

Inflating Purchase Price May Violate Law

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A troublesome mortgage lending practice in the real estate sales market has come to the attention of the Consumer Protection Division of the Office of Iowa Attorney General Tom Miller. This practice involves artificially increasing purchase prices in a way that we believe deceives consumers and some lenders and, therefore, is unlawful under the Iowa Consumer Fraud Act, and, in certain circumstances, may violate federal criminal law.

The purpose of the scheme is to create phantom "equity" in property, as a substitute for a down payment or legitimate down payment assistance. The result is that the lender is undersecured, perhaps without its knowledge; if the mortgage is sold on the secondary market, the investor likely would be unaware of the under-secured nature of the loan; and the buyer has no real understanding of the consequences of phantom equity, including potential tax consequences.

The practice has been described to work as follows:

- A property may be advertised as a "no down payment" deal, and someone (usually a loan officer or a real estate agent) involved with the listing suggests that the purchase price of a home be substantially increased over and above the original list price. Typically the original list price then becomes 80 percent of the newly-suggested purchase price.
- Financing is to be obtained from a lender in the amount of the original list price, but now ostensibly as a 80% loan-to-value mortgage. The seller is to provide financing for the remainder of the now inflated "purchase price" – thus providing the 20% phantom equity.
- Upon closing, the seller is to forgive or credit the buyer an amount approximately equal to the amount of the 20% equity loan.
- The commission to be paid on the transaction is based on the original list price, not on the suggested purchase price.

The net result is a 100% loan-to-value (LTV) mortgage, falsely made to look as though it's an 80% LTV mortgage. The phantom 20% "equity" is financed by what is in essence an equally phantom seller-take-back second mortgage. A variation of this practice may have the buyer paying five percent down, in which case the buyer's lender finances 95 percent of the original list price. The seller's net on the transaction, as calculated based on original list price, is unaffected.

This practice violates the Consumer Fraud Act, Iowa Code section 714.16, in at least two respects. First, it deceives home buyers, in that the buyer will own a home with no equity that is virtually impossible to sell or refinance for a number of years, consequences of which they are likely unaware. There may also be undisclosed tax consequences for both the seller and buyer when the purported second mortgage is forgiven at closing. (In addition, artificially inflating the sale price may also artificially inflate the future property tax assessment for the buyer.) Of course, some buyers may be willing to pay a premium for a property on a good faith basis, such as sentimental value, intense competition between offers, or proximity to existing property. That is not, of course, illegal. However, where the purpose of the practice is to falsely inflate the price as a substitute for a real downpayment, the practice violates the Consumer Fraud Act.

The practice also deceives lending institutions and the secondary market, in that the nominal purchase price does not reflect the true value of the property, resulting in an under-secured loan. Moreover, it may also run afoul of a federal criminal law, which makes it a crime to "willfully overvalue any land, property or security" or knowingly

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make a false statement for the purpose of influencing a loan decision by a long laundry list of federally-related institutions, including federal chartered lenders or state-chartered, federally-insured depository financial institutions. 18 U.S.C. § 1014.

The Consumer Fraud Act is a civil law enforcement statute enforced by the office of the Attorney General. Remedies available to the State in actions against individuals or entities who violate the Act include reimbursement for consumers who incur losses, civil penalties up to \$40,000 per violation, attorney fees and costs to the State, plus preliminary and permanent injunctive relief. The practice may also raise license disciplinary issues before the Real Estate Commission and the Real Estate Appraiser Board.

Those involved in the real estate industry should be aware of the Consumer Protection Division's concerns about this practice. Anyone seeking legal advice regarding this practice should consult a private attorney.