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Government's False Claims Act Complaint Against Major Financial Institution Alleges False Certifications of Compliance With HUD Underwriting Rules

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An action against Deutsche Bank AG and its subsidiary, MortgageIT, Inc., reinforces the need for a robust compliance program, including following up on any statements of corrective action or other identified issues, taking seriously certifications of compliance with rules and regulations, and being thorough in due diligence of potential acquisition targets, including their compliance with government rules and regulations.

The U.S. Attorney for the Southern District of New York, Preet Bharara, recently filed a False Claims Act ("FCA") suit against Deutsche Bank AG and its subsidiary, MortgageIT, Inc., for making allegedly false statements and certifications of compliance with HUD rules requiring due diligence in underwriting FHA-insured mortgages. The complaint is notable not just because of the alleged damages, which could exceed $1 billion, but also because of the government's attempt to

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use the FCA to turn due diligence failures in underwriting mortgages into fraud claims against a major financial institution.

While this lawsuit is the first FCA action the government has brought against a financial institution, alleging false certification of compliance with due diligence rules in underwriting FHA-insured mortgages that defaulted during the financial crisis, U.S. Attorney Bharara indicated that it likely will not be the last, stating, "It would not be a fantastical stretch to think we are looking at other lending institutions as well." If the government's theory in this case is upheld by the courts, it could open the door for many additional FCA lawsuits against financial institutions that underwrote mortgages insured by the FHA, which, the complaint alleges, constitute approximately one-third of all new residential mortgages in the United States.

The FCA has been in existence since the Civil War era and has, in recent years, been one of the primary tools in the government's arsenal to attempt to curb Medicare and Medicaid fraud and false claims by government contractors. However, until this action, the FCA had not been used by the government to address alleged underwriting lapses by lending institutions arising out of the mortgage boom and subsequent collapse during the past several years.

THE COMPLAINT

The complaint brings claims under three sections of the FCA: 31 U.S.C. §§ 3729(a)(1)(A), 3729(a)(1)(B), and 3729(a)(1)(G). In these claims, the government asserts: (1) that defendants knowingly, or with deliberate ignorance or reckless disregard, presented or caused to be presented false claims to an officer or employee of the government; (2) that defendants knowingly or with deliberate ignorance or reckless disregard, made, used, or caused to be made or used, false records or statements material to false or fraudulent claims for payment; and (3) that defendants knowingly made, used, or caused to be made, false records or statements in order to avoid, decrease, or conceal an obligation to pay money to the government. The complaint also alleges claims for breach of fiduciary duty, negligence, gross negligence, and indemnification.

According to the complaint, MortgageIT, a wholly owned subsidiary of Deutsche Bank, served as a Direct Enforcement Lender for the Federal Housing Administration (FHA) mortgage insurance program. As a Direct Enforcement Lender, MortgageIT allegedly was responsible for ensuring that loans submitted for insurance by FHA met certain requirements set out by the Department of Housing and Urban Development (HUD). The complaint alleges that all Direct Enforcement Lenders must perform certain due diligence items for each loan they certify as qualifying for FHA insurance.

ANNUAL CERTIFICATIONS

In order to maintain its status as a Direct Enforcement Lender, a lending institution must certify annually that it took certain steps and complied with HUD-FHA regulations in carrying out its role. According to the complaint, MortgageIT did not follow these regulations or perform many basic due diligence tasks in underwriting FHA-insured mortgages. Therefore, the government alleges that each annual certification was a "false claim" designed to allow MortageIT to maintain its Direct Enforcement Lender status without incurring the costs necessary to properly carry out the auditing and due diligence tasks required by law.

The complaint also alleges that each certification with each mortgage that MortgageIT was complying with government requirements was a false statement. A Direct Enforcement Lender approves loans for FHA insurance by certifying that the loans meet the HUD-FHA requirements for this insurance. FHA and HUD do not confirm the accuracy of these decisions, but rely entirely on the representations by Direct Enforcement Lenders to determine which loans receive the insurance. The complaint alleges that defendants certified 39,000 loans that FHA then insured. According to the complaint, defendants made these certifications without performing basic due diligence such as confirming employment or checking creditworthiness of the applicant. The government alleges that it has already paid out more than $386 million in FHA insurance claims arising out of more than 3,100 mortgages, and that an additional 7,500 mortgages totaling more than $888 million in unpaid principal balances have defaulted as of February 2011.

While the government alleges that HUD would not have permitted MortgageIT to endorse any loans as to which it falsely certified its compliance with HUD rules, the scope of the alleged wrongdoing is unclear, as the government describes limited examples of underwriting violations in the complaint. In any event, because the government is seeking not only treble damages but also penalties for each false claim, the potential damages for these alleged false certifications could be very substantial.

The third category of alleged false representations consists of statements of corrective action, for example, that MortgageIT allegedly made to the government after HUD audits and discoveries in 2003, 2004, and 2006 that MortgageIT was not reviewing early payment defaults as it said it was. The government also alleges other purportedly "egregious" quality control violations, including allegedly ignoring an outside vendor's findings of underwriting violations in 2004, understaffing quality control, and implementing a "dysfunctional" quality control system, which "upper management" at MortgageIT allegedly failed to change after a quality control manager brought the issues to their attention.

HUD AUDITS

The references to HUD audits repeatedly finding the same problems starting as early as 2003 may raise the issue of what the government knew and when. It also appears that the government may be relying on the collective knowledge doctrine to satisfy the knowledge element of the FCA, as there are only limited references in the complaint to the knowledge of specific individuals. The government may seek to establish that MortgageIT's structure prevented it from learning facts that allegedly made its certifications false and that the company therefore acted in deliberate ignorance or reckless disregard of the truth of the certifications, as discussed recently in a D.C. Circuit opinion rejecting the collective knowledge doctrine in the FCA context.[1] There also may be substantial practical difficulties, as well as significant expense, in litigating a case involving thousands of specific mortgages alleged not to comply with HUD rules.

CONCLUSION

In light of this complaint, financial institutions that underwrite FHA-insured mortgages should consider assessing their potential exposure to similar claims, including the scope of defaults of such mortgages, whether such defaults occurred within the first six months, and whether facts similar to those pleaded in this complaint possibly could be alleged against them. More importantly, the complaint reinforces the need for a robust compliance program, including following up on any statements of corrective action or other identified issues, taking seriously certifications of compliance with rules and regulations, and being thorough in due diligence of potential acquisition targets, including their compliance with government rules and regulations.

NOTE

[1] *See United States v. Science Applications Int'l Corp.*, 626 F.3d 1257 (D.C. Cir. 2010).