

# Understanding FIRREA: Revived Law Expands Government's Enforcement Options

In an effort to pursue the financial institutions perceived to be at the heart of the current financial crisis, the Department of Justice has increasingly turned to civil statutes, such as the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), in lieu of criminal prosecutions. While FIRREA presents an attractive enforcement option, allowing for a civil standard of proof and the possibility of significant damages, it was not originally intended for its current use. The government has read the act expansively to bring actions against financial institutions that FIRREA was arguably designed to protect. In light of several favorable rulings on FIRREA's scope—and a subsequent trial victory—we can expect that the government's FIRREA beachhead will expand even further in the years ahead.

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In the wake of the financial crisis and progressively stronger criticism for not vigorously prosecuting those market participants perceived to have acted improperly in the years before the downturn, the Department of Justice (DOJ) has increasingly turned to civil statutes to bring cases against both individuals and financial institutions. Most notably, federal prosecutors have begun to brandish the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA or the Act),<sup>1</sup> a super-statute that arms them with a long statute of limitations, lower burden of proof, and significant fines based on relatively uncomplicated and familiar predicate acts. Recently, the government has had great success using FIRREA

in matters that heretofore would have been pursued under the criminal laws.

Notably, FIRREA does not create new prohibitions or requirements; rather, it imposes hefty penalties for pre-existing proscribed acts while giving the government an easier path to prosecution. With several litigation and enforcement victories under its belt thus far, it is likely that Act will become a mainstay of the DOJ's arsenal.

## THE S&L CRISIS PRODUCED A POWERFUL, YET NEGLECTED, TOOL

The economic impact of the savings and loan (S&L) scandal was profound. Between 1980 and 1994, more than 1,600 banks failed;<sup>2</sup> the total cost associated with resolving the crisis has been estimated to be as high as \$160 billion, including approximately \$132.1 billion paid for by federal taxpayers.<sup>3</sup> As with any complex phenomena, a singular cause may be impossible to identify; however, multiple studies found that fraud, insider abuse, and financial misconduct contributed to

<sup>1</sup> Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), P.L. 101-73, 103 Stat. 183 (1989).

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<sup>2</sup> Federal Deposit Insurance Corporation, *History of the 80s* 15 (1997), available at <http://www.fdic.gov/bank/historical/history/vol1.html>.

<sup>3</sup> See U.S. General Accounting Office, *Financial Audit: Resolution Trust Corporation's 1995 and 1994 Financial Statements* 13 (1996); see also FDIC, *supra* note 2, at 187.

a significant percentage of this loss, and inadequate internal controls allowed the crisis to spread.<sup>4</sup> Shortly after his inauguration, on February 6, 1989, President George H. W. Bush announced a bail-out plan to address the S&L crisis.<sup>5</sup> That plan was designed to bail out failed institutions, strengthen regulatory oversight of financial institutions in order to prevent such failures in the future, and recover assets from and prosecute individuals who acted criminally.<sup>6</sup>

Six months later, on August 9, 1989, Congress passed FIRREA, sweeping legislation that restructured the regulatory system, set stricter capital maintenance requirements, eliminated the counting of unidentifiable intangible assets (such as supervisory goodwill) toward capital reserve requirements, shortened amortization periods, and provided funding to prosecute financial fraud. The Act also created harsh new civil

penalties for violations of pre-existing criminal laws involving or affecting financial institutions.<sup>7</sup>

More significantly, Section 1833a(c)(2) further extends the possibility of FIRREA civil liability to violations of the following more generally applicable statutes as long as the underlying conduct is shown to “affect[] a federally insured financial institution”:<sup>12</sup>

- False claim upon a United States agency;<sup>13</sup>
- False statements to federal officials;<sup>14</sup>
- Concealment of assets from conservator, receiver, or liquidating agent;<sup>15</sup>
- Mail fraud;<sup>16</sup> and
- Wire fraud.<sup>17</sup>

**Easier Path to Prosecutorial Success.** FIRREA’s incorporation of the existing criminal statutes into a civil regime created an enforcement powder keg. The Act enables the DOJ to piggyback civil penalties onto the criminal fraud statutes, such as mail and wire fraud, that it has extensive experience investigating and prosecuting, while requiring the Department to establish its claims by only a preponderance of the evidence—rather than the reasonable doubt standard that applies to criminal actions.

Moreover, the Act extends the statute of limitations for such claims to 10 years after the cause of action accrued. This gives the Department more time to develop a robust investigation, a broader perspective on the effects of any alleged wrongdoing, and the ability to reach back and penalize acts that might otherwise be out of the range of the criminal statutes.

The Act also imposes hefty fines—up to \$1 million per violation or \$5 million for a continuing violation.<sup>18</sup> This recovery can be increased if a defendant

<sup>12</sup> “Financial institution” is defined by 18 U.S.C. § 20, which was itself amended by FIRREA and which, more recently, was amended by President Obama under the Fraud Enforcement and Recovery Act of 2009. See Fraud Enforcement and Recovery Act of 2009, P.L. 111-21, 123 Stat. 1617. The term is now defined to mean: an insured depository institution; a credit union with accounts insured by the National Credit Union Share Insurance Fund; a federal home loan bank or member; a system institution of the Farm Credit system; a small business investment company; a depository institution holding company; a Federal Reserve bank or member bank of the Federal Reserve System; an organization operating under Federal Reserve Act § 25 or § 25a; a branch or agency of a foreign bank; or a mortgage lending business or any person that makes in whole or in part a federally related mortgage loan. See 18 U.S.C. § 20.

<sup>13</sup> 18 U.S.C. § 287.

<sup>14</sup> 18 U.S.C. § 1001.

<sup>15</sup> 18 U.S.C. § 1032.

<sup>16</sup> 18 U.S.C. § 1341.

<sup>17</sup> 18 U.S.C. § 1343.

<sup>18</sup> See 12 U.S.C. § 1833a(b). With the inflation adjustments, the fines may reach \$1.1 million per violation or \$5.5 million for a continuing violation. See 28 C.F.R. § 85.3 (inflation adjustments for civil monetary penalties).

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**Broad Slate of Civil Penalties.** Section 1833a(c)(1) extends FIRREA’s civil penalties to crimes that by their terms relate to financial institutions. Those include:

- Theft, embezzlement, or misapplication by bank officer or employee;<sup>8</sup>
- False entries fraud by an officer, agent, or employee of a bank;<sup>9</sup>
- False statements to the FDIC;<sup>10</sup> and
- Financial institution fraud.<sup>11</sup>

<sup>4</sup> FDIC, *supra* note 2, at 33–34.

<sup>5</sup> President George H.W. Bush, The President’s News Conference (Feb. 6, 1989), available at [http://bushlibrary.tamu.edu/research/public\\_papers.php?id=44&year=1989&month=2](http://bushlibrary.tamu.edu/research/public_papers.php?id=44&year=1989&month=2)

<sup>6</sup> *Id.*

<sup>7</sup> Codified in 12 U.S.C. § 1833a. Unless specifically noted otherwise, references in the text to Sections refer to sections of the United States Code.

<sup>8</sup> 18 U.S.C. § 656.

<sup>9</sup> 18 U.S.C. § 1005.

<sup>10</sup> 18 U.S.C. § 1007.

<sup>11</sup> 18 U.S.C. § 1344.

“derives pecuniary gain from the violation, or if the violation results in pecuniary loss” to a person other than the defendant.<sup>19</sup> As under criminal laws, the Act allows prosecutors to seek such penalties for *each* transmission of a fraudulent statement or other discrete violation—enabling prosecutors to seek potentially billion dollar aggregate penalties.

And yet, despite these enhanced enforcement tools, FIRREA remained a sleeping giant for the first two decades of its existence. Prosecutors rarely relied on the Act in the years preceding the most recent financial crisis, and when they did so, their efforts were focused on small-scale fraud and individuals, many of whom had already been convicted of the underlying criminal acts.<sup>20</sup>

## AWAKENING THE GIANT

FIRREA's resurgence was glacial. The decade following the Clinton presidency saw a more than 50 percent drop in financial institution fraud prosecutions, a downward trend that continued through 2011.<sup>21</sup> Faced with increasing criticism over the failure to prosecute more individuals and financial institutions in connection with the crisis, the Obama administration attempted to turn the enforcement tide by launching the Financial Fraud Enforcement Task Force (the Task Force) in late 2009.<sup>22</sup> The interagency Task Force was charged with improving cooperation among federal, state, and local authorities in order to enhance

the investigation and prosecution of significant financial crimes.<sup>23</sup> Yet despite this nominal attention to financial fraud prosecution, the Task Force's record led to renewed criticism that it was nothing more than “a press release collection agency.”<sup>24</sup>

Although FIRREA had been underutilized since its enactment, it was not completely idle. Leon Weidman, Chief of the Civil Division in the Central District of California, had been using civil fraud suits in small-stakes financial litigation in Los Angeles since the 1990s.<sup>25</sup> Facing pressure to take a hardline approach against actors in the financial crisis, senior DOJ officials turned to Weidman for advice in using civil remedies to respond.<sup>26</sup> In late 2009, then-Assistant Attorney General for the Civil Division Tony West met with Weidman to discuss his use of FIRREA and, shortly thereafter, the Department issued a FIRREA subpoena to credit rating agency Standard & Poor's.<sup>27</sup> In May 2010, the United States Attorneys' Bulletin circulated a short article by Weidman suggesting the use of three civil remedies to supplement criminal prosecutions of mortgage fraud: the False Claims Act; injunctive relief to enjoin fraudulent activities; and, most notably, FIRREA.<sup>28</sup> FIRREA, Weidman suggested, might be a particularly useful tool to supplement criminal prosecutions due to its lower standard of proof, thus rendering FIRREA investigations “more efficient and faster” than criminal investigations.<sup>29</sup>

Weidman's guidance was well timed with developments in the United States Attorney's Office (USAO) for the Southern District of New York. In March 2010, just prior to the publication of Weidman's article in the United States' Attorneys Bulletin, United States Attorney Preet Bharara announced the creation of a new Civil Frauds Unit, which was specifically charged with combatting “large-scale and sophisticated financial frauds.”<sup>30</sup> Bharara described the newly formed unit as a counterpart to the Office's Complex Frauds Unit

<sup>19</sup> See 12 U.S.C. § 1833a(b)(3).

<sup>20</sup> See, e.g., *United States v. Moser*, 168 F.R.D. 171 (M.D. Pa. 1996) (entering a \$10,000 civil penalty against a wife and her convicted husband for submitting fraudulent submissions to financial institutions); *United States v. Mullins*, No. 91-4331, 1992 U.S. Dist. LEXIS 1818 (E.D. Pa. Feb. 12, 1992) (denying convicted defendants' motions to dismiss government's civil action seeking penalties under FIRREA); *United States v. Cohen*, No. 98-0131-R, 1998 U.S. Dist. LEXIS 8105 (W.D. Va. Mar. 27, 1998) (seeking FIRREA penalties against individuals related to allegations of bank fraud and submitting false statements to bank regulators); *United States v. Stemberger*, No. C 98-1807 CRB, 1998 U.S. Dist. LEXIS 18078 (N.D. Cal. Nov. 16, 1998) (entering a \$52,000 civil penalty against an individual accused of falsifying his residential mortgage loan application to Bank of America); *United States v. Vanoosterhout*, 898 F. Supp. 25 (D.D.C. 1995) (dismissing FIRREA claims against an individual accused of submitting false statements to the Small Business Administration); *United States v. Irizarry-Colon*, 2006 U.S. Dist. LEXIS 38850 (D.P.R. June 8, 2006) (seeking FIRREA penalties against convicted defendants related to false statements made to the Department of Agriculture's Farm Service Agency).

<sup>21</sup> Transactional Records Access Clearinghouse (TRAC), “Criminal Prosecutions for Financial Institution Fraud Continue to Fall” (Nov. 15, 2011), available at <http://trac.syr.edu/tracreports/crim/267/>.

<sup>22</sup> See, e.g., Dealbook, “Lawmakers Pursue Financial Crisis Prosecutions” (N.Y. Times, Dec. 9, 2009), available at <http://dealbook.nytimes.com/2009/12/09/lawmakers-pursue-financial-crisis-prosecutions/>.

<sup>23</sup> Exec. Order No. 13519, 74 Fed. Reg. 60123 (Nov. 17, 2011).

<sup>24</sup> Oversight of the Financial Fraud Enforcement Task Force: Hearing Before the Subcomm. on Admin. Oversight and the Courts of the S. Comm. on the Judiciary, 112th Cong. (Jun. 20, 2011) (statement of Sen. Chuck Grassley).

<sup>25</sup> Peter Lattman & Ben Protess, “From Anonymity to a Scourge of Wall Street,” N. Y. Times, Oct. 31, 2012, at A1.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> Leon (Lee) Weidman, “Civil Remedies for Mortgage Fraud,” 58(3) U.S. Attorneys' Bull. 22 (May 2010), available at [http://www.justice.gov/usao/eousa/foia\\_reading\\_room/usab5803.pdf](http://www.justice.gov/usao/eousa/foia_reading_room/usab5803.pdf).

<sup>29</sup> *Id.* at 23.

<sup>30</sup> U.S. Attorney S.D.N.Y., “U.S. Attorney Preet Bharara Announces Formation of Civil Frauds Unit” (Press Release, Mar. 31, 2010), available at <http://www.mainjustice.com/files/2010/03/Civil-Frauds-Unit-PR.pdf>.

in the Criminal Division, intended to take advantage of the civil law's lower burden of proof; broad pre-trial discovery; and the ability to recover substantial penalties, including, in some cases, treble damages.<sup>31</sup> Working side by side with their criminal counterparts, prosecutors in the Civil Frauds Unit would be "charged with using every weapon in [the Office's] diverse arsenal" to combat financial fraud.<sup>32</sup>

### NEW APPLICATIONS OF FIRREA

Bharara, along with DOJ prosecutors throughout the country, began employing FIRREA to address wrongdoing arising out of the financial crisis.<sup>33</sup> The first FIRREA cases used the statute conservatively. Prosecutors sought FIRREA penalties against companies for allegedly fraudulent activities that classically involved or affected financial institutions. Typical early FIRREA claims included creating fraudulent mortgage-related documents and submitting those fraudulent statements and claims to the Department of Housing and Urban Development (HUD), constituting false entries fraud and false credit applications.<sup>34</sup> Other allegations

representative of the conservative use of FIRREA included selling falsified loans to federally insured financial institutions, allegedly constituting mail and wire fraud affecting a federally insured financial institution.<sup>35</sup> The uptick in FIRREA claims filed by federal prosecutors was, perhaps, noteworthy, but not revolutionary. Shortly thereafter, however, the spark of revolution was lit and Bharara championed the application of FIRREA's stringent standards to a new type of defendant: the victimized financial institution itself.

On October 4, 2011, Bharara announced that his Southern District prosecutors had filed a civil lawsuit against the Bank of New York Mellon Corporation ("BNY Mellon"), one of the world's largest custody banks, alleging violations of FIRREA.<sup>36</sup> According to the complaint, BNY Mellon violated the federal mail and wire fraud statutes by guaranteeing certain foreign exchange customers that it would execute currency transactions according to "best execution standards" or at the "best rate of the day," and that the currency transactions would be executed free of charge.<sup>37</sup> The complaint alleged that, rather than charging the best rate of the day, BNY Mellon in fact reviewed the full range of prices at which a currency traded over the day, selected the worst rate, and then charged its customers a variation of that rate.<sup>38</sup> These misrepresentations "affected" the federally insured financial institutions that were BNY Mellon's institutional clients, thereby giving rise to FIRREA liability.<sup>39</sup>

These allegations represented the quasi-traditional application of FIRREA, albeit in a new context (foreign exchange transactions) and seeking significant penalties from a powerful defendant. The novel application of FIRREA appeared in the Amended Complaint, filed in February 2012. There, the USAO alleged that an additional federally insured financial institution had

<sup>31</sup> Id.

<sup>32</sup> Id.

<sup>33</sup> See, e.g., *United States v. Black Hills Tree Farm*, Civ. 09-5049-JLV, 2011 U.S. Dist. LEXIS 27773 (D.S.D. Mar. 17, 2011) (alleging that defendants violated 18 U.S.C. §§ 1001 and 1014 by falsely certifying to Rural Community Insurance, a private insurance company that held reinsurance through Federal Crop Insurance Corporation, that that it had sold its indemnified tree crop at 50 cents per tree); *Complaint, United States v. Morris*, No. 10 CV 10-4436 (GHK) (C.D. Ca. June 16, 2010) (alleging that defendant real estate brokers and agents created false and fraudulent statements and documents in borrowers' mortgage loan applications and submitted those false applications to financial institutions and to the Federal Housing Administration (FHA) and the Department of Veterans Affairs in violation of 18 U.S.C. §§ 1006, 1014, 1341, 1343, and 1344); *United States v. Luce*, No. 11 C 5158, 2012 U.S. Dist. LEXIS 85095 (N.D. Ill. June 20, 2012) (alleging that defendant made numerous false statements to HUD and FHA in connection with the origination of FHA-insured loans in violation of 18 U.S.C. §§ 1006 and 1014).

<sup>34</sup> I.e., violations of 18 U.S.C. §§ 1006 and 1014. See, e.g., *Amended Complaint, United States v. Buy-a-Home, LLC et al.*, No. 1:10-cv-09280 (S.D.N.Y. Feb. 15, 2012) (alleging that defendants created false and fraudulent records, appraisals, and certifications and submitted the same to HUD and FHA in violation of 18 U.S.C. §§ 1006 and 1014, and that defendants sent false, fraudulent, and misleading records, appraisal, and certifications to Countrywide Home Loans, Inc., in violation of 18 U.S.C. §§ 1341 and 1343); *United States v. Luce*, No. 11 C 5158, 2012 U.S. Dist. LEXIS 85095 (N.D. Ill. June 20, 2012) (alleging that defendant made numerous false statements to HUD and FHA in connection with the origination of FHA-insured loans in violation of 18 U.S.C. §§ 1006 and 1014); *Second Amended Complaint, United States v. Allied Home Mortg. Corp.*, No. 12 Civ. 02676 (GCH) (S.D. Tex. Nov. 2, 2012) (alleging that defendants knowingly made false statements to HUD for the purpose of fraudulently obtaining HUD mortgage insurance and obtaining HUD approval of various programs in violation of 18 U.S.C. §§ 1006 and 1014).

<sup>35</sup> I.e., violations of 18 U.S.C. §§ 1341 and 1343. See, e.g., *Amended Complaint, United States v. Buy-a-Home, LLC et al.*, No. 1:10-cv-09280 (S.D.N.Y. Dec. 13, 2010) (alleging that defendants created false and fraudulent records, appraisals, and certifications and submitted the same to HUD and FHA in violation of §§ 1006 and 1014, and that defendants sent false, fraudulent, and misleading records, appraisal, and certifications to Countrywide Home Loans, Inc., in violation of §§ 1341 and 1343).

<sup>36</sup> *United States Attorney, Southern District of New York, "Manhattan U.S. Attorney Sues Bank of New York Mellon Corporation for Fraudulent Practices in Connection with Foreign Exchange Services"* (Press Release, Oct. 4, 2011), available at <http://www.justice.gov/usao/nys/pressreleases/October11/bnymcomplaintpr.pdf>.

<sup>37</sup> *Complaint, United States v. Bank of New York Mellon*, 11 Civ. 06969 at ¶ 4 (S.D.N.Y. Oct. 4, 2011).

<sup>38</sup> Id. ¶ 5.

<sup>39</sup> Id. ¶ 67.

been affected by BNY Mellon's actions: BNY Mellon itself.<sup>40</sup> The Amended Complaint cited several legal suits that had been filed against the bank and federal and state investigations. It reasoned that these litigations and investigations had exposed BNY Mellon to "billions of dollars in potential liability, ongoing and mounting legal expenditures, as well as immediate and ongoing reputational harm which could continue to affect [the bank's] stock price," and thus BNY Mellon had been "affected" by its own conduct.<sup>41</sup>

The USAO quickly followed with two additional suits bringing FIRREA claims against defendant banks for allegedly fraudulent actions that "affected" the banks themselves, a further departure from the conservative model in which the fraud affected another financial institution:

- *United States v. Wells Fargo Bank, N.A.*: In *Wells Fargo Bank*, the government alleges that defendant Wells Fargo Bank, N.A. ("Wells Fargo") violated the mail and wire fraud statutes by, *inter alia*, making fraudulent representations to HUD and fraudulently certifying to HUD that certain loans were eligible for Federal Housing Administration insurance.<sup>42</sup> As in *Bank of New York Mellon*, the complaint alleges that Wells Fargo's conduct "affected" the bank by exposing it to legal liability and related expenditures, and by leading to actual financial loss and increased risk of loss.<sup>43</sup>
- *United States ex rel. O'Donnell v. Countrywide Financial Corporation*.<sup>44</sup> Here, the government alleged 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.<sup>45</sup> 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 and Countrywide had been exposed to billions of dollars of repurchase demands, the alleged fraud "affected" the banks themselves as federally insured financial institutions.<sup>46</sup> 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.<sup>47</sup>

### THE AFFECTING REQUIREMENT: INSTITUTIONAL PUSH BACK AND PROSECUTORIAL SUCCESS

The trio of Southern District suits were the first to test the boundaries of Section 1833a(2)'s "affecting a federally insured financial institution" requirement. Each defendant filed motions to dismiss, arguing, *inter alia*,

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that the defendant bank could not be both the perpetrator of the alleged fraud and the institution affected by such fraud for the purposes of Section 1833a, and that the government's reading of the statute was overbroad, inconsistent with both the natural reading of the statute and the statute's purpose.<sup>48</sup>

<sup>40</sup> Id. ¶¶ 124–129.

<sup>41</sup> Id. ¶¶ 126–127.

<sup>42</sup> First Amended Complaint of the United States of America at ¶ 169, *United States v. Wells Fargo Bank, N.A.*, No. 12 Civ. 7527 (JMF) (S.D.N.Y. Dec. 14, 2012). Notably, the government alleges both FIRREA claims premised on allegedly fraudulent statements and certifications to HUD (violations of 18 U.S.C. §§ 1001, 1005, and 1014), and separate FIRREA claims premised on the method of transmission of those statements and certifications (violations of 18 U.S.C. §§ 1341 and 1343).

<sup>43</sup> Id. ¶¶ 171–172.

<sup>44</sup> *United States ex rel. O'Donnell v. Countrywide Fin. Corp.*, No. 12 Civ. 1422 (JSR) (S.D.N.Y.).

<sup>45</sup> Amended Complaint of the United States of America ¶ 219, *Countrywide Fin. Corp.*, No. 12 Civ. 1422 (JSR) (S.D.N.Y. Jan. 11, 2013). Both Bank of America and Countrywide Financial were named as defendant banks in *Countrywide Financial Corporation*.

<sup>46</sup> Id. ¶¶ 159, 221.

<sup>47</sup> Id. ¶ 151.

<sup>48</sup> Bank of New York Mellon's Memorandum of Law in Support of its Motion to Dismiss the Second Amended Complaint at 10–15, *Bank of New York Mellon*, No. 11 Civ. 6969 (LAK) (S.D.N.Y. Aug. 6, 2012); Memorandum of Law in Support of Defendant David Nichols' Motion to Dismiss at 27, *Bank of New York Mellon*, No. 11 Civ. 6969 (LAK) (S.D.N.Y. Aug. 6, 2012); Defendant Wells Fargo Bank, N.A.'s Memorandum of Law in Support of Its Motion to Dismiss the First Amended Complaint at 39–44, *Wells Fargo Bank, N.A.*, No. 12 Civ. 7527 (JMF) (S.D.N.Y. Jan. 16, 2013); Memorandum in Support of Motion to Dismiss at 7–17, *Countrywide Fin. Corp.*, No. 12 Civ. 1422 (JSR) (S.D.N.Y. Dec. 21, 2012); Supplemental Memorandum in Support of Motion to Dismiss at 6–10, *Countrywide Fin. Corp.*, No. 12 Civ. 1422 (S.D.N.Y. Feb. 28, 2013).

**Bank of New York Mellon.** Judge Kaplan in *Bank of New York Mellon* became the first judge to interpret the “affecting a financial institution” requirement. He rejected the defendants’ arguments. The court held that the “victimization” interpretation of “affecting” advocated by the defendants—i.e., that in order for a financial institution to have been affected it must have been the victim of the unlawful conduct rather than the alleged perpetrator—was unduly narrow. The opinion notes that predicate acts underlying FIRREA liability include making false claims against the government, and such an act does not inherently require the victimization of a financial institution.<sup>49</sup> Indeed, Judge Kaplan held that actions benefitting a financial institution could serve as a basis for Section 1833a liability.<sup>50</sup>

Mindful of the inevitability that this first decision interpreting Section 1833a’s affecting requirement

Addressing the statutory structure of FIRREA, the court dismissed the defendants’ argument that the language “affecting a federally insured financial institution” in Section 1833a(c)(2) was added to ensure that subsection (c)(2), like subsections (c)(1) and (c)(3), would be limited to circumstances in which the victim of the wrongdoing was a federally insured financial institution.<sup>54</sup> The court noted that several of the offenses in subsections (c)(1) and (c)(3) do not require that any financial institution be victimized, and that nothing in the text forecloses the possibility that an institution could participate in and benefit from a proscribed act.<sup>55</sup> To that end, the court opined that in passing Section 1833a, Congress was not exclusively concerned with harm to financial institutions, but instead sought to address the “presence of criminal activity in matters meaningfully involving financial intuitions, however that activity may affect them.”<sup>56</sup>

Next, the court ruled that Section 1833a liability can extend to the “affected” financial institution itself, not only to third parties that may independently affect the financial institution. The court reasoned that the question of whether a financial institution is affected by an act is distinct from whether the institution participated in the act: “The former concerns the effects on the institution that proximately flowed from the charged scheme; the latter relates to the institution’s culpability in the scheme in the first place.”<sup>57</sup> According to the court, the textual basis for determining which entities may be found liable under FIRREA resides in Section 1833a(a), which prescribes liability to “whoever” violates the enumerated statutes; “whoever,” as defined by the United States Code, includes *any* person, corporation, or other entity.<sup>58</sup>

In short order, the court dismissed the remainder of BNY Mellon’s arguments. It held that the natural reading of “affecting” a financial institution did not preclude the possibility that an institution can affect itself, noting that it was “perfectly natural to say that one’s actions may affect oneself.”<sup>59</sup> Also unavailing was BNY Mellon’s argument that the penalty scheme set forth by FIRREA in Section 1818(i),<sup>60</sup> assigning penalties to be imposed on institutions by their

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would be appealed, Judge Kaplan’s opinion offered many reasons for rejecting the defendants’ proposed interpretation. First, the court looked to dictionary definitions of the word “affect,” noting that none of those definitions support the notion that “‘affecting’ may mean only victimizing,” and held that the “singularly broad word” chosen by Congress did not convey an intent to limit the application of the statute.<sup>51</sup> The court also cited the Second Circuit’s opinion in *United States v. Bouyea*,<sup>52</sup> interpreting a different provision of FIRREA, for the proposition that an institution could be “affected” even if it were not itself the victim of the defendant’s acts.<sup>53</sup>

<sup>49</sup> *Bank of New York Mellon*, No. 11 Civ. 6969 (LAK), 2013 U.S. Dist. LEXIS 58816, at \*30-32 (S.D.N.Y. Apr. 24, 2013).

<sup>50</sup> *Id.* at \*30-31.

<sup>51</sup> *Id.* at \*25-26.

<sup>52</sup> *U.S. v. Bouyea*, 152 F.3d 192 (2d Cir. 1998) (rejecting the argument that a financial institution was not affected when its subsidiary, but not the institution itself, was defrauded). The defendant in *Bouyea* had been convicted of defrauding Center Capital Corporation, a wholly owned subsidiary of Centerbank, which was a financial institution. The court found that given the evidence presented at trial, the effect of the fraud on Centerbank was “sufficiently direct” so as to support the jury’s finding.

<sup>53</sup> *Bank of New York Mellon*, 2013 U.S. Dist. LEXIS 58816, at \*26. In *Bouyea*, however, the financial institution at issue was not the defendant in the FIRREA action and its subsidiary was the victim, at least arguably making the financial institution an indirect victim. See *Bouyea*, 152 F.3d at 195.

<sup>54</sup> *Bank of New York Mellon*, 2013 U.S. Dist. LEXIS 58816, at \*28-34.

<sup>55</sup> *Id.* at \*28-34.

<sup>56</sup> *Id.* at \*32.

<sup>57</sup> *Id.* at \*42-43.

<sup>58</sup> *Id.* at \*56-57 (citing 1 U.S.C. § 1).

<sup>59</sup> *Id.* at \*57-58.

<sup>60</sup> See 12 U.S.C. § 1818(i).

regulators, foreclosed the imposition of additional penalties under Section 1833a. The court opined that the argument entirely irrelevant since there was no textual basis to exempt an institution from coverage under Section 1833a.<sup>61</sup>

Finally, the court rebuffed BNY Mellon's argument that assessing penalties against a financial institution would defeat the purpose of FIRREA by weakening the financial institution and creating additional risk to insured deposits—in other words, that a penalty would compound the effect of any alleged misconduct. This argument, the court stated, “ignore[d] the principal purpose of these penalties—deterrence.”<sup>62</sup> The court speculated that Congress may “have concluded that the deterrent effect of meaningful penalties is more important” than the risk of harm to the financial institution, and that courts can tailor the penalties to avoid such harm.<sup>63</sup>

**Countrywide Financial Corporation.** The defendants in *Countrywide Financial Corporation* were the next to go before a judge on this question. Oral arguments on 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.”<sup>64</sup> Despite that concern, Judge Rakoff issued an order just over a week later denying the defendants' motions to dismiss the FIRREA claims and promising that a reasoned opinion would be forthcoming. Three months later, the court released that opinion, becoming the second to interpret Section 1833a(c)(2)'s requirement that the underlying criminal violation must “affect[] a federally insured financial institution.”<sup>65</sup>

Like Judge Kaplan, Judge Rakoff turned to the dictionary definition of “affect,” observing that it means “to have an effect on.”<sup>66</sup> As the complaint alleged that Bank of America had paid billions of dollars to settle repurchase claims by Fannie Mae and Freddie Mac, Judge Rakoff ruled that the DOJ had

adequately alleged that a federally insured financial institution had been affected.<sup>67</sup> Unlike Judge Kaplan, Judge Rakoff declined to consider FIRREA's legislative history, statutory construction, or the other arguments put forth by the defendants to support their 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.<sup>68</sup> Rather, the court characterized the defendants' arguments as “endlessly complicated” and “utterly unconvincing, for the simple reason that they cannot explain away the plain language of section 1833a(c)(2), which is as unambiguous as it is dispositive.”<sup>69</sup>

After wholeheartedly adopting the theory that an institution could affect itself for the purposes of FIRREA liability, the court declined to rule on the government's second theory. That theory postulated that Countrywide's conduct affected federally insured financial institutions by proximately causing 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.<sup>70</sup> The court expressed deep reservations about the viability of that theory, noting that it “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.”<sup>71</sup>

**Wells Fargo Bank.** The third case in the Southern District “affecting” trio, *Wells Fargo Bank*, relied heavily on its predecessors' reasoning. 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.”<sup>72</sup> The court held that the government had sufficiently alleged that the bank had “affected” itself through both actual harm and, significantly, an increased risk of loss, including potential damages resulting from the government's suit itself.<sup>73</sup>

<sup>61</sup> Id. at \*58–\*61.

<sup>62</sup> Id. at \*61.

<sup>63</sup> Id.

<sup>64</sup> 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>.

<sup>65</sup> United States 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).

<sup>66</sup> Id. at \*16 (citing Webster's New World Collegiate Dictionary 23 (4th ed. 2002)).

<sup>67</sup> Id. at \*16.

<sup>68</sup> Id. at \*16–\*17.

<sup>69</sup> Id. at \*17.

<sup>70</sup> Id. at \*17–\*19.

<sup>71</sup> Id. at \*18–\*19.

<sup>72</sup> 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) (quoting Bank of New York Mellon, 2013 U.S. Dist. LEXIS 58816, at \*42).

<sup>73</sup> Id. at \*98–\*100.

## PRACTICAL CONSEQUENCES FOR FINANCIAL INSTITUTIONS

**Litigate or Settle?** FIRREA's hefty penalty provisions and lower burden of proof requirement will undoubtedly impact the negotiating positions of financial institutions that find themselves facing FIRREA investigations. Whereas a financial institution might previously have had leverage to argue that the government could not satisfy the "beyond a reasonable doubt" standard for a criminal prosecution, the hurdle that must be cleared before facing a potential sanction, albeit a civil penalty in lieu of a criminal prosecution, has now been lowered. Indeed, the financial exposure created by FIRREA will make it even more difficult for financial institutions to risk a prosecution where the government must only prove

an \$863.6 million penalty commensurate with what it contends was the gross loss incurred by Fannie Mae and Freddie Mac from the loans at issue.<sup>76</sup> Bank of America vigorously contests the government's assertions, arguing, *inter alia*, that the government has not shown that the banks proximately caused losses incurred by Fannie Mae and Freddie Mac, that gross loss is an incorrect measure of damages under Section 1833a, and that the government vastly overstated the number of loans at issue and incorrectly included in its figure loans that were not actually defective.<sup>77</sup> At most, the bank asserts, the court should impose the statutory maximum penalty of \$1.1 million.<sup>78</sup>

In the face of such a powerful enforcement tool, some institutions will certainly decide that, unlike Bank of America, they are not willing to take the risk of litigation but rather would prefer to settle the government's FIRREA claims, even if that means voluntarily paying significant penalties. For example, just one month after the *Countrywide Financial Corporation* verdict came down, the DOJ announced a significant FIRREA settlement with JPMorgan Chase & Co. (JPMorgan). The \$13 billion settlement resolved a variety of state and federal civil claims relating to residential mortgage backed securities issued by JPMorgan, Bear Stearns, and Washington Mutual. But, of that \$13 billion, \$2 billion was designated as a civil penalty to settle FIRREA claims.<sup>79</sup> Though just a portion of the overall settlement—itsself the largest with a single entity in American history—the FIRREA settlement reflects the largest individual FIRREA penalty to date.<sup>80</sup>

**Impact on Day-to-Day Operations.** It is important to note that while the Justice Department's current use of FIRREA is new, FIRREA itself does not create new liability. It simply makes it easier to bring an enforcement action regarding alleged conduct that was already prohibited. Accordingly, the Act should have little effect on the day-to-day operations of financial institutions. Simply put, what once was

**FIRREA's hefty penalty provisions and lower burden of proof requirement will undoubtedly impact the negotiating positions of financial institutions that find themselves facing FIRREA investigations.**

its claims by a preponderance of the evidence. The trial in *Countrywide Financial Corporation* illustrates the risks faced by financial institutions that are in the government's FIRREA crosshairs.

After the release of Judge Rakoff's denial of Bank of America's motion to dismiss, the case moved quickly to trial. Although the stakes were high, a statement made by spokesperson Lawrence Grayson at the time the lawsuit was announced offers insight into the bank's strategic perspective: "At some point, Bank of America can't be expected to compensate every entity that claims losses that actually were caused by the economic downturn."<sup>74</sup> Nonetheless, after a four-week trial, the jury returned a verdict in favor of the government. Damages have yet to be decided. Because the acts at issue "resulte[d] in pecuniary loss to a person other than the violator," the government contends that Section 1833a(b)(3)'s special rule for violations creating gain or loss applies, and that the civil penalty imposed should equal the amount of loss caused by the loans sold to Fannie Mae and Freddie Mac.<sup>75</sup> The government has asked the court to impose

<sup>74</sup> Ben Protes, "Tallying the Costs of Bank of America's Countrywide Nightmare" (N.Y. Times, Oct. 25, 2012), available at <http://dealbook.nytimes.com/2012/10/25/tallying-the-costs-of-bank-of-americas-countrywide-nightmare/>.

<sup>75</sup> Government's Memorandum of Law in Support of Imposition of Civil Penalties at 10, 24, *Countrywide Fin. Corp.*, No. 12 Civ. 1422 (JSR) (S.D.N.Y. Nov. 8, 2012).

<sup>76</sup> *Id.* at 24.

<sup>77</sup> Bank Defendants' Memorandum of Law Regarding Penalties at 1-3, *Countrywide Fin. Corp.*, No. 12 Civ. 1422 (JSR) (S.D.N.Y. Nov. 20, 2012).

<sup>78</sup> *Id.* at 35.

<sup>79</sup> JPMorgan Settlement Agreement at 3 (Nov. 19, 2013), available at <http://www.justice.gov/iso/opa/resources/69520131119191246941958.pdf>.

<sup>80</sup> U.S. Department of Justice, "Justice Department, Federal and State Partners Secure Record \$13 Billion Global Settlement with JPMorgan for Misleading Investors About Securities Containing Toxic Mortgages" (Press Release, Nov. 19, 2013) available at <http://www.justice.gov/opa/pr/2013/November/13-ag-1237.html>.

improper remains improper. Financial institutions that already have sufficient policies and procedures, and appropriate internal controls, should have no need to make changes to their operating procedures.

However, just as it will affect settlement negotiations with the government, the new aggressive use of the FIRREA enforcement regime may affect negotiations related to M&A transactions. Because it does not prohibit otherwise legal conduct, the FIRREA risk is unlikely to cause acquirors to perform additional diligence. However, if the due diligence they do perform suggests that a target company may have engaged in misconduct, the high penalties and ease of enforcement under FIRREA should cause acquirors to adjust their calculus as to whether the conduct is likely to lead to prosecution or settlement, how much such a prosecution or settlement would cost, and what type of indemnity or price reduction to negotiate.

### CONCLUSION: A BRAVE NEW WORLD?

The government's winning record thus far in the Southern District is likely to embolden federal prosecutors to expand their use of FIRREA and other civil statutes in cases that previously would have been brought as criminal matters. Indeed, in announcing the JPMorgan settlement, the DOJ's Assistant Attorney General for the Civil Division, Stuart F. Delery, said as much when he stated that the global settlement "underscore[d] the power of FIRREA and other civil enforcement tools for combatting financial fraud."<sup>81</sup> The DOJ has a history of taking an enforcement tool and pushing it as far as the courts will allow and into new areas outside what it was originally intended to address. Indeed, once that frontier is crossed, the Department rarely looks back. Given the courts' broad view thus far of what can constitute an effect on a financial institution—with even the legal costs incurred in defending against civil litigation or government investigations being a sufficient effect—it is difficult to see where the government will draw the line in employing its prosecutorial discretion.

The Department's use of the Racketeer Influenced and Corrupt Organizations statute, more commonly known as RICO,<sup>82</sup> is illustrative. Originally designed to enable prosecutors to more effectively combat the mafia, RICO presents prosecutors with similar advantages as FIRREA. It allows prosecutors to seek convictions for engaging in activity connected to predicate criminal acts but with the ability to put a defendant's

entire criminal history, including crimes for which he or she has not been charged, before a jury. RICO also allows prosecutors to seize assets pre-trial and to seek lengthy prison terms and treble damages against defendants who have committed two or more predicate acts of "racketeering activity"—one of a number of prohibited acts under pre-existing federal and state law—in connection with an "enterprise."<sup>83</sup> In addition, only one of the predicate racketeering activities need fall within the relevant statute of limitations;<sup>84</sup> all other predicates need only occur within 10 years of the first, effectively leap-frogging the statute's reach decades back in time. This is a powerful tool which, like the FIRREA statute of limitation extension, allows prosecutors to bring cases based on conduct for which the statute of limitations would have otherwise expired. Although RICO was enacted as part of the Organized Crime Control Act of 1970,<sup>85</sup> prosecutors have used it to pursue charges against a broad array of companies, associations, and individuals with no

**Just as it will affect settlement negotiations with the government, the new aggressive use of the FIRREA enforcement regime may affect negotiations related to M&A transactions.**

connection to organized crime. RICO is now utilized wherever prosecutors can fit it, from police corruption<sup>86</sup> to insider trading.<sup>87</sup>

The Supreme Court's decision in *Gabelli v. Securities and Exchange Commission* will only further incentivize prosecutors to deploy FIRREA. *Gabelli* held that the five-year statute of limitations for actions seeking civil penalties<sup>88</sup> begins to run when an alleged fraud occurs and not, as the SEC contended, when the government discovers or reasonably could have discovered the fraud.<sup>89</sup> Accordingly, the SEC may not bring civil penalty claims for conduct older than five years. That means that the window for

<sup>83</sup> 18 U.S.C. §§ 1961–1964.

<sup>84</sup> 18 U.S.C. §§ 1961.

<sup>85</sup> See supra, note 82.

<sup>86</sup> See, e.g., *United States v. Casamayor*, 837 F.2d 1509 (11th Cir. 1988) (affirming former police officers' convictions for racketeering in connection with drug smuggling).

<sup>87</sup> See, e.g., *United States v. Rothstein*, 717 F.3d 1205 (11th Cir. 2013) (describing underlying RICO charges filed against attorney Scott Rothstein in relation to a Ponzi scheme operated by Rothstein).

<sup>88</sup> See 28 U.S.C. § 2462.

<sup>89</sup> *Gabelli v. SEC*, 133 S. Ct. 1216, 1244; see also 28 U.S.C. § 2462.

<sup>81</sup> Id.

<sup>82</sup> Organized Crime Control Act of 1970, tit. IX, P.L. 91-452, 84 Stat. 922 (codified at 18 U.S.C. §§ 1961–1968).

bringing suits for conduct occurring in the lead up to the September 2008 financial collapse has passed. In light of the potential enforcement vacuum created by *Gabelli*, the DOJ may be all too happy to utilize FIRREA's 10-year statute of limitations to pursue litigation or settlements that the SEC previously would have spearheaded.

Accordingly, unless and until a court of appeals issues an opinion walking back the lower courts' expansive interpretation of FIRREA's scope, we can expect that prosecutors will continue to expand their use of the erstwhile response to the savings and loan crisis against the financial institutions that allegedly played a role in the more recent credit crisis. ■

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