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Thank You, Sir, May I Have Another?: Five Fixes to Avoid Unfounded DOJ Claims Under the False Claims Act

It is hard to criticize the purpose of the False Claims Act ("FCA"). The 100+ year old statute, which authorizes the imposition of triple damages on companies that knowingly make false or fraudulent claims for money or property to the US government, is designed to make it hurt for those who allegedly wrongfully take money from the public coffers. And hurt it has. Whether it is the residential mortgage industry, health care industry or government procurement industry, the US Department of Justice ("DOJ") successfully has extracted billions of dollars in settlements between 2009 and 2016. During that time period, according to DOJ press releases, residential mortgage lenders have paid more than $7 billion in FCA damages, including $1.7 billion in 2016 alone, without regard to the dollar value of the settlements based on consumer relief to mortgagors and related claims under other federal laws.

But successful settlements do not necessarily mean fair settlements. At least in the mortgage industry, allegations abound that the DOJ has abused its power by cajoling and pressuring settlements with questionable legal foundation on the bet that few want to be sued by the federal government. Some have reacted to the fear of unfair DOJ claims of FCA violations by either sharply limiting the origination of government-insured loans or overlaying strict underwriting requirements that go beyond government-program requirements. There is no risk of an unfounded claim by the DOJ for a loan that was either never made or that was made and was based on such strict eligibility criteria that the risk of a subsequent mortgage insurance claim to the government is negligible.

In lieu of withdrawing from or sharply limiting involvement in government loan insurance programs, some may elect to continue to make and service insured loans as if the past huge settlements had never occurred. That alternative, some believe, is akin to Kevin Bacon's famous line in "Animal House" of "Thank you, sir, may I have another?" in response to a paddling at a fraternity hazing. Some significant mortgage loan originators have rejected that course of action.

Given that the FCA has been a "cash cow" for the federal government for the past several years, there perhaps is not a willingness on Capitol Hill to tamper with a revenue-producing law, particularly one that is labeled as fighting fraud. Indeed, during that same time period of 2009-2016, the DOJ has taken in over $19 billion in FCA cases involving allegations of health care fraud, which is more than twice as much as the DOJ collected in the residential mortgage arena over the same time period. At a time, though, when regulatory reform is front and center, rethinking the reach and applicability of the FCA may be an idea whose time has come.

The main provision of the FCA that the DOJ has used against mortgage lenders and servicers is Section 3729(a) of Volume 31 of the US Code. In part, it imposes liability on any person who "***knowingly*** presents, or causes to be presented, a ***false*** or fraudulent claim for payment or approval" or "***knowingly*** makes, uses, or causes to be made or used, a ***false*** record or statement ***material*** to a ***false*** or fraudulent claim." The liability to the US Government for FCA violations is enormous. It consists of two elements: a civil penalty of not less than $5,000 and not more than $10,000, as adjusted by inflation (now $11,000) and three times the amount of **damages** which the government sustains ***because*** of the act of that person.

FCA claims are subject to a long statute of limitations. The government may bring a claim up to the later of three years after the date when facts material to the right of action are known or reasonably should have been known by the official of the United States charged with responsibility to act in the circumstances (in this case, generally, the US Department of Housing and Urban Development, "HUD"), but in no event more than 10 years after the date on which the violation of Section 3729 is committed. In any action brought under section 3730, the United States shall be required to prove all essential elements of the cause of action, including damages, by a **preponderance of the evidence**.

In the residential mortgage banking arena, payment by HUD of mortgage insurance claims to holders of residential mortgage loans insured by the Federal Housing Administration ("FHA") is the most common context for FCA claims by the DOJ. Many of the claims to date relate to whether the loans were eligible for insurance in the first place based on loan-level certification of compliance submitted at the time of endorsement for insurance. Other claims relate to the accuracy of the annual certification of general program compliance, such as whether the lender met the FHA requirement of timely reporting of material violations of FHA requirements uncovered in quality-control reviews. More recently, the DOJ has been investigating potential claims based on the accuracy of the amount claimed for mortgage insurance benefits. In the origination context, the claim generally is predicated on the default by the borrower under an insured loan, the foreclosure of the loan and the conveyance of the resulting foreclosed property to FHA in exchange for mortgage insurance benefits.

The damages on which FCA claims by the DOJ are based is the amount of the mortgage insurance benefits paid by FHA, and the violation of Section 3729 for purposes of the statute of limitations is the filing of the claim for insurance benefits, even if the originator had filed the allegedly false loan-level or general annual certification years before.

Interestingly, if the DOJ filtered potential lawsuits by strict adherence to the FCA's statutory requirements, there likely would be fewer and smaller causes of action. The explicit language of the FCA includes important qualifiers, such as "knowingly," "material" and "because of" (i.e., causation). Many in the industry believe that the DOJ has asserted potential causes of action that would not survive judicial scrutiny if litigated in order to force companies to the settlement table. This means that the concerns about the FCA may be less about the language of the statute itself than about the DOJ's alleged disregard of such statutory language as part of an aggressive litigation strategy designed to obtain large settlements with those who do not want to be sued by the federal government. US attorneys, however, are a notoriously independent lot, and mere internal guidelines for bringing an FCA claim may not dissuade a prosecutor from pursuing the prospects of a lucrative FCA settlement and the victory lap of a resulting salacious press release.

Below are five potential legislative fixes to promote more fairness in the administration of the FCA. If the DOJ is at times unwilling to screen potential cases through the application of existing statutory qualifiers or limitations, there is no reason to assume that the DOJ would restrain itself through enhanced limitations or qualifiers. Lenders, however, may be more willing to sue and be sued by the federal government if the law more clearly defines what constitutes a violation of the FCA.

Clarify What Is a "Knowingly False" Claim, Record or Statement

Only "false" or "fraudulent" claims that are "knowingly" made will trigger FCA violations. While the term "false" is not defined in the FCA, Section 3729(b)(1) defines the term "knowingly" as follows:

(1) the terms "knowing" and "knowingly"—

> (A) mean that a person, with respect to information—
>
> > (i) has actual knowledge of the information;
> >
> > (ii) acts in deliberate ignorance of the truth or falsity of the information; or
> >
> > (iii) acts in reckless disregard of the truth or falsity of the information; and
>
> (B) require no proof of specific intent to defraud.

As the definition above indicates, while the term "knowingly" goes beyond "actual knowledge," at least it does not include a "should have known," or what is commonly referred to as a "constructive knowledge," standard. The practical problem is that the DOJ generally presumes "knowledge" without any material proof, claiming that it is up to a jury to decide this element. This is particularly true where the purported false claim, record or statement is based on the DOJ's interpretation of a government program requirement, not on an objective fact, and the lender could not reasonably have known of such interpretation in advance, particularly if the program requirement is inherently ambiguous and requires subjective judgments. Alternatively, the lender clearly could have known of the underwriting requirement but believed that the issue in question did not impact the insurability of the loan and thus subsequently could not rise to the level of a false claim.

An underwriting determination of the borrower's creditworthiness for a loan is the best example of this. The FHA guidelines have both objective and subjective elements, including a subjective determination of whether there are compensating factors that justify approving the loan even if the loan does not neatly fit the objective elements of the underwriting criteria. Reasonable people could differ on whether reliance on compensating factors is appropriate under the circumstances, but a disagreement in judgment does not a false claim make, and certainly not a knowingly false claim. Yet the DOJ has routinely sought to replace the good faith judgment of a lender with its own subjective determination.

One type of statutory change to Section 3729(a) to address interpretations of subjective government requirements could be as follows:

> "A person shall not be deemed to have presented or made a knowingly false or fraudulent claim, record or statement based on any good faith interpretation or judgment of a Government's program requirements, including in reliance on or conformity with any rule, regulation, or interpretation thereof by the Government that issues the program requirement or in conformity with any interpretation or approval by an official or employee of the Government with apparent authority to issue such interpretations or approvals, notwithstanding that such rule, regulation, interpretation, or approval subsequently is amended, rescinded, or determined by judicial or other authority to be invalid or incorrect for any reason."

Tighten the Term “Material”

A knowingly false record or statement, such as a loan-level certification or annual general program certification, has to be “material” to the false or fraudulent claim in order to violate Section 3729 (a). The term “material” is defined in the FCA to mean “having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property.” This definition is a relatively “low bar” because the false record or statement does not have to necessarily be relevant to the false or fraudulent claim—it only needs to have a tendency to influence, or be capable of influencing, the payment of money or property.

But in many cases, the false record or statement is not directly relevant to the government’s own established criteria for the initial insurance of a mortgage loan or the subsequent payment of an insurance claim. For example, many of the FHA FCA cases were based on an allegedly inaccurate annual certification of general program compliance that had little or maybe nothing to do with either the up-front eligibility of the loan for insurance or the subsequent payment of individual claims for mortgage insurance benefits. For example, many of the cases involve allegedly false annual certifications pertaining to the lender’s failure generally to report adverse quality control findings of which the lender subsequently became aware. In other cases, the false statement or record is directly relevant to the government’s own established criteria but would not have changed the outcome. For example, some of the FHA FCA cases were based on an inaccurate loan-level certification of the loan’s compliance with program requirements, but the inaccurate statement did not impact the insurability of the loan.

The most effective way to amend the FCA on this point is to require that a false statement actually influence the payment of money, not merely *be capable* of influencing such payment. Completely revising the definition of “material” might be a non-starter with some. One type of related lesser change could be as follows:

> “A false or fraudulent record or statement shall not be deemed to be material to a false or fraudulent claim if the submission of such record or statement or its related information to the Government either (a) is not expressly required by the Government program requirements as part of the eligibility criteria for the Government’s issuance of the insurance policy under which payment of property or money for an individual claim to the Government may be made, (b) pertains to compliance with general program requirements and not to the facts and circumstances underlying the individual claim to the Government or (c) in fact did not influence the Government’s payment of money or property based on the proper application of the applicable Government program requirements in connection with such individual claim.”

Clarify the Requirements for Calculation of “Damages”

The element of “because of”—that the government sustained the damages because of the violation—means causation or, in other words, but for this false statement the damages would not have occurred. We refer to this in legal terms as “proximate cause.” As with the terms “knowingly” and “material,” the DOJ often glosses over the required legal element of causation, again suggesting that the jury can determine if the test is met.

In the context of government-insured loans, the issue of causation comes up in two ways. First, would the individual loan have been eligible for insurance under agency program requirements notwithstanding the false or fraudulent record or statement? If so, would the loan be insured with the same amount of coverage? Second, would the individual claim for mortgage insurance benefits have been eligible for payment under agency-program requirements notwithstanding the false or fraudulent record or statement? If so, would the amount of the mortgage insurance benefits be the same? In some respects, the terms "material," "because of" and "damages" point to the same question of whether the decision to insure a loan, or pay an insurance claim on such loan, would have been different if the false record or statement instead were true and accurate. If not, there is a "no harm/no foul" analysis that should apply.

If the loan should not have been insured in the first place, perhaps any resulting mortgage insurance benefits paid by HUD could be construed to be a "damage" suffered by HUD from an assumption of risk perspective. If, however, the loan qualified for insurance, but for a lesser amount, the amount of damages suffered because of the falsity should not be the total amount of the insurance claim but only the amount attributable to the excess insurance above the amount for which the borrower would have qualified. Whether one labels the falsity in the record or statement itself as immaterial or that the amount of the damages suffered by HUD is not "because of" such falsity, the result should be the same—either no liability or reduced liability under the FCA.

One type of change to address this scenario could be as follows:

> "Damages shall not be deemed to have been sustained by the Government because of a false or fraudulent claim, record or statement if and to the extent the claim would have been eligible for payment under Government program requirements, notwithstanding such false or fraudulent claim, record or statement."

In addition, the DOJ uses a methodology that does not accurately account for damages. The actual total damages on an individual FHA-insured loan should be the amount of the claim payment minus the amount of net liquidation proceeds received by the government from the sale of the related foreclosed home. The FCA then would provide for the net amount times three. The DOJ, however, does not subtract liquidation proceeds from the amount of the claims payment; instead, it only subtracts the liquidation proceeds from the claims payment times three. For example, assume FHA pays an individual mortgage insurance claim of $100,000 and sells the related foreclosed property for $70,000. The actual damages should be $30,000, and the treble damages would be $90,000. The DOJ uses a different kind of math. It would treble the actual claim payment of $100,000 to $300,000 and then subtract the liquidation proceeds of $30,000 to produce damages of $270,000, which creates a windfall beyond the damages actually suffered by HUD. Some past judicial cases have rejected this "new" math.

One type of change to address this concern could be as follows:

> "The term 'damages' shall mean the net amount of actual losses after subtracting any net liquidation proceeds received by the Government in disposition of the property giving rise to such damages."

Lastly, the DOJ has used extrapolation to calculate purported damages without making specific findings on each claim. For example, it might review a sample of loans for adverse findings and then assume the same percentage of findings and amount of damages would be found on that same percentage of all loans for which HUD had paid claims over a defined time period and then extrapolate damages based on that sample without having to prove the elements of a claim on a loan-level basis.

While extrapolation might have a place in complex cases with common facts across a broad swath of substantially similar situations with no questions of law or regulations, it does not fit the residential mortgage context where claims based on subjective determinations of underwriting eligibility are commonplace. These cases do not typically involve the uniform misapplication of an underwriting guideline. Rather, they often focus on the reasonableness of a subjective determination or whether a loan would have been insurable notwithstanding an underwriting defect, which only can be fairly analyzed on an individualized basis. Adding the "knowingly" qualifier further undermines the use of extrapolation, which in and of itself suggests that one must analyze the individual circumstances of a claim to determine the satisfaction of this required pleading element.

One type of change to address this concern could be to add the highlighted language as follows:

> "In any action brought under section 3730, the United States shall be required to prove all essential elements of the cause of action **with respect to each individual claim**, including damages, by a preponderance of the evidence."

Shorten the Statute of Limitations

In the context of government-insured loans, the three- and six-year time limitations start from the date of claim payment, not loan origination. This is a substantial period of time that exceeds many federal or state statutes of limitations. Practically speaking, this could extend the statute of limitation to 40 years from the time a loan is originated, if it did not default until the end of its term. While recent FCA cases involving government-insured loans generally have focused on loans with early payment defaults, nothing in the current FCA compels the DOJ to exercise such restraint in pursuing future FCA investigations. The risk is real. It is not uncommon for seasoned loans to default because of a change in circumstances, such as loss of job, loss of spouse or health problems. It is very difficult for a lender to be able to defend itself in a reasonable way when the facts underlying the claim are several years old. In other words, the claim for mortgage insurance benefits may only be a few years old, but the precipitating false statement or record may be whether the loan was eligible for insurance at the time of origination, and several years may have elapsed between the time the lender originated the loan, the time the loan went into default and the time the lender filed a claim for mortgage insurance benefits.

One type of change could be as follows:

> "Notwithstanding the foregoing, if the false or fraudulent claim for payment of property or money is based on an earlier false determination of an asset's eligibility for a federal benefit, such as Government insurance or guaranty, the violation of section 3729 is deemed to be committed as of the date of such false determination and not when the payment of property or money is made in respect of such false determination."

Heighten the Evidentiary Standard

The "preponderance of the evidence" standard is a low threshold. The standard is met if the proposition is more likely to be true than not true. The standard is satisfied if there is greater-than-50-percent chance that the proposition is true. Given the possibility of both per-claim civil money penalties and treble damages, one could argue for a higher evidentiary standard. One type of change could be as follows:

> "In any action brought under section 3730, the United States shall be required to prove all essential elements of the cause of action, including damages, by **clear and convincing evidence**."

This is one step up from "preponderance of the evidence" but a lesser standard than "reasonable doubt." Another idea is to bifurcate the standards for civil money penalties and treble damages with the lower standard for the former and the higher standard for the latter.

Conclusion

The concerns of Congress that the government could misuse the provisions of the FCA is evident in the statutory qualifiers already present in the existing statute, such as "knowingly," "material," and "because of." Perhaps the proper up-front application of these filters to potential cases would allay the industry's concerns that the law is reserved for truly materially false and fraudulent cases. Absent taking one's chances in federal court to defend what are perceived to be unfair FCA claims, there is no guaranty that the federal government will restrain itself from the pursuit of claims that some might argue should never have been brought in the first place. Tightening the statutory language could well embolden residential mortgage lenders to resist or defend against an unwarranted paddling by the DOJ.

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