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A New Front in Financial Institution Scrutiny— Treble Damage Threat Against HUD Lenders Based on Alleged Program-Level Failures

The Department of Justice has served notice that it intends to take aggressive action – and seek billion-dollar recoveries – against banks and residential mortgage lenders on a new front for conduct it alleges amounts to fraud.

Yesterday, the government filed a sprawling, 50-page long complaint in federal court against Deutsche Bank and MortgageIT alleging violations under the federal False Claims Act (and other common law principles), seeking damages and penalties of more than 1.1 **billion** dollars. In a press conference announcing the lawsuit, the U.S. Attorney for the Southern District of New York strongly indicated that there are similar lawsuits on the horizon against other lenders: **“It would not be a fantastical stretch to think we’re looking at other financial institutions as well.”**

The complaint filed yesterday alleges that residential mortgage lender MortgageIT and Deutsche Bank (which acquired MortgageIT in 2007) defrauded the federal government between 1999 and 2009 by making false certifications and statements to the Department of Housing and Urban Development (HUD) in connection with federally-insured Federal Housing Administration (FHA) loans to homebuyers. The government alleges that MortgageIT and Deutsche Bank lied to HUD and fraudulently induced it to insure loans by certifying compliance with various requirements of the Direct Endorsement Lender program, even though the lenders were not in compliance. The Direct Endorsement Program permits approved lenders to determine whether a proposed mortgage is eligible for FHS insurance under applicable program regulations, and then to underwrite and close the mortgage without prior HUD review. In its complaint, the government alleges that lapses in compliance that should lead to liability included failures to audit early payment defaults by borrowers; to dedicate “sufficient” staff to quality control; and to affirmatively address deficiencies in the quality control system.

The potential exposure for such violations of the False Claims Act (FCA) is extraordinary. The FCA provides for treble damages, as well as mandatory civil penalties of up to \$11,000 for each false claim to the government. In the case against MortgageIT and Deutsche Bank, the government alleges single damages of at least \$386 million, which amounts to over \$1.1 billion when trebled – and that does not even include the civil penalties.

The government’s filing of this case raises significant concerns for lenders who participated in the Direct Endorsement Program and were engaged in underwriting FHA mortgages. FCA liability has been found in connection with federally insured mortgages where false claims were submitted to government entities such as HUD by virtue of false certifications of compliance with criteria required for loan origination. However, traditionally such FCA cases have resulted from individual loans with specific issues that HUD questioned after paying out reimbursements.

Since the financial crisis began, commentators have noted the potential for an increase in this type of liability due to the surge in foreclosures. However, to date this has not occurred. As recently as last year, Assistant Attorney General Lanny Breuer, in testimony to the Financial Crisis Inquiry Commission, described recoveries in such cases as ranging from \$318,000 (for one loan) to nearly \$6,000,000 (for 27 loans). By contrast, the case against MortgageIT and Deutsche Bank attempts to call into question all defaulting federally-backed loans approved during the period the government alleges that the defendants fraudulently certified compliance with HUD rules and regulations, leading to the demand for over \$1 billion. There are serious questions as to whether such allegations, unmoored from specific loan files and from defaults to which the alleged miscertification is material, would satisfy the requirements of the FCA.

Because the case highlights the potential for such enormous damages, it is virtually inevitable that the relators’ bar and opportunistic whistleblowers will follow the government’s lead and look to file

claims complaining of program-level fraud under the FCA's unique "qui tam" provisions, which permit private individuals to file FCA lawsuits on the government's behalf and to obtain a percentage of any recovery obtained. Postings encouraging such behavior are already appearing on whistleblower internet sites.

The government's indication that it intends to pursue similar suits against other lenders, the substantial potential exposure based on the government's theories of liability, and the renewed emphasis on financial fraud particularly in the context of the housing meltdown, all counsel that financial institutions which participated in the Direct Endorsement Program and were engaged in underwriting FHA mortgages insured by the government would be well advised to take affirmative steps to internally evaluate potential issues in this area and/or prepare for a government subpoena, civil investigative demand, or other form of investigation.

At Reed Smith, we have been working closely with mortgage clients and following the industry for years, and have been closely monitoring this situation. We have a breadth of mortgage industry and government regulatory experience that we can draw upon to help clients facing this situation.

For more information, please contact Wendy Schwartz, Andrew Bernasconi, or your Reed Smith relationship partner.

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