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COMPLIANCE

Avoiding the FCA & FIRREA Trap: Practical Tips for Compliance Professionals

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As the government becomes increasingly aggressive in its efforts to fight financial fraud, companies naturally are looking for new ways to avoid becoming the next target. In the last two years, the Department of Justice (''DOJ'') has filed lawsuits seeking billions of dollars in damages from financial institutions, premised in large part on claims of recklessness and noncompliance. And DOJ is not alone. Other federal agencies, including the Department of Housing and Urban Development (''HUD'') and the Federal Housing Finance Agency (''FHFA''), also are focused on areas fraught with technical and contractual pitfalls, including loan origination defects, servicing missteps, consumer complaint management, and Home Affordable Modification Program (''HAMP'') compliance.

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Traditionally, managing legal risk has been a task that falls squarely within the walls of the general counsel's office. But as the current enforcement environment evolves, institutions increasingly are looking to their compliance departments to anticipate risk at both line-of-business and enterprise-wide levels. Given the challenges institutions face, incorporating compliance professionals into this new wave of risk management may in fact be a natural and efficient first step to proactively identifying and managing the types of risk on which the government's recent efforts are centered.

What's at Stake

In the wake of public outcry to right the wrongs of the financial meltdown blamed on Wall Street and the ''too big to fail'' banks, the government has reinvigorated old statutes and theories to maximize potential recovery. In particular, DOJ has filed several lawsuits that rely on, and potentially may expand, the reach of the battle-tested False Claims Act (''FCA''). It also is revitalizing the Financial Institutions Reform, Recovery and Enforcement Act (''FIRREA'') to recover for alleged financial fraud. These laws allow the government to seek damages and civil penalties for (arguably) minor misstatements made to the government which, when aggregated, can result in headline-making figures.

The FCA generally is used to target false claims for payment made to the government, but has recently been expanded to cover failures to self-report (on a reverse FCA theory) as well as alleged false claims made indirectly to the government, including through the Government-Sponsored Enterprises (''GSEs''), Fannie Mae and Freddie Mac. Indeed, the FCA was amended by the Fraud Enforcement and Recovery Act of 2009 specifically to cover indirect recipients of federal funds and to expand reverse FCA liability. Most recently, in addition to bringing claims related to the origination of government loans—including loans originated under the HUD Federal Housing Administration's (''FHA'') Direct Endorsement Lender Program—the government is using these expanded provisions to pursue alleged

 ISSN 0891-0634

fraud in connection with loan sales to the GSEs, supposed self-reporting failures, and allegations of improper loss mitigation practices, including under HAMP.

FIRREA allows the government to bring civil claims whenever a person or entity violates any of 14 criminal statutes, such as the classic mail and wire fraud provisions, and where the conduct affects a federally insured financial institution. The use of FIRREA allows the government not only to bring more claims, but also to expand its prosecutorial reach. FIRREA allows the government to file more claims, more quickly, and with a lower burden of proof. Unlike the FCA, a cause of action under FIRREA may arise even before a claim for payment is made. And a misrepresentation affecting any financial institution is enough under FIRREA, whereas under the FCA, there must be a nexus between the alleged false claim and government funds.

Both statutes have significant penalty provisions. The FCA allows for penalties of $5,500 to $11,000 per violation as well as treble damages. Significantly, the Seventh Circuit Court of Appeals recently held that the appropriate calculation of treble damages is ''net trebling,'' as opposed to the traditionally used ''gross trebling'' method used by the government, reducing the potential recovery in that Circuit and putting in flux the potential recovery available in other circuits.[1] FIRREA also brings with it the risk of greater potential penalties, with statutory penalties ranging from $1 million to $5 million for continuing violations, and enhancements equal to amounts gained from the alleged misconduct. Indeed, the government made big headlines last October when it filed a $1 billion suit under the FCA and FIRREA against Bank of America, alleging fraud in connection with loan sales to the GSEs (99 BBR 724, 10/30/12).

Similarly, both the FCA and FIRREA provide powerful whistleblower incentives. The FCA provides the largest potential whistleblower recovery, allowing the whistleblower to share in 15-30 percent of any recovery. FIRREA also provides whistleblower incentives up to a maximum award of $1.6 million. FIRREA allows whistleblowers to file declarations with the government that must be kept confidential while the government investigates the claims. And, even more worrying, the FCA allows whistleblowers to file lawsuits under seal, which are then investigated by the government to determine whether it should join the suit. As a result, you may already be a party to a lawsuit without even knowing it. With the government seeking over $1 billion in damages in recent FCA-FIRREA cases, potential whistleblowers are certain to be incentivized to come forward.

A Natural Fit

Compliance testing and internal audit functions may be the first to spot potential issues. Compliance also may work closely with in-house and external counsel to resolve complex legal issues. These various information touch points position compliance professionals to have a broad understanding of exposure and potential weaknesses within an institution. Thus, in many ways, compliance provides a natural first check for potential enforcement issues. While there are many ways to manage risk within an institution, many of which depend on particulars of a business model, there are a few universal elements that can help create the foundation for a strong compliance risk management program.

One: Reinforce Lines of Business

Compliance often is one of the first points of contact for lines of business when questions arise, and frequently is the first to know about potential risk areas. In the current enforcement environment, areas traditionally viewed as ''business-related'' are colliding with regulatory-like expectations. It therefore is critical that regulatory and investor requirements be communicated to and understood by all lines of business, particularly as they relate to government programs and to the GSEs. In addition, business personnel often receive informal guidance from the GSEs and FHA regarding performance expectations for the institution. As a result, and given the current environment, it is increasingly important that both Compliance and Legal have an opportunity to review and document any informal guidance received through the business lines. Considering the ad hoc nature of such communications, procedures should be implemented and widely distributed to ensure that review process takes place.

There are, for example, strict regulatory requirements related to quality control testing, complaints management, and loan origination and servicing, where small missteps can equal large penalties. Compliance professionals have significant experience in interpreting and implementing controls around these very sorts of issues and, indeed, may very well be dealing with them in other contexts. Leveraging this experience and exposure not only is a valuable risk management tool, it is also an efficient use of resources.

Companies should also—if they have not already—supplement their existing programs with rigorous quality control initiatives. Not only are these initiatives a valuable tool in early identification of problem areas, but also they are something the government expects to see as part of a fulsome compliance program. In the current environment, policies and procedures, even when accompanied by robust training, are unlikely to generate much goodwill if the government views them as ''box-checking'' and not a central part of an organization's activities. Compliance professionals, who are experts in areas of testing and analysis, also can be natural allies to lines of business as they address QC improvements.

Two: Update Training, Policies and Procedures

Policies and procedures—even those recently updated—should be evaluated to determine whether they can be strengthened to more directly address current areas of focus. Regulations are complex, often involving both objective and subjective criteria, and even minor errors can sometimes mean big penalties. Policies and procedures should be in place that go beyond stating ''we comply with the law'' and provide concrete, specific guidance on what is required and how those requirements are satisfied.

Policies and procedures alone, however, are unlikely to be effective if all employees subject to and responsible for them have not been adequately trained. Therefore, even where policies and procedures do not require

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[1] See Schilling, Morrison, Rogers, *FCA Allows Treble Damages – 'But Treble What?'* Law360, March 26, 2013.

updating, additional training to emphasize the institutions' policies and procedures may be warranted to reinforce the importance of strict compliance in the current enforcement environment.

Three: Build on Culture of Compliance

Finally, it simply is not sufficient to develop policies and procedures, conduct training, and retreat until an issue is raised—particularly in light of the ever-increasing risk of whistleblower actions. There must be a clear process for issues to be reported, and an outline of the steps that must be taken in response, including when the legal department should be notified. Issues can often be prevented, or at least mitigated, if they are reported and addressed through appropriate channels.

To that end, compliance and audit should have a strong presence within the lines of business and an open line of communication with the legal department. An on-the-ground compliance presence can help to head-off problems that result when businesses operate in a vacuum. Similarly, when compliance has a supportive legal department as a sounding board, the two can increase efficiency in working to identify and manage potential issues together.

And while it is often said that a culture of compliance comes from the top down, this is no longer just good corporate management. The government now regularly scrutinizes individuals—particularly senior management—in addition to the company itself. If allegations can be made that management ignored or concealed alleged fraud, the government has upped the ante, seeking to hold individual employees accountable.

Final Words

Compliance walks the fine line of balancing regulatory and legal risk with business realities, while remaining an independent and objective body, and thus is well-situated to spot potential issues early on. We expect to see a continued increase in FCA and FIRREA actions, initiated by both the government's own investigations and whistleblowers. With the government under increasing public pressure to pursue financial fraud, the resulting scrutiny on institutions will only increase. Having a compliance system in place that can prevent and identify potential issues, as well as provide an appropriate response when issues do arise, is imperative in this enforcement environment.