



Second Circuit Rejects Government’s Theory of Fraud in Major FIRREA Case

Court’s Ruling Restricts When a Contractual Breach May Be Held Fraudulent Under Federal Law

On May 23, 2016, the U.S. Court of Appeals for the Second Circuit reversed a nearly \$1.3 billion civil penalty imposed against Countrywide Home Loans, Inc. and related defendants (collectively, “Countrywide”) under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”). See *United States ex rel. O’Donnell v. Countrywide Home Loans, Inc.*, Nos. 15-496, 15-499, 2016 WL 2956743 (2d Cir. May 23, 2016). As a necessary predicate offense for these FIRREA penalties, the government alleged that Countrywide violated the federal mail and wire fraud statutes when selling poor-quality mortgages to government-sponsored entities.

On appeal from the U.S. District Court for the Southern District of New York (Rakoff, J.), the Second Circuit addressed an important and recurring question in federal law: Under the mail and wire fraud statutes, when can a willful breach of contract constitute an actionable fraud? The Second Circuit’s answer to that question affects not only the scope of civil liability under

FIRREA but also civil liability under other federal statutes—including the Racketeer Influenced and Corrupt Organizations Act (“RICO”) and the False Claims Act—that incorporate either mail and wire fraud violations as predicate offenses or common-law fraud principles.

The Second Circuit held that a contractual breach can be fraudulent under federal law only if the defendant had fraudulent intent *at the time the purportedly fraudulent statements were made*. Thus, if a fraud case rests solely on representations made only at the time at which the contract is entered—as was the case against Countrywide and is frequently the case—the defendant can be liable only if it believed the representations were false when it signed the contract. This ruling significantly constrains the ability of the government and private plaintiffs to allege that contractual breaches rise to the level of fraud, and it will affect not just FIRREA claims but any claims that can rest on mail or wire fraud as a predicate offense or that otherwise incorporate common-law fraud principles.

Background

Following the collapse of the mortgage market in 2007, Countrywide transformed its subprime lending division with the goal of selling prime loans to government-sponsored entities, such as Fannie Mae and Freddie Mac. Countrywide's contracts with these entities included representations about the quality of the mortgages being sold. For example, Countrywide's contract with Fannie Mae stated that the mortgages sold would, "as of the date of the transfer," each be an "Acceptable Investment," with that term defined to be an investment for which Countrywide knows "of nothing ... that can reasonably be expected to cause private institutional investors to regard the mortgage as an unacceptable investment; cause the mortgage to become delinquent; or adversely affect the mortgage's value or marketability."¹ Similarly, Countrywide's agreement with Freddie Mac represented that, "as of" the delivery date, these loans would "have the characteristics of an investment quality mortgage."²

The government contended that these contractual representations violated the federal mail and wire fraud statutes,³ because Countrywide sold loans pursuant to the agreements knowing that the loans were not investment quality. According to the government, this in turn made Countrywide liable under a FIRREA provision that permits civil penalties against anyone who violates or conspires to violate the federal mail or wire fraud statutes in a manner "affecting a federally insured financial institution."⁴ Following a multiweek trial, the jury found Countrywide liable under FIRREA, for which Judge Rakoff imposed a mammoth \$1.27 billion penalty against Countrywide, along with a \$1 million penalty against a key company executive.

Second Circuit Decision

Countrywide appealed the judgment. In a unanimous opinion authored by Judge Wesley, and joined by Judges Raggi and Droney, the Second Circuit reversed. The court declined to resolve a key argument raised by Countrywide, which was that a FIRREA penalty cannot stand when the only financial institution "affected" by the fraud is the defendant itself. (That question remains an important, open issue under FIRREA.)⁵ Instead, the Second Circuit held that the government failed

to prove Countrywide violated the mail and wire fraud statutes as a predicate for a FIRREA violation. The court used longstanding common-law principles of fraud to narrow the scope of federal mail and wire fraud.

The federal mail and wire fraud statutes impose criminal penalties on "[w]hoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises" uses the mail or wires for such purpose.⁶ As the Second Circuit noted, the exact contours of a "scheme to defraud" under the statutes have not been resolved, but statutes using common-law terms should be interpreted according to the terms' common-law meaning unless the statute indicates otherwise. Common-law fraud principles thus inform the meaning of fraud under the federal mail and wire fraud statutes.

Under the common law, the Second Circuit explained, parties cannot prove fraud solely on the basis of a contractual breach; at the same time, however, an applicable contract does not wholly remove conduct from the scope of fraud. The key to determining whether conduct that breaches a contract might also be fraudulent is not simply whether the breach was intentional or willful, but rather "*when* the [fraudulent] representations were made and the intent of the promisor *at that time*."⁷ Thus, a contractual promise can support a claim for fraud only if one proves that the promisor did not intend to perform the contract—i.e., that the contractual promise was a lie—at the time *the contract was executed*. Without such proof, even the most egregious violation of the contract will not permit the promise to be prosecuted or pursued in a civil claim as fraud.⁸

Having incorporated this principle of "contemporaneous intent" into the federal mail and wire fraud statutes, the Second Circuit then held that the government's evidence at trial was inadequate. The only statements alleged by the government to be fraudulent were Countrywide's contractual guarantees of future quality—e.g., that any mortgages sold would be an "Acceptable Investment." But the court found "no proof at trial that any quality guarantee was made with fraudulent intent at the time of contract execution."⁹ The government did not allege fraud by silence, and the Second Circuit thus did not address the scope of any such theory.

Nor did the court accept the government's argument that these contractual representations, although included in an initial contract, were in fact made later on "at the point of sale." The court found that argument irreconcilable with the contracts themselves, which stated that Countrywide "'makes' or 'warrants or represents' certain statements" about loan quality—as opposed to stating that Countrywide "will make" guarantees about loan quality in the future.¹⁰

Because the government failed to meet its evidentiary burden for FIRREA's predicate mail or wire fraud violation, the Second Circuit held that the jury had no legally sufficient basis for its decision. The court accordingly reversed the \$1.3 billion judgment of the District Court and remanded the case with instructions to enter judgment for the defendants.

Implications

The Second Circuit's decision significantly limits the government's ability to penalize what it perceives to be financial wrongdoing or fraud based on contractual representations. Without proving contemporaneous fraudulent intent at the time a contract is made, the government can no longer use contractual representations as the basis for mail or wire fraud prosecutions and, in turn, for alleged FIRREA violations—which means that contractual breaches are more likely to remain simply breaches, instead of being converted after the fact into fraudulent schemes that can carry far more severe penalties.

Moreover, notably, although the Second Circuit's decision came in the context of a FIRREA claim, mail or wire fraud violations can be predicate offenses for other statutes as well—including RICO, which (unlike FIRREA) can be enforced by private plaintiffs.¹¹ This decision is thus an important addition to the quiver of more than just parties facing a government investigation or lawsuit under federal fraud statutes. The decision may also prove useful to parties defending against charges of other types of federal fraud, such as alleged violations of the False Claims Act,¹² that incorporate principles of common-law fraud.

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Endnotes

- 1 2016 WL 2956743, at *2 & n.4.
- 2 *Id.* at *2.
- 3 18 U.S.C. §§ 1341, 1343.
- 4 12 U.S.C. § 1833a(a), (c)(2).
- 5 Three decisions in the Southern District of New York—including a ruling by Judge Rakoff in the *Countrywide* case—have endorsed this theory of "self-affecting" conduct. *See United States v. Bank of New York Mellon*, 941 F. Supp. 2d 438, 453-56 (S.D.N.Y. 2013); *United States v. Countrywide Fin. Corp.*, 961 F. Supp. 2d 598, 605 (S.D.N.Y. 2013); *United States v. Wells Fargo Bank NA*, 972 F. Supp. 2d 593, 630 (S.D.N.Y. 2013). The Second Circuit has yet to squarely address the issue, however.
- 6 18 U.S.C. §§ 1341, 1343.
- 7 2016 WL 2956743, at *6.
- 8 *See, e.g., id.* at *7 (requiring "proof—other than the fact of breach—that, at the time a contractual promise was made, the promisor had no intent ever to perform the obligation").
- 9 *Id.* at *11.
- 10 *Id.*
- 11 18 U.S.C. §§ 1962, 1964(c).
- 12 31 U.S.C. §§ 3729–3733.

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