



JONES DAY  
**COMMENTARY**

## FIRREA CIVIL MONEY PENALTIES: THE GOVERNMENT'S NEWFOUND WEAPON AGAINST FINANCIAL FRAUD

In recent years, the U.S. Department of Justice (“DOJ”) has begun using the civil money penalty provision of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”) to investigate and prosecute persons suspected of financial fraud. Although FIRREA was enacted more than 20 years ago in the wake of the savings and loan crisis, its civil money penalty provision generally lay dormant until its recent resurrection by the DOJ as a tool to combat financial fraud, particularly residential mortgage fraud. As a result, there was until recently a scarcity of case law interpreting the civil penalty provision. Two recent decisions, however, address important issues of first impression regarding the scope of liability and calculation of civil penalties under FIRREA. On April 24, 2013, a New York federal district court ruled that a federally insured financial institution may incur FIRREA liability for engaging in fraudulent conduct “affecting” itself (as opposed to frauds by third parties that victimized the bank). See *United States v. The Bank of New York Mellon*, No. 11 Civ. 06969 (S.D.N.Y.). This case followed on the heels of a March 6, 2013 ruling by a California

federal district court that set forth an eight-factor analysis to be used in assessing civil money penalties under FIRREA. See *United States v. Menendez*, No. 11 Civ. 06313 (C.D. Cal.).

### WHAT IS THE FIRREA CIVIL PENALTY PROVISION?

Section 951 of FIRREA, codified at 12 U.S.C. § 1833a, authorizes the DOJ to bring a complaint seeking civil money penalties against persons who violate one or more of 14 enumerated criminal statutes (or predicate offenses) that involve or affect financial institutions and government agencies. For nine of the predicate offenses, which deal specifically with banks or other financial institutions in one way or another (such as bank fraud, 18 U.S.C. § 1344), the government does not have to prove any additional element beyond violation of the predicate offense itself. For the five others, which are more general offenses such as false claims on the U.S.

government (18 U.S.C. § 287), false statements within federal jurisdiction (18 U.S.C. § 1001), fraud on federal receivers and conservators (18 U.S.C. § 1032), and mail and wire fraud (18 U.S.C. §§ 1341, 1343), the government must additionally prove that the violation of the underlying criminal statute was one “affecting a federally insured financial institution” (such as an FDIC-insured bank or thrift). FIRREA does not define the term “affecting” and, until recently, there were no reported decisions interpreting that term.

Recently, the DOJ has invoked FIRREA, often in conjunction with the False Claims Act (31 U.S.C. § 3729 *et seq.*), to seek multimillion- or multibillion-dollar penalties against some of the largest financial institutions in the United States. Earlier this year, the DOJ filed its largest-ever lawsuit under FIRREA against the world’s largest credit rating agency, Standard & Poor’s (“S&P”), seeking more than \$5 billion in civil money penalties based on allegations that S&P engaged in a scheme to defraud investors who purchased residential mortgage backed securities and collateralized debt obligations.

## WHAT ARE THE BENEFITS OF FIRREA FROM THE DOJ’S PERSPECTIVE?

FIRREA provides the DOJ with a number of key advantages in conducting investigations and bringing civil penalty suits against persons suspected of financial fraud.

**Scope.** FIRREA is broader in scope than the False Claims Act, which is generally limited to circumstances in which the United States suffers a pecuniary loss as a result of a fraud. By comparison, FIRREA allows the DOJ to pursue civil money penalties for any frauds involving or affecting certain types of financial institutions. 12 U.S.C. § 1833a(c). FIRREA’s broad scope is principally derived from the inclusion of the mail fraud and wire fraud statutes (18 U.S.C. §§ 1341 and 1343) among FIRREA’s predicate offenses, provided that the fraud “affects” a federally insured financial institution. The mail fraud and wire fraud statutes encompass virtually any fraud where interstate mail, email, telephone, faxes, or other electronic communications are used in furtherance of the fraud.

**Burden of Proof.** Unlike in a criminal prosecution, where the government must prove the defendant’s guilt “beyond a reasonable doubt,” in a FIRREA civil case, the DOJ must prove only that a defendant committed one of FIRREA’s predicate offenses by a “preponderance of the evidence.” 12 U.S.C. § 1833a(f). This lower standard of proof makes FIRREA a useful alternative or supplement to criminal prosecutions, because it allows the DOJ to seek substantial civil money penalties even when it lacks evidence to prove the defendant’s guilt beyond a reasonable doubt.

**Investigative Powers.** FIRREA authorizes the DOJ to issue administrative subpoenas for the purpose of conducting a civil investigation in contemplation of a civil proceeding. 12 U.S.C. § 1833a(g). Under this broad subpoena power, the DOJ may engage in extensive pre-trial investigations, including taking depositions of key witnesses and compelling the production of documents and records, without obtaining prior judicial authorization. For instance, FIRREA’s subpoena power enabled the DOJ to conduct a multiyear investigation of S&P prior to filing its lawsuit early this year. During the course of that investigation, the DOJ’s attorneys reportedly served hundreds of civil subpoenas, spent thousands of hours reviewing and analyzing millions of pages of documents, and contacted and interviewed more than 150 witnesses, including dozens of former S&P analysts and executives.

**Statute of Limitations.** FIRREA has a 10-year statute of limitations, which is far longer than the more typical period of three to five years applicable to civil lawsuits. 12 U.S.C. § 1833a(h). This extended time period provides the DOJ with additional time to conduct its pre-suit investigations and to bring suits in connection with violations that would ordinarily be time barred.

**Civil Money Penalties.** While FIRREA does not authorize the imposition of criminal sanctions (such as imprisonment), the civil money penalties available under FIRREA are potentially crippling. FIRREA authorizes penalties of up to \$1.1 million per violation. For continuing violations, the maximum increases up to \$1.1 million per day or \$5.5 million per violation, whichever is less. 12 U.S.C. § 1833a(b)(1) and (2) (as adjusted pursuant to 28 C.F.R. § 85.3(a)(6) and (a)(7)). Moreover, FIRREA allows the court to increase the penalty

up to the amount of the pecuniary gain that any person derives from the violation, or the amount of pecuniary loss suffered by any person as a result of the violation. 12 U.S.C. §1833a(b)(3). The DOJ has invoked this special penalty rule to seek more than \$5 billion in civil money penalties from S&P in the current litigation.

## WHEN DOES A FRAUD “AFFECT” A FEDERALLY INSURED FINANCIAL INSTITUTION?

On April 24, 2013, the U.S. District Court for the Southern District of New York issued the first judicial interpretation of the phrase “affecting a federally insured financial institution” as used in FIRREA. In *United States v. The Bank of New York Mellon*, the DOJ brought suit against The Bank of New York Mellon (“BNYM”) and one of its employees under FIRREA for alleged violations of the mail fraud and wire fraud statutes. These charges were in connection with the defendants’ alleged scheme to defraud BNYM’s custodial clients by fraudulently misrepresenting that BNYM provided “best execution” when pricing foreign exchange trades under its “standing instructions” program.

In support of its claims, the DOJ contended that the defendants’ alleged fraudulent scheme “affected” a federally insured financial institution—namely BNYM itself—as well as a number of other federally insured financial institutions that were BNYM foreign exchange clients. BNYM moved to dismiss the complaint, contending that a federally insured financial institution may be “affected” by a fraud only if it were the victim of or an innocent bystander to the alleged fraud, but not if it were the perpetrator.

After considering the text, statutory structure, and legislative history and purpose of FIRREA, the court rejected the defendants’ narrow construction. The court held that Congress intended the statute to apply in circumstances in which a federally insured financial institution was “affected” by the fraud, not just a “victim” of a fraud. The court viewed the term “affecting” as a “singularly broad term” meaning something closer to “involving” than “victimizing.” The court stated that the word “affect” ordinarily means “to act upon” as in “to produce an effect ... upon,” “to produce a material influence

upon or alteration in,” or possibly “to have a detrimental influence on” and, in the court’s opinion, none of those definitions came close to equating “affecting” with “victimizing.”

The court considered that the essential purpose of FIRREA’s civil money penalties was to deter fraud that put federally insured deposits at risk, in order to protect depositors and ultimately U.S. federal taxpayers. It was entirely consistent with that purpose to hold an institution liable for fraudulent conduct that harmed itself. The court also noted that FIRREA’s penalty provision applied to “whoever” violated a predicate offense, and that the statute could not be read to exclude the affected financial institution itself from the meaning of the word “whoever.”

The court also concluded that a fraud may “affect” an institution within the meaning of FIRREA if it exposes that institution to a new or increased *risk* of loss, even without a showing of any *actual* loss. As such, the court held that the DOJ sufficiently alleged that BNYM was negatively affected by its own fraud, even though BNYM may have profited from that fraud. The DOJ’s complaint alleged that BNYM had been named as a defendant in numerous private lawsuits as a result of its alleged fraud, which required it to incur litigation costs, exposed it to billions of dollars in potential liability, and damaged its business by causing a loss of clients, forcing BNYM to adopt a less-profitable business model and harming its reputation. Furthermore, the court held that these negative effects were of a different character than any profits BNYM gained from the alleged fraud, such that those profits could not be understood to offset the negative losses and risks that affected BNYM. As the DOJ’s complaint had sufficiently alleged that the fraud had negatively affected BNYM, the court declined to determine whether a direct but positive effect alone would be sufficient to “affect” a financial institution for the purposes of FIRREA.

The court did state one limiting principle on FIRREA liability, holding that to “affect” an institution, the fraud must be the proximate cause of the alleged negative effects on the institution, and that the touchstone of proximate causation was reasonable foreseeability. The court recognized that at “some point” the effect of a defendant’s fraud on a financial institution may become “so attenuated, so remote, so indirect” that

it does not in any meaningful sense “affect” the institution. In the case before it, however, the court held that it was reasonably foreseeable that the alleged scheme, if uncovered, would result in the kind of harms suffered by BNYM.

The court’s decision will be of immediate relevance in at least two other cases currently before the Southern District of New York, which present the same question of whether FIRREA recognizes an “affect yourself” theory of liability. Interestingly, according to recent public reports, a district court judge presiding over one of those cases commented that he was “troubled” by the DOJ’s “affect yourself” theory of liability, although he stated that his comment was only a preliminary one. Arguably, the court’s broad reading of FIRREA in *The Bank of New York Mellon* case appears to contradict the view of at least one other federal district court that “[p]unitive statutes, such as FIRREA, are to be narrowly construed.” See *United States v. Vanoosterhout*, 898 F. Supp. 25, 30 (D.D.C. 1995). In any event, the court’s conclusion that the term “affecting” is a “singularly broad term”—such that a financial institution is “affected” by a mere increased risk of loss—will encourage the DOJ to continue invoking FIRREA as it aggressively investigates and prosecutes financial institutions and others for financial fraud.

## HOW ARE CIVIL MONEY PENALTIES CALCULATED UNDER FIRREA?

As discussed above, FIRREA establishes maximum penalty limits but otherwise leaves the precise award within the discretion of the court. FIRREA does not set forth any factors that a court must consider in calculating civil money penalties, and until recently, there were no reported cases that discussed such factors. On March 6, 2013, the U.S. District Court for the Central District of California issued the first judicial decision setting forth factors relevant to assessing civil money penalties under FIRREA.

In *United States v. Menendez*, the DOJ brought a FIRREA suit against a licensed real estate broker who had allegedly committed bank fraud in violation of 18 U.S.C. § 1344(1) by submitting a false certification to the U.S. Department of Housing and Urban Development (“HUD”) in connection with a short sale of a residential property. After obtaining summary judgment on the issue of the defendant’s liability, the DOJ requested that the court impose a penalty in the amount of approximately \$1.1 million, which was the amount of the loss allegedly suffered by HUD as a result of the defendant’s fraudulent scheme. (The damages claim included 27 other transactions, as to which the court struck the DOJ’s proof of damages for inadequate foundation.) The defendant argued that the amount sought by the DOJ was excessive and requested that the court either deny the DOJ’s motion or impose a substantially reduced penalty.

In its ruling on the issue, the court noted the absence of any authority setting forth factors or criteria that the courts should consider in assessing a civil penalty under FIRREA. In the absence of such authority, the court looked to factors that courts have applied in other contexts involving civil penalties. The court set forth the following eight factors for determining the civil penalty amount under FIRREA:

1. The good or bad faith of the defendant and the degree of his/her scienter;
2. The injury to the public, and whether the defendant’s conduct created substantial loss or the risk of substantial loss to other persons;
3. The egregiousness of the violation;
4. The isolated or repeated nature of the violation;
5. The defendant’s financial condition and ability to pay;
6. The criminal fine that could be levied for this conduct;
7. The amount the defendant sought to profit through his fraud; and
8. The penalty range available under FIRREA.

Applying these factors, the court imposed a civil money penalty of \$40,000, or the amount that the defendant had profited from his alleged fraud. In determining that the \$1.1 million penalty sought by the DOJ was excessive, the court noted that the *maximum* criminal fine for bank fraud was \$1 million. The court also found that the likely fine under the federal sentencing guidelines would be in the range of \$20,000–\$30,000. The court also rejected the DOJ’s argument that a defendant’s finances are irrelevant to assessing a civil penalty under FIRREA, holding that a heavy penalty was not warranted due to the fact that the defendant had limited assets and income and had filed a petition for Chapter 7 bankruptcy.

*Menendez* establishes that the courts have flexibility in determining the actual civil penalty awarded under FIRREA. Under this framework, the courts are instructed to consider the particular facts of the case and the defendant’s unique circumstances, and not to rigidly adhere to the statutory maximums. The *Menendez* factors will likely be followed by other courts adjudicating FIRREA claims. In the meantime, the decision provides a general framework for defendants and their advisers to evaluate the likely range of financial penalties that a court may impose for FIRREA violations.

## LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our “Contact Us” form, which can be found at [www.jonesday.com](http://www.jonesday.com).

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