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Department of Justice Contends Due Diligence Failures Can Be the Basis for False Claims Act Liability

In early May 2011, the U.S. Department of Justice sued Deutsche Bank and its subsidiary, Mortgage IT Inc., in the Southern District of New York for alleged violations of the False Claims Act, 31 U.S.C. §§3729, et seq. This civil suit is widely considered to signal a new wave of False Claims Act prosecutions to recover government funds expended in the recent mortgage crisis.

The suit relates to statements allegedly made by Mortgage IT (prior to its acquisition by Deutsche Bank) when arranging for Federal Housing Administration (FHA) insurance on (what in actuality were) non-qualifying loans. The government alleges that the defendants ignored numerous red flags and made false certifications to the U.S. Department of Housing and Urban Development (HUD) regarding their compliance with HUD eligibility rules generally and the eligibility of specific loans for FHA insurance. Once such loans were insured, they became very marketable for resale and securitization and often were transferred to other institutions while removed from the defendants' books.

The government asserts that because Mortgage IT falsely certified that it was screening loans for default risk when qualifying them for FHA insurance, non-qualifying Mortgage IT loans were insured. When they defaulted, HUD became responsible for hundreds of millions of dollars in claims. To put this situation in context, during the 12 month period ending in March 2011, FHA paid more than $15 billion in insurance claims relating to mortgage defaults. Through this case and the other cases that are certain to follow, the government is attempting to turn due diligence underwriting failures into actionable fraud.

The False Claims Act was passed in 1863 to recover monies from contractors who defrauded the Union army. As times changed and government grew, the scope of the law expanded to cover fraud related to Medicare, military contracts, and other government contracts and programs. Suits under the False Claims Act can be brought by the government or, subject to stringent government review conditions, by "whistle-blowers" on behalf of the government. Individual whistle-blowers can get a portion of recovered damages, including treble damages and penalties, for each act of fraud. The amount of damages varies based upon whether, after reviewing the matter, the government pursues the case itself or the individual pursues the case on his own.

To recover under the False Claims Act, it must be shown that a defendant knowingly submitted a false claim or made a false statement material to a false claim. In order to prevail in its case against Deutsche Bank and Mortgage IT, the government, among other things, will attempt to establish that the submission of false certifications was common in the business of the defendants and endorsed and enforced by management. Moreover, the government must show that the actions of the defendants were the proximate cause of the injuries to the government. However, as has been well documented, mortgage fraud

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cases often involve multiple bad actors: borrowers lie about their income and home value, mortgage brokers submit false property and borrower information, appraisers fail to properly do their jobs or are otherwise complicit in inflating property values, and others in the chain move loans through the process despite knowledge of problems with borrowers and loans. In order to prevail, the government will need to show that Deutsche Bank and Mortgage IT, and not the acts of others, was the proximate cause of the government's paying illegitimate claims.

The claims against Deutsche Bank and Mortgage IT – which, if proven, could subject the defendants to more than $1 billion in damages and fines – came after aggressive investigations by the Justice Department into mortgage lending practices and the use of federal guarantees. While the current case is for civil damages, in the past, civil cases have been the precursor to criminal actions. Moreover, more potential False Claims Act cases are likely percolating at the individual claimant level as – with the significant layoffs in the financial services industries – potential whistle-blowers purporting to have first-hand knowledge of bad acts abound. The potential for increased whistle-blowing can also be gleaned from the surge in suspicious activity reports filed with the government related to mortgage lending. And, smelling blood in the water, many plaintiffs' attorneys have identified potential causes of actions and are actively looking for the "right" plaintiff to be the face of their cases.

In this climate, financial institutions involved in mortgage lending and underwriting – especially where certifications to the government or government reliance on the institution is a factor – should be aware of the possibility that if the government incurs a financial loss related to such mortgages, federal False Claims Act liability may become an issue. In addition, most states have their own equivalent false claims statutes. Legislation was introduced in Ohio in April 2011 to create such a law as it relates to Ohio contracts and relationships.

In light of public governmental statements indicating that the case against Deutsche Bank and Mortgage IT may not be the last, institutions engaged in mortgage lending, underwriting, and due diligence for FHA-insured loans should consider their potential exposure to claims based upon statements made to the government and/or relied upon by others who make representations to the government. Such institutions should take appropriate steps to bolster their compliance programs in such areas. In fact, any entity or industry which contracts with the federal (and, likely, state) government or otherwise uses federal or state funding or loans should be aware of the increased use of false claims laws as a means of regulation and recoupment, and ensure that all necessary steps have been taken to minimize institutional risk related to such activities.