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Client Alert

Special Matters and Government Investigations Practice Group

August 21, 2013

FIRREA—Aging but Agile, the Government's Newest Formidable Weapon of Enforcement

In the wake of the savings and loan crisis of the 1980s, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).[1] Upon its enactment, FIRREA dramatically impacted the banking industry and the functions and powers of federal banking regulators, but it was rarely used for civil fraud enforcement. Lately, however, prosecutors have added FIRREA to their arsenal by using its provisions to bring claims of financial fraud against major financial institutions and rating agencies. Taking advantage of FIRREA's lengthy statute of limitations, arguably low burden of proof[2], and the ability to issue administrative subpoenas to conduct a civil investigation in advance of filing a civil complaint, the government's actions appear to promise a host of suits targeting many financial institutions.

FIRREA's re-emergence is due in part to two critical facets of the law. First, since the typical statute of limitations for anti-fraud suits is five years, many causes of action tied to the peak of the financial crisis in 2007 and 2008 have expired. FIRREA, however, offers a ten-year statute of limitations, which enables prosecutors to bring new lawsuits that extend back through the entirety of the crisis period. Potential defendants must now wait an entire decade to see whether they are the subject of a civil suit. Second, as FIRREA is a tool for civil as opposed to criminal enforcement, the burden of proof is lower. Essentially, FIRREA offers the flexibility for prosecutors to pursue cases with a better chance of recovering tens of millions in penalties.

FIRREA provides for punishment in the form of fines—$1.1 million; the actual loss incurred; or $5.5 million in the case of "continuing violations." For most cases, the actual loss incurred will be the operative amount at issue, and can aggregate to tens of millions. As for litigants, any entity that "derives pecuniary gain" from a violation is ripe for attack. Alternatively, where a violation "results in pecuniary loss to a person other than a violator" the violator may be subject to penalties under FIRREA. Additionally, violations "affecting a federally insured financial institution" are also punishable. The statute's language does not define the term "affect", but recent rulings by Judge Lewis Kaplan and Judge Jed Rakoff, both in the Southern District of New York, appear to expand the reach of the statute.

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In an opinion issued April 24, Judge Kaplan ruled that a federally insured financial institution may be prosecuted under FIRREA for allegedly engaging in financial fraud that “affects” itself. The Kaplan ruling was the very first to interpret the statutory wording “affecting a federally insured financial institution” to mean that the government may pursue a bank for its own misdeeds. Without a “victim” in play, this interpretation could greatly expand the class of defendants sued under FIRREA for financial fraud. Notably, in footnotes, Judge Kaplan addressed similar arguments offered by a number of other defendants in recent major FIRREA fraud cases, and rejected them in favor of greater FIRREA reach.[3]

In May, S.D.N.Y. District Judge Jed Rakoff also addressed the use of FIRREA in a different case, targeting a different financial institution. Judge Rakoff had initially indicated his hesitation regarding FIRREA’s newly expansive interpretation, saying he was “troubled” by the government’s recent application of the statute. Despite this reluctance, however, he allowed FIRREA claims to stand in a two-page order issued on May 8 while at the same time dismissing False Claims Act counts.[4] Initial reaction to the court’s ruling focused on Judge Rakoff’s decision to grant the defendant’s motion to dismiss the False Claims Act cause of action that sought treble damages, an apparent blow to the government’s use of the FCA’s low bar for penalties. But by allowing the FIRREA claims to stand, the government saw this ruling as a victory.

Most recently, on August 19, Judge Rakoff explained his decision not to dismiss the FIRREA claims, stating that a “straightforward application of the plain words” of FIRREA allows the government to go after “self-affecting” fraud at federally insured financial institutions.[5] Citing a definition of “affect” from the dictionary,[6] the judge said that the fraud in question had a “huge effect” on the bank itself, not to mention its shareholders, as it paid “billions” to settle repurchase claims as a result of the fraud.[7] Judge Rakoff called the bank’s argument that the interpretation was not one Congress intended “utterly unconvincing”[8] and clearly aligned himself with Judge Kaplan’s April ruling.

This ruling, which endorses the expanding use of FIRREA, likely will embolden the Justice Department to pursue financial institutions for fraud against third parties where the ultimate financial impact on the bank and its shareholders is substantial.

Beyond the “self-affecting” expansion, the government continues to use FIRREA to pursue massive claims against other entities, in addition to financial institutions. In a complaint filed on February 4, the government sued McGraw-Hill Companies, Inc. (“McGraw-Hill”) and Standard & Poor’s, seeking $5 billion in penalties and alleging mail fraud, wire fraud, and financial institution fraud under FIRREA. Attorney generals from seven states have joined the DOJ in filing the suit, and suits against similar rating agencies may follow.

In the S&P case, the government alleged the rating agency falsely represented that their credit ratings were objective, independent, and uninfluenced by conflicts of interest, when in fact these representations were materially false. Further, the government asserted that S&P’s desire for increased revenue and market share led them to “downplay and disregard” the true extent of certain credit risks in order to favor the interests of large investment banks and others who selected S&P to provide ratings.[9] The suit does not confront the same FIRREA issue as address by the S.D.N.Y. cases discussed above, since S&P is not a federally insured financial institution. Notably, however, prosecutors allege that some of the very same banks that packaged securities at issue were defrauded, despite the fact that some of those same banks have been accused of fraud by the SEC. In response, the S&P filed a strongly worded motion to dismiss on April 22, mocking the government for “back-slapping” and “fanfare” when it announced the complaint, and asserting that the claims of fraud were invalid because S&P’s statements of objectivity were mere puffery.[10]

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On July 8, Judge David O. Carter of the Central District of California denied the motion to dismiss, and then followed his denial with an 18-page order on July 16. He disagreed with S&P's assertions concluding that the statements of objectivity were not puffery because the rating agency used such non-aspirational, non-subjective words as "must not" and "shall".[11] Further, Judge Carter highlighted the reduced pleading requirements under FIRREA by saying that under the statute, intent need not be pleaded with "a high degree of particularity" (as under the Private Securities Litigation Reform Act). As the PSLRA governs many securities cases, this begs the question whether prosecutors will start to bring such suits under FIRREA, in order to take advantage of the lower pleading standards.

Judge Carter also pointed out that under FIRREA—prosecutors need only allege that defendants specifically intended to deprive victims of money or property—not that they specifically intended to obtain money or property "from the parties who were allegedly deceived."[12]

Judge Carter did not consider the weight of the government's evidence or the merits of the case, as the government's factual allegations were accepted as true for purposes of deciding a motion to dismiss. As the case progresses, it will likely shed more light on this expansive interpretation of the statute – particularly whether S&P's alleged statements were part of a "scheme to defraud", thus fulfilling a vital element of a FIRREA claim. Interestingly, this case could also give rise to mortgage-backed securities litigation under FIRREA, as the Judge found that issuer banks in the case could be victims misguided by the rating agencies fraudulent ratings of their own mortgage backed securities products.

FIRREA offers fourteen criminal predicates to the civil fraud cause of action, each with its own varied requirements. The government's renewed use of and creative theories regarding this statute and related decisions should be closely watched given the potential risks for financial institutions.

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[1] 12 U.S.C. § 1833a.
[2] "preponderance of the evidence"
[3] Opinion, page 28.
[4] Order, *United States ex rel. O'Donnell v. Bank of America*, No. 12-01422 (S.D.N.Y. May 8, 2013). Written decision to follow.
[5] Opinion, page 12.
[6] "The key term, 'affect,' is a simple English word, defined in Webster's as 'to have an effect on.'" *Id.*
[7] *Id.*
[8] *Id.*
[9] S&P Complaint, *U.S. v. McGraw Hill Companies Inc*., No. 13-00799 (C.D.Ca. filed February 4, 2013).
[10] S&P Motion to Dismiss, *U.S. v. McGraw Hill Companies Inc*., No. 13-00799 (C.D.Ca. filed April 22, 2013).
[11] *U.S. v. McGraw-Hill Cos., Inc.,* No. 13-779, slip. Op (C.D. Cal. Jul. 16, 2013).
[12] *Id.*