

Expanding FIRREA Liability for Financial Institutions: Southern District of New York Developments [UPDATE]

A recent SDNY ruling strengthens the Department of Justice's expanding application the Financial Institutions Reform, Recovery and Enforcement Act of 1989.

UPDATE On October 23, a jury returned the first FIRREA verdict under the Department of Justice's new application of the Act.¹ Discussion of that verdict and its ramifications are included in this update.

Once a rarely used and little known statute, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA or the Act)² has seen a resurgence in the last two years as the Department of Justice (DOJ or the Department) has repeatedly used the statute to bring civil, rather than criminal, cases against financial institutions. In doing so, the government seeks to take advantage of the Act's lower standard of proof than that which applies to criminal prosecutions. In a trio of cases moving through the Southern District of New York, the DOJ has pushed the boundaries of the Act – so far successfully – to bring civil charges against the very institutions the Department alleges were harmed by fraudulent acts.³

Bank of New York Mellon

A decision earlier this year in *United States v. Bank of New York Mellon* was first to interpret FIRREA's "affecting a federally insured financial institution" nexus, the key issue in the government's expansive view of the Act's scope.⁴ At issue in *Bank of New York Mellon* was whether defendant The Bank of New York Mellon could be both the perpetrator of the alleged fraud and the affected institution under Section 1833a of the Act, which allows the government to pursue civil penalties for alleged violations of criminal statutes where those violations affect a federally insured financial institution.⁵ In a lengthy opinion, Judge Kaplan considered judicial decisions analyzing other provisions of FIRREA, the statutory structure of Section 1833a, Congressional intent, and multiple dictionary definitions of "affect." He ultimately concluded that a bank's actions could "affect" itself for the purposes of Section 1833a liability.⁶

Countrywide Financial Corporation

Similar issues were raised in *United States ex rel. O'Donnell v. Countrywide Financial Corporation*, pending before Judge Jed Rakoff.⁷ Oral arguments regarding the defendants' motions to dismiss were held after the *Bank of New York Mellon* opinion was issued, and during the hearing Judge Rakoff stated he was "more troubled, notwithstanding Judge Kaplan's opinion, by the affecting argument."⁸ Despite that concern, however, Judge Rakoff issued an order on May 8, denying the motions to dismiss the FIRREA claims and promising that a reasoned opinion would be forthcoming.⁹ On August 16, the court released

that opinion, which is now the second to interpret the Act's requirement that the underlying criminal violation must "affect[] a federally insured financial institution."¹⁰

Judge Rakoff succinctly reasoned that the dictionary definition of "affect" means "to have an effect on," and thus, because the complaint alleges that Bank of America has paid billions of dollars to settle repurchase claims by Fannie Mae and Freddie Mac, the DOJ had adequately alleged that a federally insured financial institution was affected.¹¹ Unlike Judge Kaplan, Judge Rakoff declined to consider FIRREA's legislative history, statutory construction, or the other arguments put forth by the defense to support its position that the "affects a federally insured financial institution" requirement means that a defendant's conduct affecting only itself cannot form the basis for a violation.¹²

The complaint in *Countrywide Financial Corporation* alleges that the defendant banks violated the mail and wire fraud statutes (thereby creating liability under FIRREA) by originating loans in violation of Freddie Mac and Fannie Mae guidelines and then, while selling those loans to Freddie Mac and Fannie Mae, misrepresenting that they had complied with the guidelines.¹³ The government argued that such acts "affected" federally insured financial institutions in two ways. First, under what the parties dubbed the "self-affecting" theory, the government contended that because Bank of America is itself a federally insured financial institution, the alleged fraud "affected" a federally insured financial institution.¹⁴ That is the theory that Judge Rakoff ultimately found sufficient to survive the motion to dismiss. The complaint also articulated a theory of an indirect, or "derivative," affect by alleging that Countrywide's fraud proximately caused the insolvency of Freddie Mac and Fannie Mae, which in turn affected individual federally insured banks by devaluing their investments in Freddie Mac and Fannie Mae.¹⁵ While declining to rule on this second theory, the court expressed deep reservations about its viability, noting that the theory "squarely raises the question of whether a fraud that does not directly or immediately affect insured financial institutions is too attenuated to give rise to a FIRREA claim."¹⁶

UPDATE: In late September the case went to trial and, on October 23, a jury returned a verdict in favor of the government. Judge Rakoff has not yet ruled on damages but has promised the parties that, unless an evidentiary hearing is needed, he will do so by year end. Unless the parties settle before then, however, the question of the meaning of "affecting a federally insured financial institution," which has significantly expanded the scope of FIRREA, almost certainly will be before the Second Circuit in 2014.

Wells Fargo Bank

Defendants in a third FIRREA case pending in the Southern District, *United States v. Wells Fargo Bank, N.A.*, also moved to dismiss FIRREA charges based on the "affecting" requirement.

UPDATE: Referring to both the *Bank of New York Mellon* and *Countrywide Financial Corporation* decisions, Judge Furman denied the defendant bank's motion to dismiss the FIRREA claims on the theory that the bank could not "affect" itself, stating that argument "merits little discussion."¹⁷ The court held that the government had sufficiently alleged that the bank had "affected" itself through both actual harm and an increased risk of loss due to its conduct. Specifically, the court relied upon the government's allegations that the bank has had to satisfy its indemnification obligation with respect to loans, faces the prospect of providing further indemnification, has spent a considerable sum on legal expenditures, and may be subject to legal liability (including the False Claims Act and FIRREA charges at issue in the suit itself).¹⁸

Conclusion

The DOJ's winning record in the Southern District thus far is likely to embolden the government to deploy FIRREA and other civil statutes in a broader array of cases that heretofore would have been brought only as criminal matters – involving a higher burden of proof, less flexible pleading standards, and narrower discovery options. History has shown that when the government succeeds in pushing out the frontiers of a powerful enforcement tool, it uses that tool with increasing breadth and frequency. While ultimately only time will tell if that pattern repeats itself, an appeal to the Second Circuit in *Countrywide Financial Corp.* would offer some hope for financial institutions that further judicial scrutiny will serve to check the government's aggressive new use of FIRREA.

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Endnotes

¹ The original version of this article appeared as Latham & Watkins Client Alert No. 1581, *Expanding FIRREA Liability for Financial Institutions: Southern District of New York Developments*, Sept. 3, 2013, available at <http://www.lw.com/thoughtLeadership/LW-FIRREA-ruling-SDNY>.

² Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Pub. L. 101-73, Aug. 9, 1980, 103 Stat. 183.

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- ³ For an in-depth look into FIRREA and the three cases interpreting FIRREA's "affecting a federally insured financial institution" requirement, see Latham & Watkins Client Alert No. 1521, *A Second Wind: Government Civil Enforcement Cases Breathe Life Into FIRREA*, May 14, 2013, available at <http://www.lw.com/thoughtLeadership/firrea-civil-enforcement-tool-revived>.
- ⁴ *U.S. v. Bank of New York Mellon*, No. 11 Civ. 6969 (LAK), 2013 U.S. Dist. LEXIS 58816, (S.D.N.Y. Apr. 24, 2013).
- ⁵ *U.S. v. Bank of New York Mellon*, No. 11 Civ. 6969 (LAK), 2013 U.S. Dist. LEXIS 58816, (S.D.N.Y. Apr. 24, 2013); see also 18 U.S.C. § 1833a.
- ⁶ *Bank of New York*, 2013 U.S. Dist. LEXIS 58816, at *5, *25–26, *30–31.
- ⁷ *U.S. ex rel. O'Donnell v. Countrywide Fin. Corp.*, No. 12 Civ. 1422 (JSR), 2013 U.S. Dist. LEXIS 117140 (S.D.N.Y. Aug. 16, 2013).
- ⁸ Nate Raymond, *Judge Questions Fraud Statute's Use Against Bank of America*, Reuters, Apr. 29, 2013, available at <http://www.reuters.com/article/2013/04/30/us-bankofamerica-fraud-hearing-idUSBRE93T02M20130430>.
- ⁹ *Countrywide Fin. Corp.*, No. 12 Civ. 1422 (JSR), at 1–2 (S.D.N.Y. May 8, 2013).
- ¹⁰ *Countrywide Fin. Corp.*, 2013 U.S. Dist. LEXIS 117140.
- ¹¹ *Id.* at *16.
- ¹² *Id.* at *16–17.
- ¹³ Amended Complaint of the United States of America at ¶ 219, *Countrywide Fin. Corp.*, No. 12 Civ. 1422 (JSR) (S.D.N.Y. Jan. 11, 2013).
- ¹⁴ *Countrywide Fin. Corp.*, 2013 U.S. Dist. LEXIS 117140, at *15.
- ¹⁵ *Countrywide Fin. Corp.*, 2013 U.S. Dist. LEXIS 117140, at *15.
- ¹⁶ *Countrywide Fin. Corp.*, 2013 U.S. Dist. LEXIS 117140, at *17–19.
- ¹⁷ See *U.S. v. Wells Fargo Bank, N.A.*, No. 12 Civ. 7527 (JMF), 2013 U.S. Dist. LEXIS 136539, at *96–97 (S.D.N.Y. Sept. 24, 2013) (citing *Bank of New York Mellon*, 2013 U.S. Dist. LEXIS 58816, at *42).
- ¹⁸ *Id.* at *98–101.