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Fannie And Freddie Loans Could Be Next FCA Targets

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By now, lenders that make loans insured by the federal government are well acquainted with the False Claims Act. Following the financial crisis, the U.S. Department of Justice has aggressively used the FCA to collect billions of dollars in settlements from mortgage lenders whose loans are backed by the Federal Housing Administration (FHA), a component of the U.S. Department of Housing and Urban Development (HUD). While most of the DOJ's cases to date have focused on loan origination, more recently both the DOJ's and the relator's bar have pursued an increasing number of cases on the servicing side as well,[1] including in the area of reverse mortgages.[2] The government has also used the FCA to pursue mortgage lenders whose loans were insured by the Veterans Administration, albeit not on the same scale as its pursuit of FHA lenders.[3]

While the DOJ's pursuit of government lenders and servicers has been aggressive, at least so far most of the government's enforcement attention in this area to date has focused on loans insured by the federal government. But what if the government applied its same aggressive approach to conventional loans sold to Fannie Mae and Freddie Mac, which for some lenders and servicers constitute a much greater percentage of their business?

The risk of the DOJ applying the False Claims Act to Fannie and Freddie loans may seem remote. After all, this Civil War-era law — enacted to protect the Union Army from war profiteers — is designed to protect against fraud perpetrated upon the U.S. government, and Fannie and Freddie are not part of the government. End of story.

But the risk is not nearly as remote as it may seem. In fact, the Justice Department has already pursued several FCA cases involving government-sponsored enterprise (GSE) loans, and recovered more than $1 billion. And the number of cases involving GSE loans is sure to increase if the government prevails in a case that is pending before a federal appeals court. That case, United States ex rel. Adams v. Aurora Loan Services, will be fully submitted for decision by Feb. 12, and its outcome could have significant ramifications for mortgage lenders.

Background: Why the FCA Can Apply to FHA Lending

While the DOJ's use of the False Claims Act to pursue mortgage lenders has been aggressive, so far no one has seriously questioned that basic proposition that the FCA can apply to FHA lending. At its core, the FCA is about fraud on the government, and the FHA is part of the government.

Specifically, the False Claims Act imposes civil liability for treble damages and penalties upon anyone who "knowingly" presents a "false claim" to an employee or agent "of the United States."[4] HUD lenders have faced FCA claims premised on allegedly false certifications that are made to HUD at the time the loan is endorsed for FHA insurance, which attest to the loan's compliance with FHA requirements, as well as annual certifications of compliance with FHA program requirements more generally.[5] In these cases, the government generally alleges that these compliance certifications are "false," and that the FHA was harmed when the loans defaulted because it was fraudulently induced to insure noncompliant loans that it claims it never would have insured.[6]

It has been settled for some time that the False Claims Act applies to FHA lending because these allegedly false statements are made to an agency of the federal government. In 1958, the U.S. Supreme Court specifically rejected an argument that a claim made to the FHA was not a claim made to the "government."[7] As Justice Hugo Black observed at the time, "the FHA is about as much a part of the government as any agency can be."[8]

It had long been equally well settled, however, that Fannie and Freddie are not part of the federal government for most purposes. Although Fannie and Freddie are "government-sponsored entities," they were established as private corporations. So, just as the FCA does not reach false claims made to Amtrak,[9] a private company established by congressional action, it does not reach false claims made to the GSEs. In fact, even the Justice Department has conceded that the FCA, at least for most of its long life, did not reach claims made to Fannie and Freddie.[10]

The 2009 FCA Amendments and the DOJ's Current Position

The Justice Department recently changed its tune, however, and is citing a 2009 amendment to the FCA to support its new position.

Specifically, Congress amended the False Claims Act in 2009 to clarify and expand the reach of the law. As relevant here, Congress amended the definition of a "claim." While a "claim" had been defined as a request for money that was "presented" to the government, Congress expanded that definition to include requests for money even when they were not presented to the government. Now, a "claim" can include a request for money made to a "recipient" of government money, so long as the government has provided some of that money "to advance a Government program or interest."[11] In other words, a request for money even to a private entity may now constitute a "claim" under the False Claims Act, so long as the federal government is ultimately providing or reimbursing "any portion" of the money, and so long as the money is spent to advance the government's agenda.

The Recent Government's Pursuit of FCA Liability for Claims to the GSEs

With that new definition in hand, the government has been broadening its FCA target list in the mortgage industry to include those that make and service GSE loans. To date, the government pursued at least five cases relating to GSE lending.[12] In one case, the court dismissed the FCA claims as inadequately pled. But the court in that case observed in dicta that the 2009 amendment to the FCA "arguably extends the FCA to false claims made to Fannie Mae and Freddie Mac."[13] The other four cases settled without litigating the issue, and for significant sums.

First, in June 2014, the government intervened in and settled a False Claims Act case involving the servicing of both FHA and Fannie Mae loans.[14] In that case, the government alleged that the servicer

had made claims to both FHA and Fannie Mae for reimbursement of certain foreclosure-related expenses that were alleged to have been "inflated." With respect to Fannie, the government alleged that, between May 2009 and December 2010, the servicer "failed to create or maintain Fannie Mae audit and control systems sufficient to ensure"[15] that these fees and expenses were within program guidelines. The case was never litigated, and the servicer settled the case for $10 million.

Later that same year, the government settled three other FCA cases involving GSE loans, and for substantially greater amounts. Specifically, the government collected a total of $1 billion in settlement of three FCA cases premised on Fannie and Freddie loans, all three of which were resolved as part of a larger DOJ settlement with the defendant. In one case, originally filed in 2011, the relator alleged that the lender originated loans using inflated appraisals, and fraudulently sold those loans to the GSEs with misrepresentations as to the quality of those loans. That case settled for $350 million.[16] In the second case, filed in January 2014, the relator alleged that the lenders breached representations and warranties made to the GSEs by failing to report thousands of defective loans to the GSEs. That case settled for $300 million.[17] The third case, filed in June 2014, alleged that the lender fraudulently sold defective loans to the GSEs with misrepresentations as to the loans' quality. That case settled for $350 million.[18]

Although the government had not, prior to 2009, taken the position that the FCA applied to GSE loans, it took that position in these cases and walked away with more than $1 billion. It is a safe bet, therefore, that the government will continue down this road until a court tells it definitively that it may not.

The Adams Case and the DOJ's Position

And that brings us to Adams. Adams is a False Claims Act lawsuit filed by whistleblower James Adams on behalf of the United States government. The suit names 16 banks, lenders and mortgage servicers as defendants, and accuses these defendants of breaching certain representations and warranties made in their seller/servicer contracts with the GSEs. The Justice Department declined to intervene in the case, but it submitted its views to the court in its capacity as amicus curiae.[19] Although the relator's theory is hard to follow, and has changed several times since he filed his initial complaint, he basically alleges that the servicer defendants violated the False Claims Act when they falsely certified to the GSEs that they were in compliance with their seller/servicer agreements and representations when they were not, mainly because they allegedly caused the GSEs to pay for certain homeowner association assessments and charges for which the GSEs are not liable.

The district court dismissed the complaint for failure to state a claim.[20] It held that that an attempt to defraud the GSEs does not violate the False Claims Act, even as amended in 2009, because the GSEs are not instrumentalities of the United States but rather "private corporations created by the government."[21] Although the relator had argued that the 2008 conservatorship of the GSEs made them part of the government for FCA purposes, the court rejected that theory, explaining: "If the GSE were agencies of the United States, there would be no need for Congress to have created the FHFA to take conservatorship of them, because the President could have directed their activities through whichever agency they ostensibly belonged. The very fact of conservatorship necessarily implies a sovereign-subject division between conservator and conservatee."[22] Finally, the court rejected the argument (advanced by the Justice Department as amicus curiae) that the 2009 amendment to the FCA was broad enough to reach fraud on the GSEs, given that the GSEs became "recipients" of government funds when the United States purchased securities of the GSEs as part of their bailout. On this point, citing "familiar principles of corporate law," the court found that the United States' "majority ownership of the GSE stock does not change the result."[23]

Adams has appealed to the U.S. Court of Appeals for the Ninth Circuit, where the case is awaiting decision. As it did in the district court, the Justice Department has submitted a brief to the court of appeals as amicus.[24] Although the Justice Department stops short of supporting a win for Adams (its brief is submitted "on behalf of neither party"), it takes the position that the district court was wrong when it held that defrauding the GSEs could never state a claim under the FCA. Without taking a position on the adequacy of the complaint in this case, the DOJ maintains that the GSEs became "recipients" of federal funds when the U.S. government purchased preferred stock in the GSEs beginning in 2008. The DOJ also argues that the "enormous investment" authorized by Congress to rescue the GSEs advanced a government interest within the meaning of the FCA as amended.

The Implications for Mortgage Lenders and Servicers

The Ninth Circuit is therefore set to decide an issue of tremendous significance to mortgage lenders that sell loans to the GSEs and/or service GSE loans. In the FHA context, the DOJ has pursued massive claims for treble damages for alleged fraud on the government, using as evidence certifications of compliance made to the FHA, coupled with allegations that the lenders and servicers were not in full compliance with FHA program requirements. Of course, lenders and servicers make similar statements and certifications of compliance to Fannie and Freddie, both annually as well as in the loan-level representations and warranties that are memorialized in the seller/servicer contracts. If the DOJ and relators are permitted to effectively treat the GSEs as part of the government for False Claims Act purposes, lenders and servicers that cannot demonstrate compliance with program requirements potentially face litigation and enforcement actions seeking treble damages and penalties for every dollar they receive from the GSEs as seller or servicer of these loans.

A win for the Justice Department in Adams certainly is far from assured, however. For starters, even though the FCA may now reach some "recipients" of federal funds, the FCA authorizes treble damages only for "damages which *the Government* sustains";[25] and it's not clear that the government has sustained any damage from claims submitted to the GSEs. To be sure, the federal government injected $187.5 billion into the GSEs between 2008 and 2012.[26] But the GSEs have since repaid the government far more than that in dividends.[27] It's hard to see, therefore, how the U.S. Treasury could be said to have sustained any damage from claims paid out by the GSEs.

Also, even if the court in Adams were to adopt the government's interpretation, a narrow holding that a plaintiff could state an FCA claim for defrauding the GSEs (which is all that the Justice Department is asking for in that case) would not resolve the more difficult question of what exactly needs to be alleged to state such a claim successfully. Notably, the DOJ refused to take a position on whether the complaint filed by Adams passed muster, and it's not at all clear what a successful plaintiff would need to show.

In FCA cases involving claims submitted to nongovernment entities as "recipients" of federal funds, courts have typically required plaintiffs to establish that it was the government's money — and not that of the private entity — that went to paying the false claim. Given the complexities of the government's bail out of the GSEs, that showing might be insurmountable in this context. As one court observed in rejecting an FCA case over false claims made to Freddie Mac, Freddie continued to generate revenue during the period in which it was receiving government funds, and the plaintiff could not show "how Freddie Mac allocated its revenue such that Defendants' invoices were paid with at least a portion of government money."[28] In other words, there is at least some hope that, even if the government prevails in this case, the Ninth Circuit will rule narrowly, and impose a high burden on future plaintiffs to plead such a case.

Conclusion

In short, Adams is a case worth watching. A win for the government threatens a new wave of enforcement against conventional lenders, similar to what government lenders and servicers have experienced for years, and on a potentially larger scale. While a Ninth Circuit ruling will not determine the law nationwide, it may well be viewed as a green light to the government to continue down a path that holds great peril for GSE lenders and servicers.

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[1] See, e.g., U.S. v. HSBC Bank USA NA, Case No. 13-civ-1467 (S.D.N.Y), which settled for $10 million.

[2] See, e.g., U.S. ex rel. McDonald v. Walter Inv. Mgmt. Corp., Case No.13-cv-1705 (M.D. Fla.), which settled for $29 million.

[3] See, e.g., U.S. ex rel. Edwards v. JPMorgan Chase Bank NA, Case No. 13-civ-0220 (S.D.N.Y.) (filed Feb. 4, 2014), which settled for $614 million, with $49.4 million allocated to V.A. loan origination claims.

[4] 31 U.S.C. § 3729(b)(2)(a)(1).

[5] See, e.g., U.S. v. Eghbal, 548 F.3d 1281 (9th Cir. 2008).

[6] See, e.g., U.S. v. Wells Fargo Bank NA, 972 F. Supp. 2d 593 (S.D.N.Y. 2013).

[7] U.S. v. McNinch, 356 U.S. 595 (1958). Notably, the Supreme Court in McNinch did not directly address the fact that the FHA does not use taxpayer money to pay insurance claims. As the FHA itself touts, "FHA is the only government agency that operates entirely from its self-generated income and costs the taxpayers nothing. The proceeds from the mortgage insurance paid by the homeowners are captured in an account that is used to operate the program entirely." http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/fhahistory. Accordingly, even after McNinch, one could argue that the FCA should not reach false claims made to the FHA because U.S. Treasury funds are not at risk. See, e.g., U.S. ex rel. Pogue v. Am. Healthcorp. Inc., 914 F. Supp. 1507, 1512 (M.D. Tenn. 1996) ("The legislative history of the False Claims Act reveals that it was designed to protect the Federal Treasury."); see also Hutchins v. Wilentz, Goldman & Spitzer, 253 F.3d 176, 184 (3d Cir. 2001) ("[W]e hold that the submission of false claims to the United States government for approval which do not or would not cause financial loss to the government are not within the purview of the False Claims Act.").

[8] McNinch, 356 U.S. at 598.

[9] See U.S. ex rel. Totten v. Bombardier Corp., 380 F.3d 488 (D.C. Cir. 2004).

[10] Doc. 165, United States Statement of Interest With Regard to Defendants' Joint Motion to Dismiss, filed in United States ex rel. Adams v. Aurora Loan Services LLC, Case No. 11-cv-00535-RJC-PAL (D. Nev.) (Sept. 9, 2013), at 2 n.2 ("the Government does not challenge the defendants' contention that the FCA, prior to the 2009 amendments, has no application to Fannie Mae or Freddie Mac").

[11] 31 U.S.C. § 3729(b)(2)(A)(ii).

[12] See, http://www.justice.gov/opa/pr/bank-america-pay-1665-billion-historic-justice-department-settlement-financial-fraud-leading

[13] U.S. v. Countrywide Fin. Corp., 961F. Supp. 2d 598, 609 (S.D.N.Y. 2013).

[14] Stipulation and Order of Settlement and Dismissal, U.S. v. HSBC Bank NA, et al.,Case No.13-civ-1467 (S.D.N.Y.) (June 19, 2014).

[15] Id. at 6.

[16] Stipulation and Order of Voluntary Dismissal, U.S. ex rel. Madsen v. Bank of America et al., Case No. 11-civ-4207 (S.D.N.Y. Dec. 10, 2014).

[17] Stipulation and Order of Voluntary Dismissal, U.S. ex rel. Abdou v. Countrywide Fin. Corp. et al., Case No. 14-civ-Civ. 0268 (S.D.N.Y. Mar. 2, 2015).

[18] Stipulation and Order of Voluntary Dismissal, U.S. ex rel. O'Donnell v. Countrywide Fin. Corp. et al., Case No. 14-civ-4038 (S.D.N.Y. Dec. 15, 2014).

[19] Doc. 17, Brief for the United States as Amicus Curiae In Support of Neither Party, filed in U.S. ex rel. Adams v. Aurora Loan Services Inc., Case No. 14-15031 (9th Cir.) (filed May 27, 2014).

[20] U.S. ex rel. Adams v. Wells Fargo Bank Nat'l Ass'n et al., Case No. 11-cv-00535-RCJ-PAL (D. Nev. Dec. 11, 2013), appeal pending sub nom. U.S. ex rel. Adams v. Aurora Loan Services Inc., Case No. 14-15031 (9th Cir.).

[21] Id. at 11.

[22] Id. at 12.

[23] Id.

[24] Doc. 17, U.S. ex rel. Adams v. Aurora Loan Services Inc., Case No. No. 14-15031 (9th Cir.).

[25] 31 U.S.C. § 3729(a) (emphasis added).

[26] Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities (Dec. 31, 2014).

[27] See, e.g., Staff Report, The Rescue of Fannie Mae and Freddie Mac (Federal Reserve Bank of New

York Mar. 2015) ("As of end-2014, the cumulative Treasury dividend payments by Fannie Mae and Freddie Mac have now exceeded their draws: specifically, Fannie Mae has paid $134.5 billion in dividends in comparison to $116.1 billion in draws, while Freddie Mac has paid $91.0 billion in dividends in comparison to $71.3 billion in draws.").

[28] U.S. ex rel. Todd v. Fidelity Nat'l Fin., Inc., Case No. 12-cv-666-REB-CBS, 2014 WL 4636394, at *11 (D. Colo. 2014).