statute (18 U.S.C. § 1006), which prohibits in part false entries in any book, report, or statement of any lending, mortgage, insurance, credit, or savings and loan corporation, with intent to injure or defraud such institution or any other company, or to deceive any officer of such institution or its regulators.

> HUD and FHA Fraud (18 U.S.C. § 1010). The statute prohibits the making or publishing of any false statement, or altering, forging, or counterfeiting any instrument, paper, or document, or willfully overvaluing any security, asset, or income, for the purpose of obtaining any loan, with the intent that such loan will be offered to HUD for insurance, or otherwise attempting to influence in any way the action of HUD.
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> False Statements on Loan Applications (18 U.S.C. § 1014). The statute prohibits oral or written false statements or misrepresentations made knowingly on a loan or credit application to an insured institution, *i.e.*, willful over-valuing of land, property, securities or other assets or understatement of liabilities.

The DOJ may choose to investigate possible violations of these statutes through any number of techniques, ranging from informal inquiries to search warrants and grand jury subpoenas. Federal prosecutors may also rely on information gathered by the SEC and other federal agencies through administrative subpoenas and other civil investigatory techniques.

Conclusion

The DOJ and the SEC are facing increasing political pressure to investigate and bring enforcement action swiftly against suspected wrongdoers in the subprime-mortgage industry. For example, Representative Barney Frank, Chairman of the House Financial Services Committee, has called the subprime-mortgage crisis "worse than Enron" and has pressed Attorney General Mukasey to form a national subprime-mortgage task force.

But a key factor has been missing in all the bluster about enforcement: dedicated funding for investigations and prosecutions. Unlike Congress's response to the savings-and-loan crisis of the 80's, the recent housing bailout did not include additional resources for law enforcement. Congress has not yet followed through with its proposals to allocate tens of millions of dollars to the DOJ and SEC for investigating the subprime-mortgage industry. Although the collapse of the subprime-mortgage industry presents an enormous enforcement issue for the DOJ and the SEC, it is too early to know whether Congress will allocate commensurate resources.

Stay tuned.

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