Ill-fated investments

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In the past decade, a series of Southern Nevada private lenders, also known as hard-money lenders, have fallen like dominoes, often wiping out the life savings of unwary investors. All of this has happened under the noses of state regulators, who learned of irregularities but failed to intervene until many more investors had been drawn into unwise and sometimes fraudulent schemes.

USA Capital became the latest and biggest to fail April 13, when it filed for bankruptcy protection, stunning 3,200 investors in mortgage loan funds and 3,600 individuals who bought fractional interests in individual loans. USA Capital controlled $962 million in assets.

Bankruptcy Judge Linda Riegle compared USA Capital to a Ponzi scheme in which early investors are paid with money from later investors. USA Capital continued to distribute monthly interest payments to all investors, although many borrowers were not making the loan payments that supposedly were generating that interest, according to interim managers at USA Capital. Also, USA Capital received loan payoffs from four loans, released the collateral and failed to return the money to investors in those loans, according to Tom Allison, the chief restructuring officer, who took office after the bankruptcy filing.

A total of $50 million in principal payments was kept by USA Capital rather than being distributed to investors, Allison said.

Hard-money lenders attract investors by advertising yields of 12 percent or more, compared to the currently typical 5 percent on virtually risk-free bank certificates of deposit.

But investors seeking high yields sometimes are imprudent or greedy and blame others for their bad investments, analysts say. Some of the same people who lost money when Harley Harmon Mortgage failed in 1997, invested with hard-money lenders that collapsed in the years since.

Hard-money lenders reassure investors that they hold real estate as collateral for mortgage loans, often called trust deeds, that generally mature in one year.

The Nevada Mortgage Lending Division also provides an implicit reassurance, because the division regulates and licenses hard-money lenders, some of which handle sums as large as deposits in community banks. Yet four hard-money lenders have failed in Nevada in the past decade.

The Nevada Mortgage Lending Division is tasked with regulating hard-money lenders.

A year ago, USA Capital started reporting that it was being investigated by the SEC for possible fraud. In addition, USA Capital last September closed USA Capital Trust Deed Fund, one of two funds it manages, saying it would slowly liquidate assets and pay back investors.

Yet the mortgage lending division did not examine the books and records of USA Capital for 16 months, though rules require annual exams.

Real estate attorney John Netzorg put it bluntly: "The state is incapable of doing its job. There should be no question now," referring to repeated hard-money failures.

Nevada officials "tried new regulations, and that didn't work," Netzorg said. Legislators passed new state laws regulating hard- money lenders. Those didn't work, either, he said.

State regulators, Netzorg said, "are not capable of providing any meaningful supervision" of hard-money lenders.

Being blamed "comes with the territory" for the state regulator assigned to overseeing hard-money lenders, said Scott Walshaw, formerly the top Nevada regulator for hard-money lenders and banks.

"You're the lightening rod in that position," Walshaw said. "When one of these things blows up, people like to point the finger. I don't think it's the fault of the regulator. It's a difficult situation when you have these kinds of dynamics that occur."

Leo Davenport, owner of GFD Investments and a longtime hard- money lender, said, "What we have done (in Nevada) for the last 20 years has not worked. I think our current regulations that we have are adequate," with a couple of exceptions.

"USA Capital broke most of the regulations that are on the books. So why do we need more regulations so that they can break them?" Davenport asked.

Davenport, Netzorg and others offer different solutions to the continuing problems with hard-money lenders, but it's helpful to see what happened in past cases before considering solutions.

The problems date back to the 1980s. Hard-money lender Lemons & Associates of Reno filed for bankruptcy court protection in 1985. Ultimately, 900 investors lost $13 million in the Lemons & Associates debacle, according to Mills Lane, then Washoe County district attorney (and later famous as a boxing referee and celebrity television judge). Founder John Stephen Lemons was sentenced to 10 years in prison for embezzling, racketeering and other offenses. He also received a 10-year prison sentence in Arizona. Former company President Stephen Sather pleaded guilty and agreed to serve five years in prison.

MELTDOWNS IN BOOMTOWN

In the past nine years, the problem companies have been based in Las Vegas, the state's boomtown.

In 1997, the Nevada Financial Institutions Division shut down Harley Harmon Mortgage, with $22 million in assets from 350 investors. Critics complained that the division, under Walshaw's direction, was too slow to act.

A legislative committee the following year learned that the division's then-deputy commissioner, Burns Baker, urged the state to seize control of the mortgage company 11 months before Walshaw closed it.

Walshaw took no action for months while the politically connected private lender continued to solicit new investors who became new victims in the fraudulent scheme.

People knew the lender's family and trusted him. Harley L. Harmon's grandfather helped found Clark County. Harley L.'s father, Harley E. Harmon, was chairman of the Clark County Commission for eight years. And the mortgage broker himself served as the Democrats' speaker pro tem in the Nevada Assembly in 1977.

Walshaw told the committee that he did not have enough documentation to win a court battle if he had tried to revoke Harmon's mortgage brokerage license earlier. Assemblyman David Goldwater, who served as committee chairman, called Walshaw's comments "incredible," but then-Gov. Bob Miller, a Democrat, said Walshaw "had done a very good job."

The offices of then-Attorney General Frankie Sue Del Papa and then-District Attorney Stewart Bell filed no criminal case stemming from the Harmon mortgage debacle. The U.S. attorney's office prosecuted and convicted Harmon on mail fraud. U.S. District Judge Philip Pro sentenced Harmon to 57 months in prison, ordered him to pay $2.7 million and to forfeit $557,000 in assets.

The next big failure was in December 1999 when Financial Institutions Commissioner Scott Walshaw filed a lawsuit, urging a state district judge to put Interstate Mortgage Group into receivership for liquidation of assets. Interstate was managing $140 million in outstanding loans for 1,000 investors. Judge Lee Gates in February appointed accountant George Swarts as the receiver for Interstate. Interstate was managing $140 million in outstanding loans for 1,000 investors.

This time, the attorney general's office secured a guilty plea from Interstate Mortgage owner David Ferradino. Judge Lee Gates of Clark County District Court ordered Ferradino to pay some $4.27 million restitution while serving five years of probation.

Global Express Capital started having financial problems in 2002, although owner Connie Farris denied she had done anything improper, according to news stories. In late 2002, the Nevada Financial Institutions Division determined there had been numerous violations of civil law, but Farris hired a law firm and challenged the state's findings for two months.

Global Express notified state officials in May of the following year that it was closing its operations in Nevada and moving to new headquarters in Billings, Mont.

About that time, Walshaw disclosed that Global received the worst or next-to-worst possible score in a state examination.

Walshaw hired Ben Harker, a former associate of Swarts, to serve as conservator. Harker recommended the state return control of the hard-money firm to Farris. Today, Walshaw said he cannot remember why he decided not to put Global Express in receivership. "If you are going to change or ignore (the conservator's) call, it's kind of silly," Walshaw said, thinking back.

Harker at the time said putting Global Express into receivership "would be a horrible thing."

In an August 2003 letter to Deputy Attorney General Mark Krueger, Harker asserted, "It appears that Global Express has fulfilled its fiduciary responsibility to its investors."

If Global investors complained, "the state should instruct investors that the properties are legally owned by the investors, and it is now their responsibility," Harker wrote.

Only four months later, in December 2003, the Securities and Exchange Commission obtained a federal court order to freeze the $48 million in assets at Global Express. The SEC concluded that Global Express was running a "Ponzi-like investment scheme." U.S. District Judge Kent Dawson appointed James Donell of Los Angeles as receiver. Dawson in March signed an order, finding the SEC was correct in its allegations. The judge found that Farris and her No. 2 executive, Dawn Reese, should pay back $23 million in "ill-gotten gains."

To date, neither federal nor state charges have been brought against Farris.

USA Capital became the next disaster in April 2006, when it filed for bankruptcy court protection because it was insolvent. The collapse of USA Capital, with assets totaling $962 million, dwarfs previous failures of hard-money lenders.

Many people were surprised, but they shouldn't have been. USA Capital had disclosed a year earlier that the SEC was investigating possible fraud. This was when the Mortgage Lending Division let 16 months pass without an examination of USA Capital's records, despite a state law requiring annual examinations.

Current Mortgage Commissioner Scott Bice complained he has only seven examiners available to review records of about 1,000 mortgage brokers, including both those who help homeowners borrow from institutions and private lenders such as USA Capital.

During the 2005 Nevada legislative session, Gov. Kenny Guinn limited requests for additional state positions to public safety and a few critical government functions, which did not include policing mortgage lenders, said Sydney Wickliffe, director of the Business & Industry Department, which includes the Mortgage Lending Division.

Bice repeatedly asked the Legislature's Interim Finance Committee to authorize additional examiner slots, Wickliffe said.

The committee refused Bice's requests for more examiners, arguing Bice should wait and present the issue to the full Legislature when it convenes in 2007.

Davenport said he does not understand why the requests were denied given a $4.6 million surplus in fees from mortgage brokers and "profits" that the division gets by charging private lenders $60 per hour for an examination while paying examiners less than that amount in hourly wages.

Nevada provides mortgage loan investors with another level of protection because the state requires annual audits by certified public accountants for companies such as USA Capital. Lenders file the audit with the mortgage division.

USA Capital filed audited financial statements for the year 2004 with the mortgage division in May 2005, prior to license renewal, said Mark Olson, chief operating officer with the interim management team. Olson said the audit "addressed" trust accounts that hold money belonging to investors, but Olson declined to say whether the audits were "qualified."

When an auditor files a qualified financial report, it means the auditor found a problem with the records he reviewed.

Olson and Bice refused to release a copy of the 2004 audits to the Review-Journal. Bice said the audits would be made public after his final regulatory action on the bankrupt hard-money lender.

As a result, it's not clear what Bice knew about the financial condition of USA Capital and when he knew it. Bice took no regulatory action against USA Capital until after the firm filed for Chapter 11 bankruptcy in April. Despite the colossal failure of USA Capital, Gov. Guinn and Wickliffe said Bice enjoys their full confidence.

Analysts say the ultimate responsibility for the mortgage lending division rests with the governor. Guinn, formerly chairman of $3 billion-asset PriMerit Bank, was the state's chief executive when three of the four hard-money lenders failed. He is also father of Jeffrey Guinn, who is one of Nevada's most prominent hard-money lenders.

"You never hear about what you head off," the governor said, referring to potential problems corrected by state officials. "All these (hard-money lenders) were up and running before I got here." Guinn blamed the state's failure to conduct the required annual exam of USA Capital on staff limitations.

While the law requires annual audits at mortgage brokerages, "laws are passed much faster than money is allocated to support these laws," Guinn said. "We can't audit anybody every minute of the day."

The governor said he never has participated in or intervened in decisions related to enforcement actions against hard-money lenders.

"Since I've been here, we've made a number of changes," Guinn said. The governor said he supported the legislative decision to create the Mortgage Lending Division as a separate one from the Financial Institutions Division.

Guinn said his new budget will call for 19 additional examiners for mortgage lending, two supervisory examiners, a bookkeeper to maintain billable hours that private lenders must pay for, and two administrative assistants for the examiners. In addition, he favors hiring four compliance investigators and a compliance supervisor.

FINDING A FIX

Commissioner Bice recently provided a trade group with a list of recommendations for changes in the laws governing the hard-money business. The proposals came from legislators, Bice later explained, declining to identify the legislators by name.

One measure would require private lenders to use third parties to service mortgage loans, rather than allowing companies to do that work internally as USA Capital and some of the other failed companies did.

Another proposed law would prohibit private lenders from lending money to themselves. Tom Hantges and Joe Milanowski, the key owners of USA Capital, used money from investors for many projects in which they held an ownership position. Self-dealing also came to light in at least two of the other Nevada hard-money failures.

"What impetus do you have to collect with a debt on yourself?" Bice asked.

A third provision would prohibit private lenders from making loans outside Nevada. USA Capital financed real estate projects around the country.

The final suggestion would set minimum income or net worth requirements that investors must meet before investing in mortgage loans.

Ted Nicothodes, who retired from hard-money lending after 20 years, agreed with the proposal "that mortgage companies wouldn't be allowed to service their own accounts, or own a loan service company. The industry will hate that because a lot of the big boys do it, but they need that rule."

Nicothodes also wants to restrict loans to mortgage company owners. He rejected the recommendation to prevent investments by people with low net worth or low income.

"How can I possibly tell people they're not smart enough or rich enough to buy mortgages?" Nicothodes said. "I've had investors who started with $50,000 and have a million."

Jeff Guinn, chief executive officer of Aspen Mortgage, took a different position. "I truly do not think we need any more laws or reform; we already got that. We need to concentrate on getting the division the staff to regulate it. I do not believe anybody calling for reform really understands how big it is and how important to Las Vegas."

David Goldwater, a private lender and former Democratic assemblyman who pushed for industry reform, believes state regulation of private lenders has improved in recent years.

He supports the list of four proposals that Bice compiled and agreed that Bice needs a bigger budget, noting that the money for the division comes from the industry, not taxpayers.

Netzorg said hard-money lenders should be barred from handling investor money. Instead, the attorney argued that trust deed investments should be kept in escrow accounts managed by title companies listed on the New York Stock Exchange. These title companies have "deep pockets" and know they can lose money in civil judgments if they fail to do their job, Netzorg said.

"You have to ensure that the investors' money isn't placed in the hands of these (private lenders) with no supervision and no controls," he said.

Terrence "Terry" Wright, owner and chairman of Nevada Title Co., said Netzorg's idea is a good one. "The title industry will do anything as long as it's legal and they can make a profit at it," Wright said.

If a local escrow company handled all investor funds, the escrow company still could conspire with a hard-money lender to divert money from investors, Walshaw said.

Meanwhile, people should not do business with hard-money lenders who insist on controlling investor money, Netzorg said. "Once you do that, you're just gambling that you'll ever see your money again." Nor should investors sign powers of attorney to hard-money lenders. Netzorg said they should reserve their right to make decisions for themselves, such as whether to foreclose.

"If someone tells you he can't let you have control of your money, you need to say goodbye," Netzorg said. "When you put your money in a mortgage broker's account, there's a substantial risk you never see it again. If you're not looking after your money, nobody is. You might as well go down and put it on the craps line."

Walshaw expects more hard-money lenders to fail in the future, causing more suffering among investors who cannot afford to lose money.

It's easy for hard-money lenders to give into temptation and "rob Peter to pay Paul," Walshaw said. The hard-money lender improperly switches money from performing loans to pay investors on delinquent loans, Walshaw said.

"If (Nevada officials) are going to try to avoid these kinds of things," Walshaw said, "they are going to have to do something more dramatic with (state law)."

Otherwise, elderly and retired people will continue to invest with hard-money lenders, risking money they cannot replace, Walshaw said. "If one more (hard-money failure) happens in the future, we've ruined a lot of peoples' lives," Walshaw said.

Meltdowns

The history of hard-money lending problems in Las Vegas:

December 1997

The state revokes the license of Harley Harmon Mortgage Co. The company has $22 million in outstanding loans.

December 1999

The state asks a state district judge to put Interstate Mortgage Group, a private lender with $140 million in outstanding loans, into a receivership.

In February, Judge Lee Gates appoints accountant George Swarts as receiver for Interstate Mortgage.

April 2001

A federal grand jury indicts Harley Harmon for mail fraud.

July 2003

Scott Walshaw, commissioner of the Nevada Financial Institutions Division for two decades, announces his resignation.

August 2003

A 60-day conservatorship, during which Global Express Capital was under indirect state control, ends. The state accepts the recommendation of conservator Ben Harker to allow owner Connie Farris to resolve problem loans, rather than ask a state district judge to put Global in receivership for liquidation of its assets.

September 2003

Harley Harmon is sentenced to 57 months in federal prison for mail fraud, ordered to pay $2.74 million in restitution to victims and to forfeit $557,000 to the federal government.

December 2003

The Securities and Exchange Commission files a lawsuit accusing Global Express Capital, owner Connie Farris of a $48 million "Ponzi- like investment scheme." Global express is put into receivership under the control of federal court and a receiver starts unwinding loans made by the private lender.

April 2006

USA Capital files for bankruptcy protection with $950 million in mortgage loans outstanding. Tom Allison is appointed chief restructuring officer.