Second Circuit Reverses $1.3 Billion Penalty, Finding That Countrywide Did Not Defraud Government When Selling Mortgages, But Sidesteps Main Statutory Question

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On May 23, 2016, the United States Court of Appeals for the Second Circuit reversed a $1.3 billion civil penalty imposed against Countrywide Home Loans, Inc., Bank of America, N.A., and related defendants (collectively, "Countrywide") under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA").[1] Although the decision rebuffed the government's case against Countrywide, it did not address the government's novel interpretation that FIRREA permits civil penalties against financial institutions whose criminal conduct is "self-affecting." FIRREA permits civil penalties against a defendant if it commits certain unlawful acts "affecting a federally insured financial institution."[2] Over a month-long trial, the government presented evidence that Countrywide sold poor-quality mortgages to the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). But the Second Circuit held that the government did not prove that Countrywide entered those contracts with intent to defraud, thus failing to show a violation of the mail or wire fraud statutes as FIRREA requires. By reversing on those grounds, the Second Circuit avoided important questions regarding FIRREA's reach.

The Jury Finds Countrywide Liable under FIRREA

After the subprime mortgage market imploded in 2007, Countrywide Home Loans converted its subprime lending division into a loan origination division focused on selling prime loans to Fannie Mae and Freddie Mac (the "GSEs"). The division's CEO, Rebecca Mairone, implemented a loan origination process called the "High Speed Swim Lane," or "HSSL." Under this program, Countrywide sold mortgages to the GSEs and represented that the mortgages would be an "Acceptable Investment" or have the characteristics of an "investment quality mortgage" "as of the date of transfer" or "as of" the delivery date to the GSEs.

At trial, the U.S. Attorney's Office for the Southern District of New York ("SDNY") contended that those representations were lies. In an effort to prove that Countrywide defrauded the GSEs, the government showed that the HSSL loans contained quality issues, that key individuals knew about those problems, that those individuals knew about the representations in the contracts, and that Countrywide sold the loans to the GSEs anyway. A jury in the SDNY found Countrywide liable under FIRREA. Judge Jed Rakoff imposed a $1 million penalty against Mairone individually and a $1.27 billion penalty against Countrywide.

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[1] *United States ex rel. O'Donnell v. Countrywide Home Loans, Inc.*, Nos. 15-496, 15-499 (2d Cir. May 23, 2016).

[2] 12 U.S.C. § 1833a.

The Second Circuit Reverses the $1.3 Billion Penalty

Countrywide appealed the judgment to the Second Circuit, primarily arguing that the government had extended FIRREA beyond its statutory limits. The Second Circuit declined to rule on FIRREA's boundaries and instead found a fundamental problem with the government's case: the government had not proved that Countrywide committed wire fraud or mail fraud—a prerequisite to FIRREA liability.

The ruling focused on the distinction between an intent to defraud and a willful breach of contract. Contrary to the district court's ruling, courts interpret the wire and mail fraud statutes' requirement that a person "intend[ed] to devise any scheme or artifice to defraud," according to common-law fraud principles. Under common law, a defendant does not have the requisite intent to defraud when he willfully breaches a contract alone. Common law requires more than "proof that a promise was made and that it was not fulfilled."[3] The Court therefore explained that a fraud claim in the context of a contractual relationship turns on "*when* the representations were made and the intent of the promisor *at that time*."[4] In short, the government had to prove either that Countrywide did not intend to perform its promises at the time it made them in the contracts, or that Countrywide made later misrepresentations (outside of the contracts) as to which fraudulent intent could be found. Absent this requirement, the Court reasoned, any intentional contractual breach involving mail or wires could be transformed into a criminal fraud.

The Second Circuit held that the government's case did not satisfy this contemporaneous fraudulent intent requirement. Indeed, the government did not even attempt to prove that Countrywide never intended to perform its promises at the time it executed the contracts, nor that Countrywide made other representations that could underlie the fraud claim. The Court rejected the government's argument that Countrywide made the contract representations at the point of sale, rather than at contract execution, because the contract described Countrywide's representations in the present tense (e.g., "makes" or "warrants and represents"), constituting a present promise and not a future representation. The Court therefore held that no reasonable juror could find Countrywide guilty of mail or wire fraud. Absent an underlying mail or wire fraud claim, the government's FIRREA claim necessarily failed.

FIRREA Remains a Powerful Tool for the Government

The Second Circuit's ruling negates the government's case against Countrywide, but its broader impact may be limited. FIRREA remains a powerful tool for the government, which has succeeded in expanding FIRREA's purview to obtain **record monetary penalties** in recent years. The *Countrywide* case would have been the first time an appellate court considered the government's theory that the government can bring a FIRREA claim against a financial institution for "self-affecting" conduct, a theory embraced by district courts but challenged by defendants. The Second Circuit sidestepped this question, leaving district courts' approval of this theory intact, at least for now, while the government pursues investigations under FIRREA against other financial institutions in the mortgage industry and elsewhere.

The government also has a path forward even in contract-based cases similar to *Countrywide*. The government can satisfy the fraudulent intent requirement in future cases by presenting evidence that a defendant had the requisite fraudulent intent at the time it executed a contract or that the defendant made additional fraudulent misrepresentations at the time of breach. The Second Circuit's decision thus leaves open other avenues for the government to pursue FIRREA claims in a contract setting.

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[3] *Countrywide*, Nos. 15-496, 15-499 at 13 (internal quotation marks omitted).

[4] *Id.* at 14 (emphases in original).

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