With Fraud Claims, Timing Is Everything

By William S. Gyves and Monica Hanna

The U.S. Court of Appeals for the Second Circuit recently revisited an issue that has challenged commercial litigators and courts alike since the earliest days of the common law: When does a simple breach of contract rise to the level of a viable claim for fraud? In *United States ex rel. O'Donnell v. Countrywide Home Loans, Inc.*,[1] the Second Circuit wrestled with this age-old conundrum against the contemporary backdrop of a scheme in which the defendants allegedly violated the Federal Institutions Reform, Recovery, and Enforcement Act of 1989[2] (FIRREA) by selling thousands of residential mortgage loans to two government-sponsored enterprises despite knowing that those loans did not conform to the terms of the controlling purchase agreements. After a jury found for the government on its FIRREA claims, the District Court imposed jaw-dropping penalties exceeding $1.27 billion upon the defendants. Reversing and remanding with instructions to enter judgment in favor of the defendants, the Second Circuit's decision in *Countrywide* garnered considerable media attention. It was praised by some as a much needed push-back against what some see as the government's hyper-aggressive use of FIRREA to extract substantial settlements from financial institutions, and condemned by others as yet another roadblock impeding efforts to

hold accountable those whose financial shenanigans helped trigger the Great Recession.[3]

Aside from whatever light it might shed on the nuances of FIRREA and the intricacies of its wire and mail fraud predicates, the Second Circuit's decision also offers fresh, practical guidance for commercial litigators who routinely encounter the tension between breach of contract and fraud claims in meat-and-potato business disputes. *Countrywide* teaches that no matter how intentional, willful or malicious a breach of contract may be, as a general rule it will not give rise to a viable fraud claim unless the bad actor, upon entering into the contract, had absolutely no intention of ever performing its contractual obligations. The Second Circuit emphasized that when a fraud claim is based on contractual promises, the proper time to assess the bad actor's fraudulent intent is contemporaneous with its making of the promises in question and not when the counterparty relies on those promises or is otherwise injured by the deceptive conduct.

The Underlying Facts

Countrywide arose out of a program through which Countrywide agreed to provide a steady stream of residential mortgage loans to the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). In its purchase agreements with Fannie Mae

and Freddie Mac, Countrywide represented that the loans would be of investment quality -- i.e., loans that were adequately secured and on which timely repayment reasonably could be expected. After the purchase agreements were executed, Countrywide sought to boost loan volume and revenue by modifying its loan origination process. Unbeknownst to Fannie Mae or Freddie Mac, Countrywide instituted a new loan underwriting program called the High Speed Swim Lane. Ostensibly, the program was designed to reduce the time spent processing loans. In reality, the program gutted any effective underwriting of the loans and removed most of the "toll gates" that previously had been in place to help ensure loan quality. The government alleged that by removing safeguards designed to weed out poor quality loans, the High Speed Swim Lane program all but guaranteed that the loans sold to Fannie Mae and Freddie Mac would be far more risky than what was represented in the purchase agreements. When those loans predictably defaulted, the government alleged, Fannie Mae and Freddie Mac incurred massive losses.[4]

The government asserted claims under FIRREA, which imposes civil penalties for violations of the federal wire and mail fraud statutes that "affect[ ] a federally insured financial institution."[5] The government presented the jury with extensive evidence demonstrating that Countrywide was aware of the representations in the purchase agreements with respect to the quality of the loans

to be sold; knew the loans in question did not conform with those representations; and nonetheless sold the inferior loans to Fannie Mae and Freddie Mac. What the government did not do, however, was prove (or even allege) that Countrywide had any intent to defraud Fannie Mae and Freddie Mac at the time the purchase agreements were negotiated and executed. Nonetheless, following a month-long trial, the jury returned a verdict in favor of the government. Denying the defendants' motion for a new trial, the District Court stated that the "jury's conclusion that this was a massive and intentional fraud was amply supported by the evidence."[6]

On appeal, the defendants argued that the government failed to prove the wire and mail fraud predicates of the FIRREA claims. The defendants maintained that at most the government established that they had committed a series of intentional breaches of the purchase agreements. They insisted that the mere fact that, after the contracts were executed, they sold mortgages knowing they were not of the quality promised in those purchase agreements was insufficient as a matter of law to establish fraud. Because the common law does not recognize an intentional breach of contract in and of itself as being tantamount to fraud, they argued, neither do the federal wire and mail fraud statutes.

The Second Circuit's Analysis

Siding with the defendants, the Second Circuit concluded that "the trial evidence fails to demonstrate the contemporaneous fraudulent intent necessary to defraud through contractual promises." In doing so, it noted that the question of whether a party's willful but silent non-compliance with a contractual obligation can amount to actionable fraud is a recurring one at common law. The Second Circuit offered a hypothetical to illustrate that recurring issue:

A and B execute a contract requiring A to provide widgets periodically to B over a five-year term. In the contract, A represents that as of the delivery date the widgets would comply with an agreed-upon set of widget specifications. At the time the contract is executed, A intends to provide conforming widgets. Indeed, thereafter A makes several deliveries of conforming widgets. Production problems soon develop, however, and A's widgets fall short of the widget specifications. Knowing the widgets are nonconforming, A nonetheless ships the defective widgets to B without making any representations as to their quality. The widgets malfunction. B complains, alleging that A not only breached the contract but also has committed a fraud.

In this scenario, the Second Circuit reasoned, there could be no fraud claim because A had no intent to deceive B at the time the contract was executed. Moreover, during its performance of the contract, A made no misrepresentations

independent of those set forth in the contract to which a fraud claim could be pegged. But change the facts slightly and the results would be different. Had A misrepresented the quality of the widgets at the time it began delivering nonconforming widgets, B could assert a viable fraud claim independent of the breach of contract claim. Similarly, a fraud claim might have arisen had A feigned performance at the time that it was delivering nonconforming widgets or taken other measures designed to mask its non-performance.

Countrywide is a powerful reminder that when it comes to pleading and proving a fraud claim in the context of a contractual relationship, timing is everything. The Second Circuit emphasized that the viability of a fraud claim between contracting parties turns on "*when* the representations were made and the intent of the promisor *at that time*." Where a fraudulent misrepresentation and a contractual obligation are alleged to be one and the same, "a party claiming fraud must prove fraudulent intent at the time of contract execution; evidence of a subsequent, willful breach cannot sustain the claim." In that scenario, "the common law rejects any attempt to prove fraud based on inferences arising solely from the breach of a contractual promise. . . . The rule exists because, at common law, a post-agreement intent to breach the contract is not actionable as fraud." A party's "'[f]ailure to comply with a contractual obligation is only fraudulent when the promisor *never intended* to honor the contract.'" Any other approach, the court

observed, would "contravene the fundamental common law requirement of contemporaneity between representation and fraudulent intent." The Second Circuit reasoned that this requirement honors the role deception plays as the "key distinction" between breach of contract and fraud claims.

Applying these principles to the facts and circumstances presented in *Countrywide*, the Second Circuit held that the government failed to establish the wire and mail fraud predicates of its FIRREA claims. The unanimous panel emphasized that the only alleged misrepresentations were guarantees of future quality of the loans made in the purchase agreements as to which "no proof of contemporaneous fraudulent intent" was offered. Indeed, it was indisputable that the parties executed the contracts before Countrywide rolled out its alleged scheme to defraud Fannie Mae and Freddie Mac. Further, the Second Circuit noted, the government offered no 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 Fannie Mae and Freddie Mac to purchase the inferior loans.[7]

The Takeaway

Countrywide is not the first time the Second Circuit has waded into the grey area separating breach of contract claims from fraud claims,[8] nor will it be the last. It does, however, serve as a valuable primer for commercial litigators

tasked either with prosecuting or defending fraud claims arising in the context of a contractual relationship.

A contracting party burned by what it perceives to be a bad faith breach often will pressure counsel to include a fraud cause of action in the litany of claims asserted against the bad actor. Sophisticated plaintiff's counsel are sensitive to the possibility that a court may view with disfavor what at first blush appear to be duplicative breach of contract and fraud claims. They are well advised to craft their pleading in a manner consistent with the Second Circuit's laser focus on specifically when the bad actor possessed the requisite fraudulent intent to deceive. Less than detailed allegations on this critical point no doubt will trigger a motion to dismiss and only heighten a court's suspicion of purported fraud claims arising out of contractual relationships.

For defense counsel already hardwired to pounce on virtually any fraud claim asserted alongside a breach of contract claim, *Countrywide* provides a clear roadmap for distinguishing viable fraud claims from defective tag-along fraud claims shoehorned into a routine commercial dispute. Coupled with the heightened pleading standards applicable to fraud claims,[9] *Countrywide* is a potent weapon in the drive to thwart at the outset improper attempts to transform a plain-vanilla contractual dispute into a sprawling fraud case.

* * * * * *

William S. Gyves is a litigation partner and Monica Hanna is a senior litigation associate in the New York office of Kelley Drye & Warren LLP.

[1] *United States ex rel. O' Donnell v. Countrywide Home Loans, Inc.*, 822 F.3d 650 (2d Cir. 2016).

[2] 12 U.S.C. § 1833a.

[3] Editorial, The Bank Fraud that Wasn't: A Federal Appeals Court Overturns a Politicized Mortgage Case, The Wall Street Journal (May 24, 2016); Editorial, Why America Is Furious: Judges Let Financial Crash Bad Actors Off the Hook, N.Y. Daily News (May 28, 2016).

[4] *United States v. Countrywide Fin. Corp.*, 961 F. Supp. 2d 598, 601-04 (S.D.N.Y. 2013).

[5] 12 U.S.C. § 1833a(a); *see also* 18 U.S.C. §§ 1341 (mail fraud statute) and 1343 (wire fraud statute).

[6] *United States ex rel. O'Donnell v. Countrywide Fin. Corp.*, 83 F. Supp. 3d 528, 536 (S.D.N.Y. 2015).

[7] On August 4, 2016, the government filed a petition for a rehearing in *Countrywide*. Among other things, it maintained that in overturning the jury's verdict and directing judgment for the defendants, the Second Circuit "overlooked a wealth of evidence presented at trial that defendants made fraudulent misrepresentations at the time each loan was sold, well after the contracts' execution and during the course of the performance of the contracts."

[8] *See, e.g., Cohen v. Koenig*, 25 F.3d 1168 (2d Cir. 1994); *Mills v. Polar Molecular Corp.*, 12 F.3d 1170 (2d Cir. 1993); *Murray v. Xerox Corp.*, 811 F.2d 118 (2d Cir. 1987); *DiRose v. PK Mgmt. Corp.*, 691 F.2d 628 (2d Cir. 1982).

[9] *See*, *e.g.*, Fed. R. Civ. P. 9(b); CPLR 3016(b).

Reprinted with permission from the August 19, 2016 *edition of the New York Law Journal© 2015 ALM Media Properties, LLC. All rights reserved.*
Further duplication without permission is prohibited. ALMReprints.com – 877-257-3382 - reprints@alm.com.