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How The DOJ Is Adapting In The War On Financial Fraud

Law360, New York (November 09, 2012, 1:44 PM ET) -- In the wake of the financial crisis, the United States has continued to pursue major civil enforcement litigation with increasingly aggressive theories of liability against financial institutions. Now, with its sixth lawsuit against a major financial institution in less than two years, the U.S. Attorney's Office for the Southern District of New York (SDNY) has taken a giant step in its efforts to expand financial institutions' liability by targeting a seller of conventional loans to the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, with allegations of financial fraud.

Uniquely, the suit combines the force of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) — a decades-old statute that was little-used, and practically unheard of, two years ago — with the False Claims Act (FCA), as revised through the Fraud Enforcement Recovery Act of 2009 (FERA), to seek billions in alleged damages and penalties based on the banks' indirect receipt of government funds.

This lawsuit, the first-ever civil fraud suit related to the sale of loans to the GSEs, reaches far more broadly than its predecessors, rightfully causing renewed concern about the ever-expanding reach of enforcement actions.

The Latest Lawsuit: Targeting Indirect Recipients

The SDNY's lawsuit against Countrywide and its acquirer, Bank of America, continues the U.S. Department of Justice's pursuit of mortgage originators that it claims cut corners on quality control processes in favor of high-speed, high-volume loan production during the housing boom.[1]

The government alleges that beginning in 2006, the lender initiated an origination model designed to increase the speed at which it could originate and sell new loans to the GSEs. The program allegedly eliminated checkpoints on quality that the SDNY claims led to fraud and other defects in the loans that exceeded the industry average.

Additionally, the complaint alleges that the lender's senior management was repeatedly warned about high levels of fraud and defects in the subject loans, but that these warnings were ignored and the GSEs were not informed. The lender also allegedly attempted to conceal internal quality control reports indicating that the loans had high material defect rates, and misleadingly informed the GSEs that it had tightened its underwriting guidelines.

Despite these claimed defects, the defendants allegedly represented that the loans complied with GSE requirements. As a result, the GSEs pooled the thousands of loans that they purchased from the defendants into mortgage backed securities (MBS), which they sold to investors subject to guarantees on principal and interest payments. As the loans defaulted, the GSEs are alleged to have suffered over $1 billion in losses through the payment of guarantees to investors, which include federally insured financial institutions.

In addition, the complaint alleges that the lender and its acquirer have resisted buying many of the loans back after the loans defaulted.

Enforcement Ramp-Up: From the FCA to FIRREA and Back Again

Although the SDNY's latest lawsuit is one of the most aggressive efforts yet to prosecute a major financial institution, it is not the first. The intense focus on using old statutes in new ways to combat financial fraud began last year when the SDNY sued Deutsche Bank and its subsidiary, MortgageIT, in a $1 billion FCA lawsuit alleging improper underwriting and inadequate quality control processes in the origination of loans insured by the U.S. Department of Housing and Urban Development and the Federal Housing Administration (HUD/FHA) through its Direct Endorsement Lender program.[2] The suit settled this year for $202.3 million, as did several other significant SDNY cases alleging similar FCA violations related to the HUD/FHA program, including a $132.8 million settlement with Flagstar Bank FSB.

Just as financial institutions began to adjust to the idea of large-scale FCA enforcement actions, the government revealed a new enforcement tool, supplementing new FCA claims with FIRREA counts as it continued to bring financial fraud cases. FIRREA claims soon proved to be routine in any FCA complaint alleging financial fraud. Thus, in February, Citigroup agreed to pay $158.3 million to settle allegations that its subsidiary CitiMortgage defrauded HUD/FHA. While the theories of misconduct were similar to those before it, it was one of the first cases to settle FIRREA claims based on such allegations. That same month, the $25 billion national mortgage servicer settlement also resolved alleged FIRREA violations.

The SDNY's October lawsuit against Wells Fargo alleging similar theories of misconduct, and the still pending action in Allied Home, both contain FIRREA counts. The SDNY's latest suit represents another use by the government of FIRREA to pursue supposed damages amounting to the "substantial profits gained from [the] fraudulent scheme, [the lender] having originated more than three billion dollars in loans ..." FIRREA authorizes penalties ranging from $1 million to $5 million for continuing violations, with enhancements equal to amounts gained as a result of the alleged misconduct, and these penalties also are often used to supplement FCA penalties.

The evolution of cases from FCA to FIRREA is not surprising given FIRREA's prosecutorial reach. FIRREA allows the government to file more claims, more quickly, and with a lower burden of proof. Specifically, FIRREA authorizes suit whenever a person or entity violates any of 14 criminal statutes, and where the conduct affects a federally insured financial institution. For example, in the SDNY's most recent suit, the government relies on claims of mail and wire fraud, 18 U.S.C. §§ 1341 and 1343, as the basis for its FIRREA claims.[3]

Unlike the FCA, a cause of action under FIRREA may arise even before a claim for payment is made, and FIRREA has a longer statute of limitations than the FCA. A misrepresentation affecting any financial institution is enough under FIRREA, whereas under FCA, there must be a nexus between the alleged false claim and government funds. Additionally, because FIRREA allows the government to recover civil penalties for violations of predicate criminal provisions, the government need only prove its FIRREA case — meaning a violation of enumerated criminal statutes — by a preponderance of the evidence, as opposed to the more stringent criminal standard of beyond a reasonable doubt.[4]

The SDNY's latest action brings the evolution of the FCA's use to combat financial fraud full circle. Prior to this case, FCA lending suits have focused on loans made by government program participants, such as those in HUD/FHA's Direct Endorsement program. In such cases, the program participants allegedly made false certifications to a government agency in connection with the loans, and the government paid claims when the loans defaulted.

Here, by contrast, the lender and financial institution allegedly made misrepresentations to the GSEs regarding conventional loans, and the GSEs used "Treasury funds ... to purchase Defendants' loans and to reimburse the losses incurred by the GSEs as a result of paying out guarantees ... [after the] loans ... defaulted." This is the first time that a major financial institution has been targeted for its indirect receipt of federal funds, and it has many wondering how we got here.

In May 2009, President Obama signed FERA into law to hold indirect recipients of federal funds accountable for false claims under the FCA. FERA's enactment was a response to the Supreme Court's 2008 decision in Allison Engine Co. v. United States ex rel. Sanders, 553 U.S. 662 (2008), which held that the FCA did not cover fraud committed by subcontractors who received federal funds through prime contractors, but not directly from the government. FERA legislatively overruled Allison Engine to allow government funds to be traced through direct recipients (here, the GSEs) to those that received the funds indirectly through fraud (here, allegedly, the defendants).[5]

The use of FERA in this unprecedented lawsuit has very significant implications for any entity that does, or has done, business with the GSEs by potentially creating liability in the amount of treble damages under the FCA, and profits gained under FIRREA, plus penalties, for any loan sale to a GSE.

Notably, the SDNY also has indicated that it may amend its complaint to add claims against individuals, presumably the senior management referenced in the complaint that allegedly ignored and/or concealed the supposed fraud that is the subject of the suit. This would not be its first suit against an individual — the Allied Home suit also includes claims against senior executives — but it could be a sign of efforts to hold those directing the supposed bad acts accountable for that misconduct on a much larger scale than has been seen to date.

Adapting to the New Enforcement Environment

The government is becoming increasingly aggressive, and creative, in its efforts to recover for alleged financial fraud. This trend is not likely to change soon. To the contrary, the Department of Justice has requested a $55 million increase for the fiscal year 2013 budget "to investigate and prosecute financial and mortgage crimes that have sorely hurt the American people and damaged their trust in the financial markets they expect to engage in fair play."

More than ever, this recent enforcement activity highlights the need to focus on risk assessment, management and compliance. There are obvious pressure points that every loan originator and servicer should be concerned about; among them, those engaged in lending programs associated with HUD/FHA, the Veterans Administration, HAMP and, now, those that sell loans to or service loans for the GSEs.

Indeed, any mortgage industry participant should be especially focused on strict program compliance and quality control initiatives. Furthermore, the FCA's powerful punch, coupled with FIRREA's expansive reach, demonstrates that every institution, even those not directly involved in government programs, must begin to think broadly about how they approach their interactions in all areas of business.

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[1] See U.S. ex rel. O'Donnell v. Bank of America Corp et al., No. 12-01422 (S.D.N.Y. filed Oct. 24, 2012).

[2] For a more detailed discussion of the case and the FCA, see Andrew L. Sandler, David S. Krakoff and Michelle L. Rogers, FCA, FHA Lending, and US v. Deutsche Bank, Law360 (May 11, 2011).

[3] In the CitiMortgage, Allied and Buy-A-Home, the Government alleged violations of 18 U.S.C. §§ 1006 and 1014 based on false statements made to HUD. To understand FIRREA's reach, § 1006 prohibits anyone who is "connected in any capacity" with certain enumerated institutions, including HUD, from making false statements with the intent to defraud, and § 1014 prohibits anyone from knowingly making false statements for the purpose of influencing those enumerated institutions.

[4] Other recent SDNY matters demonstrate some of FIRREA's advantages over the FCA. See United States v. Allied, No. 11-cv-5443 (SDNY) (filed November 2011) (invoking FIRREA to seek penalties for loans for which no claim has been made, which would not be possible under the FCA); United States v. Buy-A-Home, No. 10-cv-9280 (SDNY) (filed December 2010) (asserting FIRREA violations for properties on which claims had not yet been submitted, and basing violations on alleged misrepresentations to HUD and to the financial institutions that purchased the loans); see also United States v. Luce, No. 11-cv-5158 (N.D. Ill.) (filed July 2011) (alleging FCA and FIRREA violations for improper origination and filing fraudulent annual certifications of compliance).

[5] Indeed, FERA was made to apply retroactively to June 7, 2008.