

Special Alert: Second Circuit Reverses SDNY Judgment; Rules Fraud Claim Based on Contractual Promise Cannot Support FIRREA Violation Without Proof of Fraudulent Intent at the Time of Contract Execution

On May 23, in an opinion delivered by Circuit Judge Richard Wesley, the Second Circuit Court of Appeals [reversed](#) the District Court for the Southern District of New York's (SDNY) [July 30, 2014 judgment](#) ordering a bank and its lender subsidiary to pay penalties in excess of \$1.2 billion for alleged violations of section 951 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 12 U.S.C. § 1833a. *U.S. v. Countrywide Home Loans, Inc.*, Nos. 15-469, 15-499 (2d Cir. May 23, 2016). In relevant part, FIRREA imposes civil penalties for violations of the federal mail and wire fraud statutes that affect a federally insured financial institution. The Government had alleged in the case that the lender subsidiary had defrauded Fannie Mae and Freddie Mac (collectively, the GSEs), by originating mortgage loans through its High Speed Swim Lane (HSSL) loan origination process that it allegedly knew to be of poor quality, and subsequently selling those loans to the GSEs despite representations in the contracts between the GSEs and lender subsidiary that the loans were of investment quality. At trial, the Government presented evidence that high-level employees of the lender subsidiary "knew of the pre-existing contractual representations, knew that the loans originated through HSSL were not consistent with those representations, and nonetheless sold HSSL Loans to the GSEs pursuant to those contracts." The defendants argued on appeal that, under common-law principles of fraud the Government's trial evidence proved, at most, a series of intentional breaches of contract which did not suffice as a matter of law to establish fraud.

The Second Circuit agreed with defendants and reversed the judgment of the district court. The court held that:

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.

Thus, the Second Circuit concluded that under common law principles, which were incorporated into the mail and wire fraud statutes, "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." The Second Circuit further held that "where allegedly fraudulent misrepresentations are promises made in a contract, a party claiming fraud must prove fraudulent intent at the time of contract execution; evidence of a subsequent, willful breach cannot sustain the claim."

The Second Circuit then held that the Government had failed to meet this standard: "[t]he Government adduced no evidence and made no claim that [the lender subsidiary] had fraudulent intent during the negotiation or execution of the[] contracts" between the lender subsidiary and the GSEs. The Second Circuit further emphasized that "[t]he Government did not prove—in fact, did not attempt to prove—that at the time the contracts were executed [the lender subsidiary] never intended to perform its promise of investment quality." The court relied on the fact that "the only representations alleged to be false were guarantees of future quality made in contracts as to which no proof of contemporaneous fraudulent intent was introduced at trial." The Government also did not attempt to prove that the defendants made any later misrepresentations—*i.e.*, ones not contained in the contracts—as to which fraudulent intent could be found, nor did it allege fraud through silence.

The Second Circuit also rejected the Government's argument that the contractual representations were "made" not at contract execution but at the point of sale of the loans. "In the relevant contractual provisions, [the lender subsidiary] 'makes' or 'warrants and represents' certain statements (*i.e.*, present-tense acts), including that the future transferred loan will be investment quality 'as of' the transfer or delivery date. . . . The use of a present-tense verb in a contract indicates that the parties intend the act—here, the making of the representation—to occur at the time of contract execution, not in the future." The court reasoned that "[w]here a party makes a contractual representation of quality that is effective as of a future date rather than the time of contract execution, the date of future effectiveness determines the date of performance (and, thus, breach), but the promisor's *intent* to perform on that promise is fixed as of contract execution." Because the Government had

failed to proffer evidence that the lender subsidiary had a fraudulent intent at the time of contract execution, the Second Circuit concluded that the Government had failed to establish mail or wire fraud.

Given its holding, the Second Circuit did not reach any other issues raised by the defendants, including the issues of whether a FIRREA claim could be brought against a financial institution for “self-affecting” conduct, or whether the district court had correctly calculated the penalties it assessed against defendants. The court remanded the case to the district court with instructions to enter judgment in favor of the defendants.

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Questions regarding the matters discussed in this Alert may be directed to any of our lawyers listed below, or to any other BuckleySandler attorney with whom you have consulted in the past.

- [Andrew Schilling](#), (212) 600-2330
- [Ross Morrison](#), (212) 600-2315
- [Amanda Raines Lawrence](#), (202) 349-8089