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FCA, FHA Lending, And US V. Deutsche Bank

Law360, New York (May 11, 2011) -- The United States recently slapped Deutsche Bank and its subsidiary, MortgageIT, with a $1 billion lawsuit that has rocked the financial services industry. Although the suit cites some scandalous moments — including allegations that MortgageIT "stuffed [audit] letters, unopened and unread, in a closet" — the case's core facts shine a bright light on a newly emerging challenge for financial institutions.

Primarily, the case is built on repeated mistakes in loan underwriting which, individually, seem to be mere missteps but, together, can suggest to an enforcement official a pattern of egregious conduct. Deutsche Bank makes it clear that even small problems come with great risk and, in this case, potentially enormous penalties.

The allegations in the case against Deutsche Bank brought by the United States Attorney for the Southern District of New York are not new; look no further than the U.S. Department of Housing ("HUD") Mortgagee Review Board's decisions (published in the Federal Register) to see that HUD has been combating issues identical to those challenged in Deutsche Bank for years. The twist here, however, is that the U.S. has used the False Claims Act and formal litigation to resolve its grievances — or at least to make the most of them.

Because the case was brought under the FCA, the government is seeking treble damages and penalties, along with indemnification on the loans. But, leaving no stone unturned, common law claims for negligence, gross negligence, indemnification and breach of fiduciary duty are also appended to the suit, which are likewise unusual in these types of cases.

The government's suit against Deutsche Bank identifies a handful of underwriting mistakes to allege a pattern of abuse in MortgageIT and Deutsche Bank's endorsement of approximately 39,000 loans submitted over a 10-year period under the Federal Housing Administration's ("FHA") Direct Endorsement Lender program.

It alleges that the entities made repeated false certifications to HUD, incorrectly claiming that the loans complied with FHA requirements in order to obtain insurance. In addition to claims against each and every loan that contains some departure, however minor, from FHA guidelines, the U.S. also targets MortgageIT's annual compliance certifications, which it filed to maintain its approval as a Direct Endorsement Lender.

The suit claims that these false certifications allowed MortgageIT and Deutsche Bank to wrongfully obtain FHA insurance for the ineligible mortgages, allowing them to make huge profits by reselling the problem loans. Ultimately, HUD suffered substantial losses as a result of the insurance claims made on the properties. As of the filing of the complaint, 12,500 of MortgageIT's mortgages had defaulted.

At first glance, many saw Deutsche Bank as a warning shot to the industry. However, it was soon apparent that other suits are likely to follow. Indeed, by the tone of the conversation thus far, many predict that suits to come will have criminal undertones. But to fully understand the reach of Deutsche Bank — and, perhaps more importantly, to learn from it — it must be considered in the context of the cases that came before it.

The False Claims Act and FHA Lending: Old Dog, New Tricks

The FCA has long been considered the government's heavy artillery in combating fraud. It was most commonly reserved for prosecuting cases in the areas of defense contracting and health care fraud. Where it was invoked in the mortgage lending arena, the government used it in cases involving criminal conduct, such as mortgage fraud within the involved institution, or to leverage potential penalties in the context of negotiating a settlement. Those cases were most often privately resolved and not the subject of actual lawsuits.

The U.S. Department of Justice and HUD's joint 2008 settlement with RBC Mortgage — one of only a few public settlements of its kind — provides a helpful point of contrast. That case settled FCA claims for roughly $11 million, without formal litigation. There, the government claimed that RBC, using its direct endorsement authority, falsely certified that 219 loans met FHA's requirements. After each of the loans ended in foreclosures, RBC submitted mortgage insurance claims to HUD , which FHA paid. Resolution of that case followed a parallel criminal investigation that resulted in federal charges against three RBC Mortgage loan officers and 22 other defendants, all of whom were convicted.

Comparing RBC to Deutsche Bank demonstrates HUD and the DOJ's increasing intolerance of technical violations. The violations cited in Deutsche Bank are not materially different than those at issue in RBC (criminal allegations aside), including failure to enclose a gift letter in a file, failure to collect expense information to develop credit history, failure to verify employment, failure to verify the source of earnest money deposits, and failure to examine file irregularities suggestive of fraud. By contrast, in RBC, HUD and DOJ allowed for reduced penalties and assessments, even though there was admitted mortgage fraud by former loan officers and others.

Similarly, in recent years, HUD and the DOJ have become increasingly aggressive in these sorts of cases, seeking full multiplier penalties on pre-recovery amounts (i.e., amounts recovered by FHA through foreclosure sales that would otherwise reduce the claim amount), and leaving less room to negotiate on asserted violations. This aggressiveness is further exemplified by the resurgence of claims brought under the Program Fraud Civil Remedies Act ("PFCRA"), often considered an administrative mini-FCA, which allows for double damages.

Enacted to allow federal agencies to pursue "small" administrative claims, PFCRA was largely unused — and unheard of — five years ago. Last year, HUD's Office of Inspector General ("OIG") initiated "Operation Watchdog" to review the underwriting of 15 FHA direct endorsement lenders with high default and claim rates. It recommended PFCRA penalties in each of those cases. Moreover, because PFCRA penalties are often accompanied by FCA penalties, it is possible (indeed likely) that parallel DOJ proceedings are ongoing in each of these cases.

Moreover, unlike traditional FCA cases, which often originate with a whistleblower (called a relator) as a qui tam action, many of the mortgage lending FCA cases like Deutsche Bank begin at HUD. Quite commonly, an institution is targeted during an audit, at which point HUD's counsel becomes involved. The DOJ is often not far behind.

The RBC case began with an HUD audit report, and Deutsche Bank is no exception. The complaint alleges that, as early as 2003, an audit by HUD of MortgageIT revealed that the company had not maintained a satisfactory Quality Control Plan and was not properly reviewing loans in early default.

Predicting and Preparing for What's Next

Deutsche Bank indicates the need for increased focus on risk assessment and compliance. Certainly every FHA program participant has begun to consider their own underwriting and quality control measures in the wake of last week's events. But while the various risks in the direct endorsement program continue to be the focus of conversation, the greater significance of Deutsche Bank has been widely overlooked.

It is clear that HUD is intently focused on FHA's Direct Endorsement Program at the moment, as evidenced by Operation Watchdog and the other trends identified above. Obviously this focus is derived in large part from the market and increasing foreclosure risks, which have resulted in huge losses to FHA.

However, other FHA programs pose equally significant risks. For example, HUD is also actively investigating the timely and accurate remittance of mortgage insurance premiums, and the timely notification of FHA-insurance termination. Like the direct endorsement program, both of these areas present PFCRA and FCA risk.

FCA risk for financial services companies, however, is not limited to the FHA program, nor is it limited to lenders. Any institution that certifies compliance in any capacity for the federal government is also at risk. For example, Troubled Asset Relief Program ("TARP") and Home Affordable Modification Program ("HAMP") participants are sure to be next. Indeed, there has been some discussion within the industry that qui tam law suits relating to both of these programs are already under DOJ consideration.

Additionally, where disgruntled employees exist, the plaintiff's bar is not far behind, and the risk of a qui tam action is quite real. There are plaintiffs firms that specialize in finding relators, and filing and prosecuting qui tam claims. Further, in the case of qui tam actions, no news is not good news. Those suits are filed under seal and can take many months, if not longer, before an institution learns of the suit.

And, because the FCA allows the government to intervene and prosecute a claim on the relator's behalf (who is rewarded handsomely by sharing in the government's recovery, if successful), first notice of the case may come from the DOJ itself. The significance of this threat cannot be overlooked. Again, Deutsche Bank is a prime example of the risk — though not a qui tam case itself, the detail and depth of the facts present in the complaint suggest that the U.S. Attorney's Office is working with a former employee to obtain information.

Finally, even FCA cases that do not begin with criminal charges often end with them. It is not uncommon for the discovery process to reveal conduct that, from the government's perspective, warrants criminal prosecution. While in the past such prosecution in the mortgage lending arena has been reserved for lower level bad actors, such as loan officers or brokers, many believe higher level executives may soon be targeted to send a message that recklessness will not be tolerated.

In this environment, risk management must remain a priority for every institution. Understanding the significance of your interactions with the government is key. If your default rate is high, if you have a less than favorable audit report, or if you have concerns about your program compliance, now is the time to take score. Similarly, if you purchased an FHA lender, you can face tremendous liability for that lender's acts long ago.

The takeaway from Deutsche Bank is that the government is now willing to bring treble damage FCA actions for garden variety program violations, and that risk is too great to be overlooked.

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Mr. Sandler and Ms. Rogers represented RBC in negotiating the settlement agreement with DOJ and HUD. They have also been involved in several nonpublic matters before DOJ, HUD and FHA involving FCA, PFCRA and administrative claims based on alleged violations of direct endorsement guidelines, and requirements relating to mortgage insurance premiums and notices of termination.