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LITIGATION SPECIAL REPORT

Making banks pay

Manhattan U.S. Attorney Preet Bharara deploys civil laws in new ways to secure record settlements from Wall Street's biggest banks over the subprime mortgage debacle.

By Julie Triedman

AT A HEARING IN MANHATTAN IN MARCH, U.S. District Judge Jed Rakoff had a question for prosecutors who had argued that Bank of America Corporation should have to pay $2.1 billion over its Countrywide unit's massive mortgage underwriting lapses: Why, he asked, weren't they demanding more?

In a rare move, the judge encouraged them to think bigger—closer to $5 billion, the amount Fannie Mae and Freddie Mac had to pony up in insurance claims when the Countrywide-underwritten loans failed by the thousands. (BofA's attorneys, meanwhile, argued that the penalty should be no more than $1.1 million.)

At press time Rakoff hadn't decided on the final bill for BofA. But his words indicate that the bank won't get off lightly after a jury found it liable last fall for misconduct within a Countrywide Financial Corporation mortgage loan processing program known as "the Hustle," where quality controls were thrown out the window.

As recently as last summer, many bank executives believed that their institutions' civil liability for the subprime market meltdown was finally winding down. More than five years had passed since the meltdown, civil statutes of limitation were expiring en masse, and the resolution of crisis-related litigation looked within reach. Then the picture changed.

In October, JPMorgan Chase & Co. agreed to pay a record-shattering $13 billion to a welter of federal and state law enforcement agencies and regulators over its part in foisting bad residential mortgage–backed securities (RMBS) on investors. Three days later, a federal jury in Manhattan found BofA liable in the Countrywide "Hustle" case for the unit's origination practices.

Now, the only thing defense counsel are certain of is that the government's civil enforcement genie is out of the bottle. The enforcement efforts "are huge and growing," says Sullivan & Cromwell's H. Rodgin Cohen, veteran counselor to Wall Street bank boards. "There are a lot more [targets] still out there."

Banks expect to pay upward of $48 billion to resolve their role in misrepresentations involving RMBS, using the JPMorgan settlement as a guide. The soon-to-be-determined BofA penalty is widely viewed as a test case for how much it will cost other banks to put the origination mess behind them.

Key to both cases is a new strategy by Manhattan U.S. Attorney Preet Bharara: aggressively deploy a law that until relatively recently hadn't been aimed at major banks. It's the Financial Institutions Reform, Recovery and Enforcement Act, dusted off by the U.S. Department of Justice in 2010 but gaining traction last year. Federal prosecutors hope that successfully wielding FIRREA and the False Claims Act, another law that hadn't been used against banks, will help quell sharp criticism for its failure to indict executives who helped cause the crisis.

Facing a newly empowered DOJ, defense lawyers betray an edge of hysteria. Where will it end? "The scary thing about FIRREA," says one who has advised banks responding to civil-side subpoenas, "is that it creates a quasi-criminal liability for financial institutions without the protections of criminal law." Negotiating a civil law enforcement settlement is "not like negotiating with a private plaintiff, where you have a sort of

Venn diagram, and wherever you overlap, that's where you find your settlement. The government just has their own circle—and you've just got to convince them to move it in your direction," says a lawyer handling a recent bank settlement.

Defense lawyers and former prosecutors credit the U.S. attorney's office in Manhattan with laying the groundwork for national efforts to prosecute mortgage-market miscreants. "It was that office bringing groundbreaking cases that emboldened the rest of the [Justice Department] to bring the same types of cases," says BuckleySandler partner Andrew Schilling, Bharara's civil division chief from 2010 to 2012.

THE CIVIL STANDARD OF PROOF

The DOJ appeared to have little appetite for mortgage-related criminal cases after it lost its only major federal criminal trial about the subprime meltdown, in 2009, involving the Brooklyn U.S. Attorney's trial of two Bear Stearns Companies Inc. hedge fund managers, Ralph Cioffi and Matthew Tannin. That prompted Sen. Elizabeth Warren, D-Mass., to question whether Attorney General Eric Holder's pricey mortgage settlements were a "timid enforcement strategy" that absolved banks of malpractice. U.S. District Judge Rakoff penned a scathing critique in The New York Review of Books in January contrasting Holder's efforts with the DOJ's successful efforts after the "junk bond" bubble to bring boardroom-level fraudsters to justice, noting that Drexel Burnham Lambert CEO Michael Milken earned a decade in prison.

Bharara, a former organized crime prosecutor, was sworn in just three months before the Bear Stearns verdicts. He had ringside seats on the Brooklyn U.S. attorney's trial disaster. Cioffi and Tannin faced up to 20 years in prison for counts including securities fraud, wire fraud and conspiracy over their failure to warn of looming losses. At trial, prosecutors presented damning emails that, they argued, proved that the two had lied to investors. But jurors interviewed postacquittal told *The New York Times* that the men's actions didn't cross the line into fraud; defense evidence that even economists had been uncertain about the direction of the mortgage market had seeded doubt in jurors' minds.

Bharara began looking for ways to bring high-impact civil cases, which require a lower burden of proof than criminal cases (a "preponderance of evidence" rather than "beyond a reasonable doubt"). Bharara and his then-deputy, Boyd Johnson III, found a like mind in Andrew Schilling, a former head of the office's civil rights unit; in March 2010 Bharara lured Schilling from Friedman Kaplan Seiler & Adelman to lead the civil division. In Schilling's first week, he was surprised to find that Bharara had temporarily moved down the hall. In the past, if civil-side lawyers had a meeting with the U.S. attorney, they trudged down Chambers Street to the criminal division. Now, the criminal side had to make the trip.

Bharara, Schilling, and Johnson (now at Wilmer Cutler Pickering Hale and Dorr) were particularly interested in the False Claims Act, a civil statute that carried the threat of treble damages, and in FIRREA, which many view as a quasi-criminal

CASES FILED IN THE SOUTHERN DISTRICT OF NEW YORK

Date filed	Target	Claims	Status
12/10	Buy-a-Home LLC and five individual defendants	FCA/FIRREA	Settled in 2011 for $4M with admissions of conduct; owner received 70-month sentence on related criminal charges.
5/11	Deutsche Bank AG, MortgageIT Inc.	FCA	Settled in May 2012 for $202M with admis-sion of conduct.
8/11; case removed to the Southern District of Texas	Allquest Home Mortgage f/k/a Allied Home Capital Corp.	FCA/FIRREA	Third amended complaint filed in October.
10/11	The Bank of New York Mellon & David Nichols	FIRREA	Partial settlement with BNY Mellon in 2012; trial on remaining claims expected in 2015.
2/12	CitiMortgage Inc.	FCA/FIRREA	Settled in February 2012 for $158M with admission of conduct.
2/12	Flagstar Bank FSB	FCA	Settled in February 2012 for $133M with admission of conduct.
10/12	Wells Fargo Bank N.A.	FCA/FIRREA	Trial expected in mid-2015.
10/12	Countywide Financial Corp., Bank of America Corp. and Rebecca Mairone	FCA/FIRREA	Trial ended 10/23/13 with government win on all counts. Appeal/penalty award pending.
4/13	Golden First Mortgage Corp. & David Movtady	FCA	Motion to dismiss decision pending.
2/14	JPMorgan Chase Bank	FCA	Settled in March for $614 million.

CASES FILED IN OTHER DISTRICTS

7/11 District of Illinois	Robert Luce	FCA/FIRREA	Luce lost motion to dismiss in 2012; settle-ment negotiations ongoing.
2/12 Northern District of Colorado	Bella Homes LLC and five executives	FIRREA	Mortgage broker settled 3/12 for $10M with admission of all allegations. Individuals settled for a combined $2.8M.
3/12 District of Columbia	Bank of America Corporation et al.	FCA/FIRREA	National mortgage servicing settlement.
11/12 Eastern District of Pennsylvania	First Bank of Delaware	FIRREA	Settled in November 2012 for $15.5M.
2/13 Central District of California	McGraw Hill Companies Inc., Standard & Poor's Financial Services LLC	FIRREA	In discovery; government pushing for early 2015 trial and seeking as much as $5B.
5/13 Northern District of California	Reunion Mortgage Inc.	FCA	Amended complaint filed in December after individual defendant won a motion to dismiss.
8/13 Western District of North Carolina	Bank of America et al.	FIRREA	Magistrate judge recommended dismissal in March.
1/14 Eastern District of North Carolina	Four Oaks Fincorp Inc.	FIRREA	Settled for $1.2M in January.

Sources: PACER and BuckleySandler

statute. Originally framed by Congress after the savings and loan crisis to ensnare those defrauding federally insured banks and S&Ls, the act imposed civil liability for two kinds of criminal violations: those that inherently involved a financial institution, like false entries in bank records; and mail and wire fraud, insofar as they "affected" a financial institution. Unusually, the law authorized civil-side prosecutors to issue subpoenas and to breach a criminal division firewall to access grand jury information. Moreover, in contrast to the False Claims Act, where a government entity had to be the victim, cases could be brought where private losses were alleged.

Though the 1989 act's statutory penalties were lower than the FCA's—limited to losses or gains due to the misconduct—it looked promising. But it hadn't been used much, except in Los Angeles, where the Central District's longtime civil chief, Leon Weidman, had been filing subpoenas under the act for years. Weidman's targets were those at the bottom of the fraud pyramid, where banks were the victim; they included borrowers who had lied on mortgage applications and neighborhood mortgage brokers who misrepresented borrowers' creditworthiness to banks. In the wake of the Bear Stearns verdict, Weidman told the DOJ to take a closer look at the statute in combating mortgage fraud.

'GETTING REAL MONEY BACK'

Weidman's team had never used the statute against bank lenders and underwriters at the top of the mortgage food chain. Bharara and his top deputies wanted to change that. "We wanted to do cases that were significant enough that they were going to be litigated hard," Bharara says. "We were going to be developing clear law and precedent." His office's theory hinged on a single word in the statute that applies the act to fraud that "affected" a federally insured financial institution. Under the interpretation Bharara's office advanced, the institution could be "affected" by its own misconduct. Manhattan prosecutors were sent to learn what they could from Weidman; in 2010 the civil division issued its first subpoenas under the statute.

Bharara was also interested in the FCA, which in 2009 was increasingly being wielded against drug companies to strike billion-dollar-plus settlements. He sent prosecutors to Boston and Philadelphia, two offices with special teams devoted to bringing complex civil fraud cases; the Philadelphia U.S. attorney had also used the FCA against small mortgage lenders, but those had generally settled without formal litigation.

Inc. The case built on a successful case filed a year before against a minor mortgage market participant, Buy-A-Home LLC.

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Bharara, says Schilling, "didn't do small." But getting major cases off the ground required a shift in priorities. Bharara's 50 civil prosecutors, a third of the number on the criminal side, were already enormously busy. At any one time, they oversee about 1,000 active mostly defense-side matters involving a federal agency, ranging from slip-and-fall lawsuits to employment, FOIA and other disputes. In 2009 they were further bogged down representing the U.S. Treasury in the General Motors Company mega-bankruptcy and others. A handful of lawyers continued to bring civil rights, environmental and FCA cases, but "people's dockets were getting overwhelmed," says Bharara. There had never been a dedicated group whose only job "was to wake up and figure out what affirmative cases to do to ferret out fraud or hold people responsible." Bharara announced the formation of a six-lawyer civil frauds unit in March 2010, transferring three attorney positions from criminal to civil.

To lead the unit, Bharara recruited Heidi Wendel, a former civil-side assistant U.S. attorney heading up the state's 350-person Medicaid fraud control unit. Wendel had never met Bharara, but he quickly won her over. The civil fraud unit's mission, Bharara told her, "was in part to do big cases, attacking the big players that caused the crisis and getting real money back," Wendel recalls. Even though the unit was tiny, its efforts would be backed by the entire division.

To get major civil frauds cases off the ground also required a shift toward a more active, even combative stance than was the norm in the division. Civil "is a little more pointy-head culture than criminal," says Wendel. That quickly changed under Bharara.

'A GUN TO YOUR HEAD'

In early 2011 the division readied its first high-profile case, the mortgage origination practices of Deutsche Bank AG and a mortgage unit it had acquired, MortgageIT

That case had alleged liability for false claims about individual loans insured by the Federal Housing Administration that later defaulted. This time, lead prosecutor Brian Feldman pegged FCA liability not on individual defective loans, but on misrepresentations by MortgageIT in its annual certifications to the FHA. Those certifications allowed the bank to bypass the administration to endorse its loans for FHA insurance as a so-called direct endorsement lender, generating huge profits for the unit by increasing the price of mortgage loans when they resold them—and costing the U.S. taxpayer billions of dollars in insurance claims when many defaulted.

The expansion of liability was vast and sudden. Using a powerful narrative that would become a Southern District model, prosecutors accused the bank of intentionally weakening quality control, claiming treble damages on the face value of all loans the bank made, not just defective ones (minus anything the government got for the loans). Feldman's HUD certification theory "changed the whole game," says Wendel. "It changed what you had to prove." Three more FCA filings—against Allied Home Capital Corp., Citigroup Inc.'s mortgage unit and Flagstar Bank FSB—soon followed. Within a year, all but Allied had settled, reaping nearly $500 million in settlements and admissions of the alleged conduct.

Litigators were beginning to draw parallels with the FCA settlements extracted from drug companies, which also relied on the government as a major buyer and on the continuing goodwill of regulators. "The business model is one where it's difficult if not impossible for companies to try these cases," says a defense lawyer involved in major pharma FCA settlements. "They've got a gun to your head." Beyond the potential for devastating trial losses, the suits expose banks to a "constant drumbeat of leaks, on-the-record statements of government officials slamming you," another defense lawyer says. A major ongoing investigation or suit also means that applications before regulators will be delayed or rejected; and under new stress test rules, a bank facing a major civil enforcement action may be asked to bump up reserves to cover potential losses.

The first real test of the U.S. attorney's interpretation of FIRREA came in October 2011, when the civil frauds unit sued The Bank of New York Mellon Corporation and a bank executive. Bharara won't say why this case was chosen to test-drive the theory; but with lawsuits by three state attorneys general and an exposé in The Wall Street Journal, the outlines of the bank's alleged misconduct were already widely known. The suit alleged that the bank had violated the act when it lied to customers with custodial accounts that it would execute foreign currency transactions at the best rate of the day, when in fact it routinely used the worst rates. For the first time, the government was claiming liability where the harmed party—custodial customers—were not governmental entities.

The bank's lawyers at Kellogg, Huber, Hansen, Todd, Evans & Figel quickly moved to dismiss the case, arguing that the bank could not be both the perpetrator and the "affected" financial institution under the act. But in April, U.S. District Judge Lewis Kaplan sided with prosecutors. In fact, Kaplan suggested that the law could apply even if the effect of the fraud was to generate profit for the defendant bank. (A trial is pending in 2015.)

A year after BNY Mellon, the civil fraud unit trained its civil arsenal on two of the biggest players in the mortgage origination business, Wells Fargo & Company and BofA/Countrywide. In the Wells case, as in Deutsche Bank, prosecutors claimed the bank had engaged "in a long-standing and reckless trifecta of deficient training, deficient underwriting and deficient disclosure" to the FHA in order to protect the profits it gleaned as part of the direct lenders program. Over a period of eight years, prosecutors alleged, the bank internally identified—but concealed from the FHA—that some 6,300 of loans it had certified as insured were "seriously deficient," violating the FCA.

Still, the HUD–insured loans were a small slice of the mortgage market. In its case against BofA, the unit would go larger, targeting misrepresentations that Countrywide made to private enterprises sponsored by the federal government, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. The case, if successful, promised to open up vast new areas of federal liability. "Our view internally was always that even though there's some risk when you use a statute in a particular way, that it was worth it," Bharara says. "If people weren't going to use a statute in that way because there's no precedent on it, it's the effective equivalent of having bad precedent. You weren't going to get anywhere."

Prosecutors focused on a 2007 Countrywide loan-production program, "High Speed Swim Lane," whose acronym, HSSL, or "Hustle," proved unfortunate for the bank. Its goal was to rush through approvals for mortgage loans for customers identified as good bets. But in doing so, prosecutors alleged, Countrywide stripped away quality controls and pushed through more defective loans, which were resold to and guaranteed by Fannie Mae and Freddie Mac.

The Hustle trial, the nation's first large-scale civil fraud trial related to the mortgage crisis, began in September. Seven assistant U.S. attorneys appeared for the government, versus 24 lawyers for the bank and its subsidiary and eight for Rebecca Mairone, the sole individual defendant. The play was risky, Bharara says. But "the value for the government winning in a massive case with very sophisticated counsel on the other side, who were maybe overconfident, was that the next institution would know that we're not afraid to go to trial. We're not afraid to go to trial and lose."

The verdict, returned in just six hours, stunned the defense bar. "Now you have a trial in which it becomes clear that juries are ready to return a verdict against banks in cases involving technical, complex financial issues," says former Assistant U.S. Attorney Feldman, now at Harter Secrest & Emery.

The enforcement efforts "are huge and growing," says one senior banking lawyer. "There are a lot more [targets] still out there."

The targeting of individual executives has also roiled bank executives. "What the banks most don't want is for individuals to get sued," says Wendel, now at Jones Day.

The loss, coming days after the JPMorgan settlement, has triggered a profound reassessment about remaining liability. "There's a sense now that every single case is going to have to settle," says one senior litigator, reflecting on a recent panel where federal enforcement efforts were discussed.

Lawyers for the banks continue to field state and federal demands for information. In early 2014, those combined efforts were "exponentially greater than has ever occurred before both in terms of volume and in terms of severity of potential penalties," says Sullivan & Cromwell's Cohen. Credit Suisse Group AG and Citigroup Inc. were both said to be facing similar probes related to their RMBS sales practices.

In February, JPMorgan again announced a major settlement, agreeing to pay $614 million to resolve FCA claims stemming from its loan origination practices. But in a first indication that there may be limits to the application of FIRREA, the Justice Department floundered in late March in its first effort to use the law to target alleged misconduct in a bank's securitization of mortgage loans, rather than in the origination process. A magistrate judge recommended that the case, against BofA, be dismissed, citing flaws in the complaint. A decision by the district judge was expected by late spring.

Parsing each bank's ultimate legal exposure is difficult. But it's clear that there are new rules to the game—and so far, Preet Bharara's office, at least, is on a winning streak. ■