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Second Circuit Strikes Down Imposition of $1.27 Billion FIRREA Penalty, Holds That Government Failed to Prove Countrywide Acted with Fraudulent Intent

On May 23, 2016, the United States Court of Appeals for the Second Circuit reversed a jury's finding of liability and the district court's imposition of a $1.27 billion civil penalty on Countrywide and related defendants (collectively, "Countrywide") under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") for mail or wire fraud affecting a federally insured financial institution.[1] The Second Circuit held that the trial evidence was insufficient to establish fraudulent intent. But in ruling on that basis, the court avoided the controversial legal question of whether FIRREA, which authorizes civil penalties for fraud "affecting" a federally insured financial institution, applies to fraud *by* such an institution.

The Second Circuit's decision is significant because it is the first time that a federal court of appeals has considered a challenge to the government's recent attempts to expand the scope of FIRREA—with its long statute of limitations, lower burden of proof, and hefty civil penalties—to prosecute financial institutions for subprime-related misconduct.[2] While the court declined to address the validity of the government's novel theory that FIRREA applies to "self-affecting" conduct, the decision sharply rebukes the government's overreach in this case that would "convert every intentional or willful breach of contract in which the mails or wires were used into criminal fraud." In last year's decision in *United States* v. *Newman* the Second Circuit similarly admonished the government's "insider trading prosecutions . . . targeted at remote tippees many levels removed from corporate insiders," rejecting the government's theory as a "doctrinal novelty."[3] Thus, the Second Circuit has sent another stern message to the government about overreaching in its zeal to prosecute and punish defendants—offering defendants some hope, if not leverage, in their dealings with the government.

Background

After the subprime mortgage market collapsed in 2007, Countrywide reorganized its subprime lending division to focus on originating prime loans with the goal of selling them to government-sponsored enterprises Fannie Mae and Freddie Mac (the "GSEs"). In connection with the reorganization, the division designed and implemented a new loan origination program called the "High Speed Swim Lane"—commonly referred to by the unfortunate acronym "HSSL." Under that program, Countrywide entered into contracts to sell loans to the GSEs in which it represented that the loans would be an "Acceptable Investment" and "have the characteristics of an investment quality mortgage."

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Alleging that Countrywide knowingly violated these representations by foisting subprime loans on the GSEs through the HSSL program, a former employee commenced a *qui tam* suit under the False Claims Act. The government intervened and added claims under FIRREA, which imposes civil liability—in the form of civil monetary penalties—for certain criminal offenses (including violations of the federal mail and wire fraud statutes) that affect a federally insured financial institution.[4] The case proceeded to trial solely on the FIRREA claims. The government attempted to prove the predicate offense of fraud by showing that Countrywide executives knew that loans sold to the GSEs were of lower quality than its contracts guaranteed. The jury returned a verdict finding the defendants liable under FIRREA, and the federal district judge imposed civil penalties of $1.27 billion on Countrywide and $1 million on a company executive.

The Second Circuit's Decision

Countrywide appealed the district court's judgment, arguing that: (i) FIRREA does not permit claims against federally insured financial institutions on the theory that they engaged in fraud "affecting" themselves; (ii) the claimed predicate offenses of mail and wire fraud may not be based exclusively on a breach of contract; (iii) the district court erred in certain evidentiary rulings; and (iv) the district court erred in its calculation of the civil penalties.

The Second Circuit declined to rule on the legal questions of whether FIRREA applies to "self-affecting" conduct—despite acknowledging that this was the focus of the parties' and *amici*'s briefing—or the method for calculating the civil penalties. Instead, it focused on the proof necessary for a breach of contract to support a claim under the federal fraud statutes and reversed the district court's judgment on the basis that the evidence offered by the government at trial was insufficient to meet that burden and establish a violation of the federal fraud statutes.

In doing so, the Second Circuit explained that the federal fraud statutes incorporate and should be interpreted in light of common-law fraud principles unless they are inconsistent or incompatible and that common-law fraud claims in the context of contracts turn on "*when* the representations were made and the intent of the promisor *at that time*." The court observed that the federal fraud statutes must incorporate the common law requirement of contemporaneous fraudulent intent to avoid transforming "every intentional or willful breach of contract in which the mails or wires were used into criminal fraud." Accordingly, it held that the government was required to prove that Countrywide either made the contractual guarantees regarding future loan quality with contemporaneous intent not to perform, or later made other misrepresentations not contained in the contracts as to which fraudulent intent could be found.

The Second Circuit held that the trial evidence was insufficient as a matter of law to prove that Countrywide made a false representation with contemporaneous fraudulent intent. The court observed that the only representations alleged to be false were the contractual guarantees of future quality and the

government did not prove—or even attempt to prove—that Countrywide did not intend to perform its promise at the time it executed the contracts. Instead, the government argued that Countrywide made the representations of loan quality continuously throughout its performance of the contract each time there was a sale. The court rejected that argument because the contract described the representations in the present tense (*e.g.*, "makes" or "warrants and represents") rather than the future tense (*e.g.*, "will make" or "will warrant and represent"). Because the government failed to offer any proof that the contractual representations at issue were made with contemporaneous intent not to perform, the court concluded that it failed to prove the predicate violation of the mail and wire fraud statutes necessary to sustain an award of civil penalties under FIRREA and remanded the case with instructions to enter judgment for defendants.

Although the Second Circuit avoided the legal question of whether FIRREA applies to "self-affecting" conduct, three Southern District of New York decisions have endorsed the government's theory that banks are subject to FIRREA claims for civil penalties when an alleged fraud "affect[ed]" the bank itself by causing exposure to legal liability and related expenditures, or increased risk of loss.[5] Last year, the Second Circuit did have occasion to interpret the requirement that an offense "affect" a financial institution in an appeal from a criminal conviction by three former traders based on the application of a lengthier ten-year statute of limitations where their wire fraud and conspiracy to commit wire fraud offenses "affect[ed]" three banks that were co-conspirators.[6] The court affirmed their convictions, stating that the "affect[ing]" requirement "broadly applies to any act of wire fraud that affects a financial institution, provided the effect of the fraud is sufficiently direct."[7] That case, however, is distinguishable for at least two reasons: first, the decision interpreted the "affecting" requirement in the context of whether to apply a longer statute of limitations in a criminal case, rather than FIRREA's civil enforcement mechanism; and second, and most significant, the decision did not address the validity of the "self-affecting" theory because the case involved offenses committed by individuals that affected financial institutions rather than offenses committed by financial institutions that affected themselves.

Conclusion

The Second Circuit's decision clarifies that the federal fraud statutes incorporate the common law requirement of contemporaneous fraudulent intent. This sharply narrows the circumstances in which a breach of contract—even where willful and intentional—can provide the basis for a claim under the federal fraud statutes and the predicate for the imposition of civil penalties under FIRREA. Specifically, the ruling establishes that a breach of contract can form the basis for a claim under the federal fraud statutes only upon proof of intent not to perform at the time of contract execution. Although the Second Circuit's decision leaves intact, for now, the government's theory that FIRREA applies to "self-affecting" conduct, it nonetheless is a sharp rebuke of the government's attempt to transform a breach of contract case into a claim under the federal fraud statutes to satisfy the predicate for the imposition of hefty civil penalties. And the door remains open for the Circuit to address the government's novel "self-affecting" theory.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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1 *United States ex rel. O'Donnell* v. *Countrywide Home Loans, Inc.*, Nos. 15-496, 15-499 (2d Cir. May 23, 2016). The opinion was written by Judge Richard C. Wesley on behalf of a unanimous panel that also included Judges Reena Raggi and Christopher F. Droney.

2 In the wake of the financial crisis, the Department of Justice has increasingly used FIRREA, rather than criminal statutes or the False Claims Act, to bring actions against financial institutions because it has a ten-year statute of limitations, requires proof by only a preponderance of the evidence, and authorizes the imposition of civil penalties up to $1.1 million per violation, or $5.5 million for a continuing violation, or the amount of pecuniary gain or pecuniary loss by a person other than the violator. *See* 12 U.S.C. § 1833a(b), (f), (h); 28 C.F.R. § 85.3(6)-(7) (adjusting the penalty per violation and for a continuing violation to account for inflation).

3 *United States* v. *Newman*, 773 F.3d 438, 448 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015). Paul, Weiss represented defendant Anthony Chiasson in the appeal to the Second Circuit.

4 *See generally* 12 U.S.C. § 1833a.

5 *See United States* v. *Bank of New York Mellon*, 941 F. Supp. 2d 438, 453-56 (S.D.N.Y. 2013) (Kaplan, J.) (rejecting bank's argument that the "affecting" element requires third-party "victimizing" of a federally insured financial institution); *see also*

United States v. *Countrywide Fin. Corp.*, 921 F. Supp. 2d 598, 605 (S.D.N.Y. 2013) (Rakoff, J.) (holding that the "affecting" element was satisfied because "[t]he fraud here in question had a huge effect on BofA itself"); *accord United States* v. *Wells Fargo Bank, N.A.*, 972 F. Supp. 2d 593 (S.D.N.Y. 2013) (Furman, J.) (agreeing with Judge Rakoff's observation in *Countrywide* that opposition to the "self-affecting" conduct theory is "unsupported by the text of the statute, which does not exempt from the relevant affected financial institutions those that perpetrate fraud affecting themselves").

[6] *See United States* v. *Heinz*, 790 F.3d 365, 367 (2d Cir. 2015) (interpreting 18 U.S.C. § 3293 which provides, in relevant part, that: "[n]o person shall be prosecuted. . . for a violation of, or a conspiracy to violate . . . . section 1341 or 1343, if the offense affects a financial institution . . . . unless the indictment is returned . . . . within 10 years after the commission of the offense"), *cert. denied*, 136 S. Ct. 801 (2016).

[7] *Id.* (quoting *United States* v. *Bouyea*, 152 F.3d 192, 195 (2d Cir.1998)) (internal quotation marks omitted).