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Another Court Affirms DOJ Financial Fraud Strategy

Law360, New York (October 10, 2013, 10:49 AM ET) -- On Sept. 24, 2013, Judge Jesse Furman in the Southern District of New York released his widely anticipated decision allowing the U.S. Department of Justice's False Claims Act and Financial Institutions Reform, Recovery and Enforcement Act case against a major financial institution to proceed.[1] The opinion is significant, not just because it is a victory for the government — the same week the DOJ began trial in another major case[2] — but because, for the first time, it deals with multiple developing issues in one opinion.

The DOJ's suit alleges that Wells Fargo Bank — the largest participant in the government insurance program at issue — submitted for insurance risky loans that did not comply with U.S. Department of Housing and Urban Development ("HUD") Federal Housing Administration's ("FHA") origination and quality control requirements, resulting in hundreds of millions of dollars in losses to the FHA fund.

The case has been the focus of attention, not just because of its size, but also because of two of the legal theories it tests: whether an institution can "affect" itself to support a FIRREA claim, and whether the statute of limitations for an FCA matter is tolled by a little-known war-time tolling statute.[3] The court sided with the government on both points, along with two others, buttressing the government's theories concerning the types of civil fraud claims it may bring against financial institutions, and the period during which those claims remain timely.

The Statutes

In the last two years alone, the DOJ has recovered hundreds of millions of dollars in FCA and FIRREA settlements for claims related to the origination and servicing of FHA loans, including loans originated under the FHA's Direct Endorsement Lender Program. Following that trend, the DOJ's suit here joins FCA and FIRREA counts to seek hundreds of millions of dollars in alleged damages and penalties based the direct endorsement of FHA loans and Wells Fargo Bank's alleged failure to maintain adequate quality control processes.

The FCA imposes civil liability for knowingly presenting a false claim to the government or making a false statement material to such a false claim, and allows for penalties of $5,500 to $11,000 per violation and, most significantly, allows the government to recover treble damages.[4] Generally speaking, the FCA's statute of limitations requires the government to file its claims within either six years of the underlying violation or three years from the date the DOJ knew or should have known of facts material to the claim, but no later than 10 years from the date on which the violation was committed.

As has become typical of similar large-scale FCA enforcement actions, the government also supplemented its FCA claims with FIRREA counts, expanding the breadth of potential liability. FIRREA authorizes the United States to bring a civil lawsuit for violations of any of 14 criminal statutes related to financial fraud. The DOJ has only recently revived the 1989 law, but has done so in a big way, bringing multimillion and billion dollar lawsuits against large financial institutions for claims of alleged financial fraud.

While FIRREA confers broad prosecutorial and investigative authority, the application of five of its 14 criminal predicates — mail fraud, wire fraud, false statements, false claims and concealment of assets — is limited to circumstances where those frauds "affect" a federally insured financial institution. FIRREA does not define this limitation. However, in April, another SDNY judge ruled for the first time that the government may prosecute a financial institution for fraud that allegedly affects the same institution, with a second reaching a similar decision in August, setting the stage for the latest decision.[5]

The Ruling

The DOJ's suit[6] alleges that, between approximately 2001 and 2005, Wells Fargo Bank engaged in reckless origination and underwriting practices, certifying that thousands of loans were eligible for FHA insurance when, in fact, they did not comply with FHA guidelines. The government further claims that the bank falsely certified compliance with HUD requirements, when in fact it did not have requisite quality control processes in place — including allegedly failing to address identified issues and failing to self-report loans with material deficiencies in any significant way until approximately 2010 when it first learned of the government's inquiry.

The court largely denied each of the bank's four challenges to the government's case, including most notably, two less developed, but quickly evolving applications of both FIRREA and the FCA, finding that the FCA claims were timely, and that the government's claim that the bank "affected" itself to support the FIRREA count was sufficient.[7]

First, while the court found that many of the government's common law claims were time barred, dismissing tort and quasi-contract claims arising before June 2009 and 2006 respectively, it held that the Wartime Suspension of Limitations Act ("WSLA") tolled the statute of limitations for claims still alive at its 2008 amendment — meaning that all of the government's FCA claims were timely.

Enacted in 1942, the WSLA suspends the statute of limitations for claims of fraud against the United States when the country is at war or Congress has authorized the use of military force. In 2008, the statute was amended to also cover periods when Congress has enacted a specific authorization for the use of the Armed Forces and "until 5 years after the termination of hostilities as proclaimed by a Presidential proclamation, with notice to Congress, or by a concurrent resolution of Congress."

The court recounted that Congress authorized the use of military force "against those responsible for" for the Sept. 11, 2001, terrorist attacks on Sept. 18, 2001, and again on Oct. 16, 2002. Likewise, it explained that there has been neither a presidential proclamation, nor a congressional resolution suspending hostilities. Thus, relying in part on a recent holding by the Fourth Circuit[8], the court rejected each of the bank's challenges to the statute's application — that (1) the 2008 amendment may not be applied retroactively; (2) the government's claims of reckless disregard do not rise to the level of fraud within the meaning of the WSLA; (3) the WSLA applies only to criminal, not civil, offenses; and (4) the WSLA applies only to claims related to wartime contracting — and held that there was no basis to dismiss any of the FCA claims as untimely.

Second, citing two recent decisions from the SDNY, the court held that FIRREA allows the government to pursue claims against an institution for engaging in alleged fraud that "affects" itself, finding the government had stated a claim. The court explained that the government need allege only facts that demonstrate an increased risk of loss to the bank as a result of the conduct at issue, and found that the government had done so in at least two ways through its allegations of increased business and legal risk.

First, the government claimed that the bank had originated loans that materially violated HUD regulations, resulting in higher risks of default, and in turn requiring the bank to indemnify HUD for "hundreds of loans" it would not otherwise have had to indemnify, with the possibility of additional future indemnifications. Second, the government claimed that the bank's misconduct exposed the bank to additional legal liability, including potential treble damages and civil penalties under the FCA and FIRREA in the suit.

Going Forward

With this decision's WSLA holding, the government now formally has an FCA opinion against a financial institution allowing it to toll claims without a formal declaration of war to begin the tolling period, but requiring a formal termination to end it — an unlikely result.

Practically, it could mean a tolling that extends back to at least 2001 per this opinion, with at least, at the moment, no formal end date in sight. Likewise, the court's agreement with others before it that an institution can "affect" itself for FIRREA purposes by creating increased litigation risk means, effectively, that any alleged fraud has the potential to trigger a FIRREA claim.

Meanwhile, other courts across the country are continuing to hand down opinions in similar cases, making it increasingly likely that other offices may continue to catch on to the efforts the DOJ continues to spearhead. In short, as the government continues to tally wins in support of its aggressive theories of liabilities, financial institutions can expect it to continue to advance its efforts to reach even wider.

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[1] United States v. Wells Fargo Bank, N.A., No. 12-7527 (S.D.N.Y.) (Compl. Sept. 24, 2013, Am. Compl. Dec. 14, 2012).

[2] United States v. Countrywide Fin. Corp., No. 12-1422 (S.D.N.Y.) (Compl. Oct. 24, 2012, 2d Am. Compl. Sept. 6, 2013).

[3] The Bank's motion also challenged the government's complaint on two other grounds: whether the government released the claims at issue in a separate settlement agreement the year prior, and whether the government's claims were adequately pled, discussed supra note 8. Additionally, unlike similar cases before it, DOJ also included a "reverse false claims" count, claiming that the Bank made false statements—specifically, that the Bank did not self-report deficient loans—to avoid indemnifying HUD. A ruling favorable to the government on this issue would have significantly expanded the government's reach, making this a closely watched issue. But after oral argument on the Bank's motion to dismiss, and before the court could rule on the issue, the government voluntarily dismissed its reverse false claims count without explanation, thus leaving open the question of whether the theory is viable.

[4] See Schilling, Rogers and Morrison, FCA Allows Treble Damages – 'But Treble What?,' Law360 (March 26, 2013).

[5] United States v. Bank of New York Mellon, No. 11-06969, 2013 WL 1749418 (S.D.N.Y. April 24, 2013); Countrywide Fin. Corp., No. 12-1422, 2013 WL 4437232 (August 16, 2013). See also Previn, Rogers, A Financial Institution's Fraud on Itself Triggers FIRREA, Law360 (Apr. 26, 2014).

[6] The original complaint was amended on December 14, 2012.

[7] The court also denied the Bank's other two challenges to the complaint. Relying on an order issued earlier this year by the U.S. District Court for the District of Columbia, the court rejected the bank's argument that the agreement it executed as part of the National Mortgage Servicing Settlement last year specifically released liability arising under the FCA and FIRREA for the government's claims. It also held that the complaint satisfied the heightened pleading requirements for claims of fraud under Federal Rule of Civil Procedure 9(b), and rejected several other challenges to the government's complaint raised under Rule 12(b)(6).

[8] See U.S. ex rel. Carter v. Halliburton Co., 710 F.3d 171 (4th Cir. 2013) (pet. for cert. pending); Schilling, Rogers and Morrison, Little-Known Statute May Breathe New Life Into False Claims Act Cases Against Financial Institutions, Thomson Reuters Accelus (Apr. 18, 2013).
