SULLIVAN & CROMWELL LLP

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Second Circuit Raises Bar for Proof of Fraud Under Federal Statutes

Requires Proof of Contemporaneous False Representation and Fraudulent Intent; Overturns $1.27 Billion Civil FIRREA Penalty

SUMMARY

On May 23, 2016, the United States Court of Appeals for the Second Circuit issued an important decision in *United States ex rel. O'Donnell* v. *Countrywide Home Loans, Inc.*, no. 15-496-cv, reversing a jury verdict finding Countrywide and Bank of America, among others, liable under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") for mail or wire fraud affecting a federally insured financial institution. Overturning a $1.27 billion civil penalty against the defendants, the Second Circuit held that the evidence at trial in connection with the defendants' sale of allegedly non-investment quality mortgages to government-sponsored entities was insufficient to prove fraud as a matter of law because the government failed to introduce evidence proving that the defendants fraudulently intended to breach the representations in their sale contracts at the time the contracts were executed. Absent such evidence of contemporaneous fraudulent intent, the Second Circuit held, breach of a contractual promise—even if intentional—cannot support a violation of the federal fraud statutes.

Though *Countrywide* leaves open a number of questions, it sets a high standard for the government to prove fraud against companies and individuals under federal fraud statutes, including as a prerequisite for civil penalties under FIRREA. In particular, the decision may have a direct impact on the government's pending cases and investigations into financial crisis-era mortgage-backed securities, and may also encourage financial institutions to push back more forcefully against perceived government overreach.

BACKGROUND

Countrywide concerns a loan-origination process known as the "High Speed Swim Lane"—"HSSL" or "Hustle"—that Countrywide's Full Spectrum Lending ("FSL") division developed and used between August 2007 and April 2008 to originate prime loans to two government-sponsored enterprises ("GSEs"), the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, more commonly known as Fannie Mae and Freddie Mac. Rebecca Mairone was the Chief Operating Officer of FSL during the relevant period and was responsible for overseeing FSL's reorganization, including the implementation of HSSL.

According to the government, the HSSL process sacrificed oversight and controls to speed up mortgage issuances, and led Countrywide to originate thousands of low-quality loans that were unlikely to be paid back. Countrywide then sold these loans to the GSEs pursuant to preexisting contracts that contained representations on behalf of Countrywide that, as of the date of transfer, the sold mortgages would "have the characteristics of an investment quality mortgage" (the "Preexisting Contracts").

The case originated in February 2012 in the Southern District of New York as a civil *qui tam* whistleblower suit brought by a former Countrywide employee under the False Claims Act ("FCA"). Subsequently, the government intervened in the suit, added claims under section 951 of FIRREA, 12 U.S.C. § 1833a, and named additional defendants. The FCA claim and certain defendants were eventually removed from the case, leaving only the government's FIRREA claims against four defendants: Countrywide Home Loans, Countrywide Bank, Mairone, and Bank of America (which indirectly acquired Countrywide in July 2008, after the HSSL program ended).

Section 951 of FIRREA imposes civil penalties against "[w]hoever violates" or conspires to violate the federal mail and wire fraud statutes, 18 U.S.C. §§ 1341, 1343, in a manner "affecting a federally insured financial institution." The federal mail and wire fraud statutes, in relevant part, impose criminal penalties on "[w]hoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises," uses the mail (18 U.S.C. § 1341) or wires (18 U.S.C. § 1343) for such purposes.

At trial, the government contended that Countrywide and Mairone sold the low-quality loans to the GSEs under the Preexisting Contracts with intent to defraud, because Countrywide and Mairone allegedly knew, at the time of transfer, that the loans did not conform to the contracts' requirement that they be of "investment quality." The government presented evidence indicating that: (i) there were quality problems in the loans approved through the HSSL program; (ii) key individuals in FSL, including Mairone, were informed of these quality problems; (iii) some of these key individuals, including Mairone, knew of the investment-quality representations made by Countrywide in its Preexisting Contracts with the GSEs and knew the loans originated through HSSL were not consistent with those representations; and (iv) the key individuals, including Mairone, nonetheless sold the HSSL loans to the GSEs pursuant to the contracts.

A jury found the defendants liable under section 951 of FIRREA and, on July 30, 2014, District Judge Jed Rakoff entered judgment against the defendants and imposed a penalty of over $1.27 billion on Countrywide and Bank of America and a penalty of $1 million on Mairone.

Countrywide and the other defendants appealed to the Second Circuit. Among other things, they argued that the government had failed to prove the necessary FIRREA prerequisite—that is, a violation (or conspiracy to violate) the federal mail or wire fraud statutes—and that the FIRREA action was invalid because it was brought against a financial institution pursuant to the so-called "self-affecting" theory of liability. Among other things, the defendants claimed that the conduct alleged by the government constitutes, at most, a series of intentional breaches of contract that are not recognized as fraud under the common law or the federal statutes.

THE SECOND CIRCUIT'S DECISION

In a unanimous decision authored by Judge Wesley, the Second Circuit reversed the district court's decision. The court held that the proof at trial of the FIRREA prerequisite—a violation of the mail or wire fraud statutes—was insufficient as a matter of law because the government failed to prove that the defendants' false representations were made with a contemporaneous intent to defraud. The Circuit remanded with instructions to enter judgment for the defendants.

The Second Circuit explained that federal statutes, such as the mail and wire fraud statutes, are presumed to incorporate the common-law requirements for proving a "scheme to defraud," unless the "common law principles . . . are incompatible with the language of the statutes." (Op. at 13.) Among other requirements, for a representation to be fraudulent, the common law requires that it be "made with the contemporaneous intent to defraud— *i.e.*, the statement was knowingly or recklessly false and made with intent to induce harmful reliance" (Op. at 14)—and that such fraudulent intent be proven based on evidence other than "inferences arising solely from the breach" (Op. at 16). Under the contemporaneity principle, a "contractual promise can only support a claim for fraud upon proof of fraudulent intent not to perform the promise *at the time of contract execution*. Absent such proof, a subsequent breach of that promise—even where willful and intentional—cannot in itself transform the promise into a fraud." (Op. at 22 (emphasis added).) It is this element of deception at the time the contract was made—as opposed to any point thereafter—that distinguishes fraud from intentional breach of contract and ensures that not every "willful breach of contract in which the mails or wires were used [can be converted] into criminal fraud." (Op. at 21.)

Turning to the federal fraud statutes at issue, the court observed that the common-law principle of contemporaneity promotes the statutes' underlying interests. Unlike fraud at common law, the federal fraud statutes do not require actual reliance by or injury to the victim; rather, the statutes punish the fraudulent intent and purpose that is at the core of the contemporaneity principle. (Op. at 22.)

Accordingly, the Circuit deemed "the common law's contemporaneous fraudulent intent principle incorporated into the federal mail and wire fraud statutes." (Op. at 23.) As a result, in the breach-of-contract context, "the proper time for identifying fraudulent intent is contemporaneous with the making of the promise, not when a victim relies on the promise or is injured by it. Only if a contractual promise is made with no intent ever to perform it can the promise itself constitute a fraudulent misrepresentation." (Op. at 23.)

The Second Circuit held that the government failed to present any evidence of contemporaneity. Although the evidence at trial showed that many of the loans that Countrywide sold to the GSEs were not investment-quality and that certain key, high-ranking employees such as Mairone were aware of that fact, the Preexisting Contracts were executed before Countrywide allegedly devised the scheme to defraud the GSEs. The government "adduced no evidence and made no claim that Countrywide had fraudulent intent during the negotiation or execution of these contracts" (Op. at 5), "[n]or did it offer evidence of any other representations, suggestions, or promises—separate from and post-dating execution of the initial contracts—that were made with fraudulent intent to induce the GSEs to purchase loans" (Op. at 25). Because knowledge of the faulty loans—and therefore fraudulent intent—came only after the contracts were executed and the false representations were made, the standard of contemporaneous intent was not met. The court found that, without the necessary intent element, there was no predicate fraud on which to base the FIRREA claim. (Op. at 30.)

IMPLICATIONS

FIRREA has been one of the government's most powerful tools in bringing cases against banks following the subprime mortgage crisis. The Second Circuit's decision may make future FIRREA cases predicated on fraud and other civil and criminal fraud cases more difficult for the government to prosecute in that the government will now be required to establish fraudulent intent contemporaneous with the alleged fraudulent representation. The government will often need to do so through circumstantial evidence and will not be permitted to rely "on inferences arising solely from the breach of a contractual promise" (Op. at 16), which would, per the Second Circuit, evidence only a later intention to breach. Moreover, the Second Circuit's decision may encourage some financial institutions to litigate, rather than settling, future instances of perceived government overreach.

Despite the positive implications of the Second Circuit's decision for financial and other regulated institutions, however, the Second Circuit identified a number of points that the government—and lower courts—may rely upon in the future to distinguish the decision.

- *First*, the only false representations alleged in this case were those contained in the Preexisting Contracts. Fraudulent statements or conduct may, however, also occur later in a contractual relationship—for instance, "to hide breaches of contract or nonperformance." (Op. at 12 n.12.) If fraudulent intent is proven to exist at the time of such later fraudulent

statements or conduct, the contemporaneity requirement would be satisfied and fraud may be established.

- *Second*, in this case, Countrywide's false representations were made at the time of contract execution about Countrywide's future performance: Countrywide represented at the time it executed the Preexisting Contracts that the mortgages it sold to the GSEs would be of "investment quality" as of the date of transfer. If, however, a contract provides that a party will make (rather than merely comply with) representations in the future, proof of fraudulent intent at the time such future representations are made may suffice to establish fraud.
- *Third*, the Second Circuit declined to address whether fraud without any affirmative misstatement, "such as silence . . . while under a duty to disclose material information, can constitute fraud under the federal statutes, particularly in the context of a breach of contract" (Op. at 24), or how such contractual fraud through silence would operate.

The government has not indicated whether it is considering pursuing further appellate review. Consideration of the case by the full Second Circuit would be a rare event, as the Court typically sits *en banc* only rarely. The government could, however, seek discretionary review by the U.S. Supreme Court.

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