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**Mortgage Banking Update
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**NO TITLE INSURANCE OR FIDELITY BOND
COVERAGE FOR LOAN FRAUD
INVOLVING FALSE BUYERS & FALSE APPRAISALS
CALIF. APP. CT. HOLDS**

**Court Rationalizes that Losses Not Caused by Defect in Title
& Insufficient Evidence of Employee Dishonesty**

Summary of Case

A California Appellate Court published an opinion on January 7, 2003 holding that a lenders' title insurance policies do not protect against a loan flip scheme involving loans to fictitious buyers based on grossly inflated false appraisals.

The Court also held that there was no coverage under the lender's fidelity bond because there was insufficient evidence that the lender's employees substantially profited from their involvement in the scheme.

The title insurance holding of the case is significant because the facts of the case are common to many mortgage banking fraud losses.

The case is *Mortgage Associates, Inc. v. Fidelity and Deposit Co. Of MD, et al.* (2003 DJDAR 233; 105 Cal.App.4th 28; — Cal.Rptr.2d ---; Calif. App. Ct., 2nd App. Dist.; Dec. 23, 2002, ordered published, Jan. 7, 2003). It can be viewed at <http://www.courtinfo.ca.gov/opinions/documents/B152466.PDF> .

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Facts

A mortgage lender was the victim of a loan scheme involving at least 16 loans. The scheme involved an ostensible real estate investment firm, and its principals, who purchased properties below market value and then set up sham sales of each property to straw buyers. Two underwriter employees of the lender were involved in the fraud.

The mortgage lender provided purchase money loans to the purported buyers based on false appraisals with inflated values. Each of the purported “straw buyers” used an assumed name of an identity theft victim who, in fact, had not interest in the properties and was unaware of the scheme.

The lender foreclosed and suffered significant losses due to loan balances in excess of true value.

Issues

The case involves whether or not the lender’s title insurance policies and/or fidelity bond (for employee dishonesty) covered the losses.

Holding / Analysis

The appellate court concluded that neither the title insurance policies nor the fidelity bond provided any coverage for the losses. As to the title insurance policies, the Court reasoned that there was coverage only for losses resulting from *title defects*. The Court explained that “[i]mpaired value is not the same as defect in title” and that the lender’s post foreclosure title to the properties was free of defects and “marketable without restriction.”

As to the fidelity bond (for employee dishonesty) the Court explained that the bond expressly required an affirmative showing of proof by the lender not only that employees engaged in dishonest or fraudulent conduct, but that where the losses relate to loans, that the employees benefitted by at least \$2,500.00. The lender had no evidence that the involved employees profited in such amount.

Other Issues, Notes & Commentary

The title insurance portion of the ruling is significant. The title insurance industry has long maintained that where a “fraudster,” in his or her own name or that of an alias/assumed



identity, obtains title to a property and secures a mortgage loan, there is no defect in title and the lender is free to foreclose. (*Knaugh v. Bender* (1927) 84 Cal.App. 142; *Overton v. Harband* (1935) 6 Cal.App.2d 455; *Wilson v. White* (1890) 84 Cal. 239). This case supports this position in a footnote.

If lenders are truly free to foreclose in such circumstances, lenders should nevertheless take steps to avoid impairing the credit score of the victims of the identity theft, whose names are falsely used as the buyers and borrowers. Even if in such cases a lender does not affirmatively report the foreclosure activity, the foreclosure will no doubt be “picked up” and reported by third party sources. Through many hours of effort in a multitude of almost identical cases, Wolfe & Wyman LLP has developed a series of agreements and a protocol for helping reduce the risk of a subsequent false credit remark action by the identity theft victim. If you or your company might be benefitted by this, please call.

It should also be noted that the analysis, and quite possibly the holding, would be different if the identity theft victims were in fact the true owners of the subject property and the scheme involved “fraudsters” obtaining false loans against the properties which they neither owned in their true names or in their falsely assumed aliases. In most such circumstances, title insurance policies provide coverage, following a properly presented tender.

Further Information and Assistance

For further information and/or assistance, please feel free to contact any member of the Mortgage Banking Department at Wolfe & Wyman LLP, including:

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