Feds Target FHA Mortgage Lenders in False Claims Act Cases

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Recent cases have shown a trend of financial institutions, including FHA mortgage lenders, being targeted in claims brought by the government under the federal False Claims Act (FCA). The FHA, the world's largest mortgage insurer, insures mortgages for borrowers who may not meet conventional underwriting standards. By insuring these loans, the FHA encourages lenders to lend to these borrowers by protecting the lenders from default. FHA's Direct Endorsement Lender program grants qualified private lenders the authority to endorse mortgages qualified for FHA insurance. In essence, this requires the private lenders to review the mortgage applications for compliance with the rules of the Department of Housing and Urban Development (HUD). The Direct Endorsement Lender program requires private lenders to, among other things, conduct certain due diligence for each loan and implement a quality control plan to ensure compliance with HUD rules. The lender must also submit with each loan a certification that the loan complies with applicable law and HUD rules.

One of the first high-profile uses of the FCA as an enforcement tool following the sub-prime crisis was *United States v. Deutsche Bank*[1]. Filed in 2011 in federal court in New York, the *Deutsche Bank* complaint alleges blatant noncompliance (for example, stuffing unread quality control audits in a closet), coupled with a pattern of repeated mistakes in loan underwriting. The FCA claims in *Deutsche Bank* focused on the defendants' alleged failure to comply with quality control requirements, particularly a review of early payment defaults, falsely certifying that individual loans complied with HUD rules and were eligible for FHA insurance, and submitting false annual compliance certifications[2] The complaint goes on to allege that these misdeeds allowed the defendants to wrongfully obtain FHA insurance for ineligible loans, loans that later defaulted and resulted in FHA paying over $368 million in insurance claims. The government sought treble damages and civil penalties under the FCA for current claims totaling well over $1 billion, as well as damages for potential future claims.

In May 2012, the *Deutsche Bank* defendants admitted liability, and the matter was settled for $202.3 million. In the settlement, Deutsche Bank acknowledged that MortgageIT, one of its subsidiaries, failed to maintain the required quality control program, failed to conduct reviews of early payment defaults, and falsely certified that certain loans were eligible for FHA insurance when they were not. Notably, this lump sum payment did not absolve any potential criminal liability, because the government specifically reserved all such claims.

Soon after *Deutsche Bank* settled, the government brought a similar suit against Wells Fargo. In *United States v. Wells Fargo Bank, N.A.*, the government brought claims against Wells Fargo under the FCA, FIRREA[3], and common law for the 'regular practice of reckless origination and underwriting of its retail FHA loans.'[4] *Wells Fargo* is still in litigation.

Originally enacted during the Civil War, the FCA was the government's response to procurement abuses by contractors working with the Union Army. The FCA allows for suits both by the United States government and whistleblowers (referred to as *qui tam* actions).[5] Congress enacted the FCA to impose liability on any person who (1) knowingly presents to the government a false or fraudulent claim for payment or approval; (2) knowingly makes a false record in order to have a false or fraudulent claim paid or approved by the government; or (3) knowingly makes, uses, or causes to be made or used, a false record or statement material to an obligation to pay or transmit money or property to the government.[6] Potential liability under the FCA can be massive – civil penalties of $5,000 to $10,000 per violation (i.e., per claim) and treble damages for any loss to the government.[7]

Defense contractors remained the main focus of the FCA through the 1980s, when highly-publicized frauds involving the defense industry brought about amendments to the FCA. These amendments increased both whistleblower protection and the amount of damages recoverable. The 1990s brought a shift in focus to include not only defense contractors but also health care fraud. More recently, the economic downturn brought the financial industry under FCA scrutiny. The Fraud Enforcement and Recovery Act of 2009 (FERA) and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 changed the FCA to directly address evolving issues in the financial industry. FERA focused on frauds by financial institutions and other recipients of TARP funds and economic stimulus funds, while Dodd-Frank specifically expanded recovery for persons with original knowledge of financial fraud.

While *Deutsche Bank* and *Wells Fargo* make it clear that false <u>statements</u> to induce the government to insure loans can result in FCA liability, there is no false <u>claim</u> actionable under the FCA unless demand is made on the government for payment.[8] Therefore, in the context of FHA loans, liability under the FCA does not come into play until a claim is made to the FHA for payment on a defaulted loan.[9] However, the FCA does not cover every false statement or false claim made. Any false statement or false claim actionable under the FCA is subject to the judicially-imposed requirement of materiality[10] In the context of civil FCA claims, the Fourth Circuit has articulated materiality to mean "whether the false statement has a natural tendency to influence agency action or is capable of influencing agency action."[11] If the falsity is not material, an FCA claim is subject to dismissal.[12]

One final wrinkle to consider in FCA actions is the applicable statute of limitations. While the FCA imposes a three-year, six-year, or ten-year statute of limitations for bringing actions[13], a recent Fourth Circuit decision threatens to make it significantly more difficult for financial institutions to utilize the statute of limitations to bar untimely claims. In *United States ex rel. Carter v. Halliburton Co., et al.*, the Fourth Circuit overturned a lower court that dismissed an FCA claim as untimely.[14] In citing a relatively obscure law originally enacted shortly after World War II, the Fourth Circuit held that the FCA's statute of limitations was suspended by the Wartime Suspension of Limitations Act (WSLA).[15] As amended in 2008, when the United States is at war or Congress has authorized the use of the Armed Forces, the WSLA allows for a suspension of five years after the termination of hostilities of the running of any statute of limitations applicable to any offense involving fraud or attempted fraud against the United States.[16] In *Halliburton*, the Fourth Circuit overturned the lower court's dismissal of the FCA claims and found that, not only does the WSLA apply to civil actions such as claims under the FCA, but also to civil *qui tam* actions.[17] With this precedent, and with the fact that Congress has authorized the use of the Armed Forces for most of the past 12 years, financial institutions must be prepared to address potential FCA claims dating back to the height of the real estate boom that started over a decade ago.

While Deutsche Bank and Wells Fargo were the first targets, recently the federal government has used the FCA to go after smaller financial institutions as well. The pattern seems to be that, with the large institutions having been subject to liability, the federal government will now target the small industry members. Also, some of these suits are being brought without any allegation that the underlying loans did not qualify for FHA insurance, but instead are based on allegations of technical and procedural inconsistencies. Consequently, even for loans that appear to have otherwise qualified for FHA insurance, the government is looking for reasons to bring an FCA claim.

Deutsche Bank and *Wells Fargo* are eye-openers for the financial services industry and demonstrate the increasing trend of FCA litigation against financial institutions. A focus on risk assessment and compliance in all arenas, not just FHA loans, is a must. FHA investigations and audits will naturally progress to investigations and audits of participants in TARP and other programs that require certification of compliance to the federal government as part of the payment of claims. Coupled with the financial incentives for disgruntled employees to bring whistleblower actions and potential criminal liability, financial institutions should make risk assessment and compliance a priority.

[1]*United States v. Deutsche Bank AG, et al.* 1:11-cv-2976 (S.D.N.Y. 2011). "Deutsche Bank" refers collectively to three defendants: Deutsche Bank, AG, DB Structured Products, Inc., and Deutsche Bank Securities, Inc. MortgageIT, Inc., the fourth defendant, is a wholly owned subsidiary of DB Structured Products, Inc., which is itself a wholly owned subsidiary of Deutsche Bank AG.

[2] The complaint also alleges common law theories of breach of fiduciary duty, negligence, gross negligence, and indemnification.

[3] Financial Institutions Reform, Recovery, and Enforcement Act of 1989. This Act authorizes civil enforcement for certain enumerated violations. Notably, the penalties under FIRREA are severe: up to

$1 million per violation or, for a continuing violation, up to $1 million per day or $5 million, whichever is less. 12 U.S.C. § 1833a(b)(1)-(2).

[4] *United States v. Wells Fargo Bank, N.A.*, 1:12-cv-07527 (S.D.N.Y. 2012).

[5] To incentivize private actions, if a whistleblower brings a successful *qui tam* action, he is entitled to a percentage of any recovery the government receives. 31 U.S.C. § 3730(d).

[6] 31 U.S.C. § 3729(a)(1)(A)-(B), (G). 31 U.S.C. § 3729(a)(1)(C)-(F) also enumerate potential liability under the FCA, but are less applicable to the subject matter of this article.

[7] 31 U.S.C. § 3729(a)(1). The range of potential civil penalties is currently higher than $5,000 to $10,000, because the statute requires that range of penalties to be scaled to inflation.

[8] *See, e.g., United States v. Hill*, 676 F. Supp. 1158, 1174 (N.D. Fl. 1987).

[9] *United States ex rel. Harrison v. Westinghouse Savannah River Co.*, 176 F.3d 776, 785 (4th Cir. 1999).

[10] *Id.*

[11] *United States ex rel. Berge v. Bd. of Trustees of Univ. of Ala.*, 104 F.3d 1453, 1459 (4th Cir. 1997).

[12] *See, e.g., U.S. v. Westinghouse*, 176 F.3d at 791-92.

[13] 31 U.S.C. § 3731(b).

[14] *United States ex rel. Carter v. Halliburton Co., et al.*, No. 12-1011 (4th Cir. March 18, 2013).

[15] 18 U.S.C. § 3287.

[16] *Id*.

[17] *U.S. v. Halliburton*, No. 12-1011 (4th Cir. March 18, 2013).

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