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FIRREA: A Powerful Tool for the Government

Christopher H. Casey*

To date, 10 financial institutions have reached large settlements with the Department of Justice resolving allegations of fraudulent packaging and sale of residential mortgage-backed securities in the run-up to the 2007–2008 financial crisis. A decade out from the crisis, it is worth taking a look back at the conduct that led to these cases, the reasons the government was able to extract such large penalties and how financial institutions can prepare for such enforcement actions in the future.

The U.S. Department of Justice ("DOJ") financial fraud enforcement program's actions in the wake of the 2007–2008 financial crisis have led to some of the largest settlements in the history of the DOJ. To date, 10 financial institutions have reached settlements with the DOJ resolving allegations of fraudulent packaging and sale of residential mortgage-backed securities ("RMBS") in the run-up to the crisis. The government has recovered a total of nearly $62 billion in fines and penalties from these cases. While a few institutions have yet to resolve their RMBS cases with the DOJ, the RMBS cases have largely run their course. A decade out from the crisis, it is worth taking a look back at the conduct that led to these cases, the reasons the government was able to extract such large penalties and how financial institutions can prepare for such enforcement actions in the future.

THE PACKAGING AND SALE OF RMBS

For those who have seen the movie "The Big Short," the story of how the packaging and sale of RMBS fueled the financial crisis is familiar. In the 2005–2007 time period, major financial institutions acquired pools of residential mortgage loans from mortgage originators, packaged those loans into securities and sold the securities to investors. Because many mortgage originators during this period relaxed underwriting standards to increase their volume of mortgage loans, many of the loans were of poor quality—because of the borrower's low credit score or high debt-to-income ratio, the mortgage's high loan-to-value ratio, etc. In many cases, the evidence showed that the banks that purchased the loans from the originators either did not perform adequate due

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* Christopher H. Casey is a partner in the White-Collar Criminal Defense, Corporate Investigations and Regulatory Compliance Group at Duane Morris LLP. From 2014 to 2016, he was a Deputy Associate Attorney General at the U.S. Department of Justice, where his role included supervising the Justice Department's cases against financial institutions, including the cases discussed in this article. He can be reached at chcasey@duanemorris.com.

diligence on the loans or were aware of the quality problems with the loans and bought them anyway. Once they packaged the loans into securities and sold the resulting RMBS, the banks often did not fully disclose to investors the problems with the loans. After the mortgages failed, the investors lost billions.

The federal government and many states initiated investigations of the banks' due diligence of the loans contained in the securities and the adequacy of their disclosures to investors. In these investigations, the government had a powerful tool at its disposal, the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA").

THE POWER OF FIRREA

Signed into law following the savings and loan crisis of the late 1980s, FIRREA gives the federal government the authority to bring civil actions against any company or individual that commits one or more predicate felonies, including mail or wire fraud "affecting a federally insured financial institution." Though it lay dormant for many years, the DOJ began using FIRREA after the financial crisis against mortgage originators for making allegedly false representations about the quality of mortgage loans to the Federal Housing Administration ("FHA"). The FHA relied on those representations, insured the loans and suffered losses. The DOJ also began using FIRREA against the financial institutions that purchased mortgage loans from originators, packaged and sold the RMBS to investors.

Three features of the FIRREA statute demonstrate its utility for government enforcers:

(1) The standard of proof is lower than is required to prove criminal fraud—preponderance of evidence rather than beyond a reasonable doubt;

(2) The amount of the civil penalty can be as high as the amount of the gain or loss caused by the offense; and

(3) The statute of limitations period is double the period for a criminal prosecution—10 years as opposed to five.

Each of these provisions makes FIRREA a particularly potent tool in the RMBS cases:

- Obtaining evidence to show, beyond a reasonable doubt, that a financial institution or its employees committed fraud in the packaging and sale of financial instruments such as RMBS can be challenging. By lowering the standard of proof, FIRREA allows the government to bring a civil action for fraud even when the evidence would not support

bringing criminal charges.

- The amount of the civil penalty available for the government to collect—whether the government chooses to proceed under a gain theory or a loss theory—quickly gets into the billions of dollars. Defendants facing such penalties have to think long and hard before putting the government to its proof and risking payment of a massive penalty. Most defendants conclude that cutting their losses and settling for a reduced penalty is the only viable option.
- RMBS cases are complicated and document-intensive, requiring an enormous amount of government resources and time. By doubling the limitations period, FIRREA gives the government an extra five years to comb through the voluminous documents and testimony to build the case.

FIRREA has proven to be a very effective statute for the government in the RMBS investigations. So far, all of the government's FIRREA cases against institutions that sold RMBS have been resolved without litigation, so the government did not have to prove those cases in court. The nearly $62 billion in fines and other penalties the government has recovered includes the largest settlement in the history of the DOJ, the 2014 Bank of America settlement, which totaled $16.65 billion. In addition, the government has successfully fought challenges to its use of FIRREA. Several banks tried to convince courts that Congress did not intend the law to be used in situations where, as in the RMBS cases, the bank is the alleged perpetrator of the fraud rather than the victim of it. In each of those cases, the court has ruled for the government.

HOW CAN FINANCIAL INSTITUTIONS BE PREPARED?

The DOJ's success with using FIRREA following the financial crisis suggests that the statute will continue to pose a threat to financial institutions for many years to come. If history is any guide, the recent wave of investigations in the financial sector—including, in addition to the RMBS cases, the Libor and Forex prosecutions—will not be the last. So what steps can financial institutions take to prepare for the next wave of government enforcement? Here are a few:

Invest in a Robust Compliance Program

Some institutions that have paid the government—and private plaintiffs—large amounts since the financial crisis have significantly beefed up compliance. Morgan Stanley, for example, has gone from 25 people in its internal risk

department 10 years ago to 400 today.[1] These are wise investments. The practical effect of FIRREA's lower standard of proof is that even negligent rather than intentional conduct by bank employees can lead to FIRREA charges, because the government does not need to prove the institution's intent beyond a reasonable doubt. A robust compliance program will prevent employees from making careless mistakes, which, to a prosecutor, can look like intentionally fraudulent behavior.

Don't Ignore Problems When You Find Them

A compliance program is only effective if the organization takes corrective action when it finds problems. Too often, an organization's compliance program reveals problems that the organization simply ignores. In the RMBS cases, for example, the institutions typically engaged a due diligence firm to review mortgage loans in a "loan pool" for quality before purchasing the loans and including them in a RMBS. This review would involve a "credit" review (to determine whether the loans met the originator's underwriting guidelines) and a "compliance" review (to determine whether the loans complied with federal, state and local laws and regulations). Too often the institutions ignored red flags that came back from the due diligence review, such as when high numbers of loans in a pool did not meet the originator's underwriting guidelines. Instead, the institutions often simply included the loans in the RMBS and failed to fully disclose the true quality of the loans to investors. In such cases, the government is able to show that the institutions knowingly sold defective loans, *i.e.*, they "knew" of the loans' low quality because of the results of the due diligence. The only thing worse than having a weak compliance program is having a robust one and failing to follow it.

Improve Communication within the Institution

In the RMBS cases, typically one department within the bank performed due diligence on the quality of the loans while an entirely separate department made representations about the quality of the loans to investors. And in many cases these different groups did not communicate with one another. This led to a situation where the "left hand" did not know what the "right hand" was doing, *i.e.*, the person signing off on the language in the representations to investors did not communicate with the due diligence people to be sure that the representations were accurate. A good compliance program will include systems to ensure that all departments in the institution are communicating and working together.

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[1] "Morgan Stanley GC Sees End of Big Enforcement Era," Law 360, February 28, 2018.

CONCLUSION

The government tends to keep using any law enforcement tool that it has found to be effective. FIRREA is such a tool. Thus, we can expect the government to continue to use FIRREA against financial institutions when it finds or suspects wrongdoing. Financial institutions, large and small, need to be ready. When it comes to FIRREA enforcement, an ounce of prevention is worth a pound of cure.