



Legal Counsel to the
Financial Services Industry

**The False Claims Act
and FHA Lending:**

**What Does
U.S. v. Deutsche Bank
Mean For you?**

Implications of *U.S. v. Deutsche Bank*

- *Deutsche Bank* has meaning for everyone
- The implications of *Deutsche Bank* are not limited to FHA lending
- The plaintiff's bar is already close behind
- There is a potential for criminal charges, including of higher level executives responsible for certifying or overseeing compliance
- The issues identified in *Deutsche Bank* are not uncommon, but how you handle them may be the key to successfully averting Government action

Overview of *U.S. v. Deutsche Bank*

Key Factual Allegations

- MortgageIT and Deutsche Bank falsely certified that loans satisfied HUD/FHA's direct endorsement requirements when they did not, including by failing to:
 - enclose a gift letter in a file
 - verify employment
 - verify the source of earnest money deposits
 - examine file irregularities suggestive of fraud
- They failed to implement quality control procedures required by HUD
- In addition to individual loan certifications, the companies annually certified their compliance with program requirements

Overview of *U.S. v. Deutsche Bank*

Key Factual Allegations (cont.)

- The companies invested significant resources into generating FHA-insured mortgages for resale, but few to ensuring the quality of those loans
- When HUD raised concerns, MortgageIT promised falsely that the failures had been corrected
- As a result of the false certifications, MortgageIT was able to endorse approximately 39,000 loans submitted over a ten-year period, totaling more than \$5 billion in unpaid principal balance
- It then sold the “highly marketable” FHA-insured mortgages
- As of February 2011, HUD had paid more than \$386 million in FHA insurance claims and costs on loans approved for FHA insurance

Overview of *U.S. v. Deutsche Bank*

Bringing It Together – Key Legal Claims

- U.S. claims *Deutsche Bank* acted knowingly, with deliberate ignorance and/or reckless disregard for the truth by falsely certifying compliance with HUD/FHA's Direct Endorsement Guidelines
- In doing so, the U.S. claims the companies made false statements subject to liability under 3 provisions of the False Claims Act ("FCA")
- Also tacks on common law claims for negligence, gross negligence, breach of fiduciary duty, and indemnification

Overview of HUD/FHA Program

- The FHA is the largest insurer of mortgages in the world
- FHA mortgage insurance encourages lending to low- and moderate-income borrowers, who traditionally would not meet conventional underwriting requirements, by allowing borrowers easier access to credit and protecting against lender loss
- Between 2007 and 2010, the dollar value of claims paid that resulted in FHA's paying off a mortgage increased 174%, from about \$5.3 billion to about \$14.5 billion. This trend is expected to increase

The FHA Direct Endorsement Program

- HUD/FHA grants lenders participating in the direct endorsement program the authority to certify mortgages as eligible for FHA insurance
- HUD does not review the file prior to closing; instead, it relies on the direct endorser's certification that the loan is in compliance with rules and requirements
- Additionally, the program participant must annually certify compliance with applicable rules and regulations

False Claims Act Overview

Introduction

- **31 U.S.C. § 3729(a)(1)(A), (B), and (G)**
 - Any person who (A) presents a false claim, (B) makes a false record or statement material to a false claim, and/or . . . (G) makes a false record or statement material to an obligation to pay money, or conceals, avoids or decreases an obligation to pay . . . is liable to the United States Government for a civil penalty of not less than \$5,500 and not more than \$11,000 . . . plus 3 times the amount of damages which the Government sustains because of the act of that person
- Claims may be brought by the Government, or by a whistleblower (“relator”) in a *qui tam* action, which is filed under seal
- If filed by a whistleblower, the Government has the option of prosecuting the claim on the relator’s behalf, and the relator is rewarded with a percentage of the recovery obtained by the Government
- Extended statute of limitations

False Claims Act Overview (cont.)

Origins and Key Amendments of “The Lincoln Law”

- *1863*: Response to contractors accused of gouging the Union Army
- *1943*: Response to perceived abuses by plaintiffs filing lawsuits based on information already in the Government’s possession
- *1986*: Response to series of highly-publicized frauds involving defense industry contractors. Increased whistleblower recovery and added treble damages provision
- *2009*: Fraud Enforcement and Recovery Act – Expansions aimed to reach frauds by financial institutions and other recipients of TARP and economic stimulus funds
- *2010*: Dodd-Frank Financial Reform Act – Revised FCA to specifically expand recovery for persons with original knowledge of a financial fraud committed by a business required to report to the SEC or the US Commodity Futures Trading Commission (CFTC), entitling them to 10 to 30% of any recovery over \$1 million

False Claims Act Overview (cont.)

Trends in FCA Cases

- After the 1986 amendments, the FCA was used primarily against defense contractors. By the late 1990s, the focus had shifted to health care fraud
- The FCA continues to be used in both areas to amass huge recoveries
- Prior to *Deutsche Bank*, when invoked in mortgage lending, the FCA had been used in cases involving criminal conduct and/or to leverage settlement
 - RBC Settlement (November 2008) – \$11 million
 - Government claimed 219 direct endorsement loans falsely certified
 - After each ended in foreclosures, FHA paid RBC's insurance claims
 - Resolution of that case followed a parallel criminal investigation that resulted in federal charges against 25 defendants

False Claims Act Overview (cont.)

False Claims Act Defenses, Generally

- Burden of proof
 - The Government must prove each of the following:
 - That the person presented, or caused another person to present, a "claim" for payment or approval to the United States
 - The claim was "false or fraudulent"
 - The person acted knowing that the claim was false
- Knowledge/Intent
- Standing of Relator
- Original source

False Claims Act Overview (cont.)

False Claims Act Defenses in FHA Cases

- Challenging falsity
- Mitigation arguments
- Good faith

Pitfalls of FHA Lending

- Complex regulations
- Direct endorsement guidelines contain objective and subjective criteria
- Passage of time
- Penalties may not just be monetary, but may also include suspension or expulsion from the FHA program, at significant cost to an institution

Pitfalls of FHA Lending (cont.)

- The Government is becoming increasingly aggressive in pursuing claims on behalf of FHA and expanding its arsenal
 - Program Fraud Civil Remedies Act (PFCRA)
 - Operation Watchdog
 - HUD/MRB Administrative Penalties and Indemnification
- Direct Endorsement is not the only area of concern
 - Mortgage Insurance Premium (MIP) remittance
 - Notice of termination of FHA insurance

Protecting Your Company

- Proactively assess risk and address areas of concern
 - Be mindful of compare ratios, default and claim rates
 - Consider prior HUD audit reports and notices of violation
- Recognize that HUD and DOJ often take a big picture view in determining how to proceed
- Ensure quality control resources are adequate

Protecting Your Company (cont.)

- Take all interactions with HUD/FHA seriously
- Details matter
- Even minor errors can mean large penalties

Predictions

- Continued aggressiveness by HUD/FHA to recoup losses
- Expanded application beyond FHA
 - FCA claims for *any* Government program in which you certify compliance, including:
 - Troubled Asset Relief Program (TARP)
 - Home Affordable Modification Program (HAMP)
 - Other enforcement interest, including:
 - Federal regulators, DOJ and other US Attorneys' Offices
 - State regulators and AGs – Use of state-level FCA and UDAP statutes
- Whistleblower actions and copycat lawsuits

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