

## Tools For Handling Mortgage-Based FCA Claims

*Law360, New York (September 26, 2012, 2:19 PM ET)* -- Over the past two decades, many pharmaceutical and medical device companies have been the targets of False Claims Act (FCA) litigation. Many of these cases have focused on claims that a drug or device was marketed for off-label uses — that is, uses that were not previously approved by the U.S. Food and Drug Administration. The result has been numerous settlements of hundreds of millions, or even billions, of dollars.

Increasingly, the FCA, which was established in 1863 as a means to impose liability on those who defraud the government, has been invoked in matters involving financial institutions and, in particular, the U.S. Federal Housing Administration's mortgage insurance program.

The FHA provides insurance to mortgage lenders in the event of default if the lender follows certain procedures when it grants a loan and if the borrower meets certain criteria — for example, having a debt ratio of no more than 31 percent and having “a good credit history demonstrated by a solid track record of timely payments.”<sup>[1]</sup>

Under such circumstances, the FHA guarantees that the lender will not have to report a loss on a loan if the borrower defaults and because the FHA has made this guarantee, the lender is typically willing to issue larger loans.

FCA-related cases involving financial institutions have mainly centered on allegations that specific facts about mortgage loans were misrepresented in the loan documents or that the loans were subject to inflated appraisals. The allegations in these cases may be broad based in terms of the extent of fraud.

As a result, the potential recovery amounts for the government, and the levels of risk exposure for lenders may be quite large. Early in 2012, for example, the Justice Department brought FCA-related suits against five lenders, settling with four of them for more than \$1 billion. This was followed by the announcement of a \$25-billion settlement with the five largest mortgage servicers in the United States.<sup>[2]</sup> Subsequently, in May 2012, another major U.S. bank settled FCA-related claims for more than \$202 million.

It appears likely that we will continue to see mortgage and financial-services-based FCA claims, in part, because prior settlements left open the possibility of future FCA claims against the same institutions. Moreover, the formation in January 2012 of a Residential Mortgage Backed Securities (RMBS) Working Group, plus the Justice Department's recent budget request for an additional \$55 million in fiscal year 2013, reportedly to increase its capacity to investigate and process allegations of financial and mortgage fraud, suggests more activity in this area.<sup>[3]</sup>

## Assessing Damages: Key Economic Questions

The government alleged in its lawsuit against Deutsche Bank, Allied and CitiMortgage that these financial institutions acted fraudulently by misrepresenting facts associated with loans at issue — claiming, for instance, that certain documentation was missing or that employment verification was missing in certain applications. The FHA had made insurance payments on many of the loans at issue that had defaulted, so the premise of the suit was that, but, for the alleged misrepresentations, the FHA would not have insured the loans and, therefore, would not have made those payments.

From an economic perspective, there are at least five key questions to consider in responding to these types of allegations: first, what was the nature of the alleged misrepresentations? Second, were those misrepresentations material to the granting of the loan? Third, were those misrepresentations material to the FHA's decision to insure the loan? Fourth, did those misrepresentations contribute to the underperformance of the loan? And fifth, if a particular loan had not been insured, to what extent would the FHA have insured other loans? Each of these questions can be analyzed systematically in estimating damages.

Defense strategies need to consider how the legal theory at issue translates into damages. In pharmaceutical off-label matters, for instance, the legal arguments might support a damages claim in the form of either government loss (that is, losses the government incurs from reimbursements made as a result of the alleged wrongful conduct) or corporate gains realized by the company resulting from the conduct at issue.

Either damages theory might also be applied in the mortgage industry. In particular, any damages in the form of government loss would arise from insurance payments that the government made on the defaulted loans, above and beyond what it would have made had the alleged conduct at issue not occurred.

Meanwhile, any damages in the form of corporate gain would have to consider the profits realized by the financial institution because of its alleged wrongful conduct. Depending on the type of legal theory employed and the type of damages claimed by the government, the following analytical approaches may be relevant:

1. An assessment of the actual rate of misrepresentation and its effect on lending through re-underwriting of the loans at issue (based on contemporaneous underwriting guidelines)
2. An assessment of the materiality of the alleged fraud to the FHA's provision of insurance
3. The development of a but-for scenario that considers loans the government would have insured in lieu of the alleged fraudulent loans
4. An assessment of the extent of corporate gain

## Reunderwriting

The FCA cases brought against financial institutions to date have alleged, among other things, inflated home appraisals on government-backed loans and failure to comply with reporting practices and processes required by the FHA and the Department of Housing and Urban Development.

An important step in determining an appropriate defense strategy is to directly examine the validity of these allegations and the degree to which defaults are associated with alleged misrepresentations. In many recent RMBS matters, teams of underwriters examined loan records to “reunderwrite” the loans at issue based on the underwriting guidelines that were applicable at the time the loan was granted.

This process can provide insight into types of misrepresentations, the true rate at which they occurred and whether they were material to the decision to grant the loans at issue. By determining the actual rate of material misrepresentations, the financial institution may limit the potential exposure from the alleged fraud rather than assuming that all defaults within a given bank’s portfolio are associated with misrepresentations without proof of actual flaws, which could lead to a huge overstatement of harm.

### **Assessing Materiality**

Economic analysis can help to determine not only the rate of misrepresentations in a bank’s portfolio of loans but also whether those misrepresentations influenced the FHA’s decision to insure the loan and contributed to the performance of the loan. In pharmaceutical off-label matters, a critical piece of the economic analysis is to determine what portion of the off-label sales can be attributed to improper promotion as opposed to other factors.

Similarly, in FCA cases involving financial institutions, one must determine which loans would have been insured had the alleged misrepresentations not occurred. Moreover, there are a variety of factors other than the alleged fraud that could have affected the credit (default) risk and ultimate performance of a mortgage loan and would have been present regardless of the alleged misrepresentations.

A crucial part of any damages analysis in this context would be to distinguish any insurance payments the FHA made because of fraud from those payments the FHA made for mortgages that would have defaulted anyway. In these cases, the economic analysis must focus on whether the alleged fraud had a causal effect on default risk. There are two factors to consider in this analysis.

### ***Not All Elements of Fraud Are Equal***

Consider two loans, each with a different fraudulent defect. In one loan, a borrower’s income is misrepresented to be higher than it actually is, while in another loan, a borrower simply forgot to sign a particular document, but, otherwise, the provided information is accurate. All else equal, the loan that was approved with misrepresented income is likely to have a higher-than-expected risk of default.

Meanwhile, the default risk associated with the loan in which a document went unsigned is likely to be unchanged with the proper signature. The first type of defect may be a “material” defect and may lead to greater than expected insurance payments by the government. The second type of defect is not a material defect and would be one basis for a “carve out” of loans that are not at issue for damages.

### ***One Cannot Simply Conclude That a Loan Is Fraudulent Just Because It Eventually Defaulted***

Even in the absence of fraud, there will always be some benchmark or background rate of default. In pharmaceutical off-label cases, the economic analyses conducted typically account for a background rate of off-label prescriptions that would have occurred anyway, even in the absence of inappropriate promotion by the manufacturer — for example, due to the presence of robust scientific evidence of safety and efficacy in the off-label therapeutic area at issue.

In the mortgage industry, the rate (or risk) of default is driven by multiple borrower and loan characteristics associated with a mortgage. In addition, a loan’s default risk will increase with changes in macroeconomic conditions, such as declines in home prices and increases in the unemployment rate.

The recession that started in December 2007, for instance, only exacerbated the default risk associated with loans originated before, during, and after this period of turmoil. In particular, many property owners found themselves out of work or stuck with a loan whose value was greater than the value of the home or both. Economists can use statistical analysis, such as regression modeling, to control for this background rate of default.

### **Developing a But-For Counterfactual**

In FCA matters involving pharmaceutical companies, the government often claims that it reimbursed for drugs that would not have been prescribed but for the allegedly fraudulent behavior. But in many such scenarios, another drug would have been forthcoming to treat the patients' presenting symptoms. Therefore, the government loss attributable to excess prescribing of one drug generally needs to be (partially) offset by the additional costs of the drug that would have been prescribed in its place.

If the damages theory in an FCA matter involving financial institutions is one of government loss, a central economic issue focuses on the payments the government would have made had the alleged fraud not occurred.

For instance, the government may claim that it made insurance payments on defaulted loans that it alleges to be fraudulent or somehow defective. However, had it not insured these loans, it likely would have insured a pool of nondefective loans. And, as has been shown through numerous empirical studies, during the recent financial crisis, all types of loans were susceptible to default because of the rapid and deep decline in home prices and rise in unemployment.

In other words, even if the government insured a group of loans considered to be nondefective, it is quite likely that insurance payments would have been made on some number of defaulted loans.

### **Assessing Corporate Gain**

By contrast, if the damages theory in an FCA matter involving financial institutions is one of corporate gain, the economic analysis turns to an estimation of the profits realized by the financial institution from its involvement in the securitization of the fraudulent loans. In these cases, an economic analysis would need to assess the financial institution's role in the securitization process in order to determine the revenues generated by these fraudulent loans and the company's incremental cost structure in order to isolate relevant profits.

Of course, the revenues generated by the fraudulent loans will vary depending on the type of financial institution and its role in the securitization process. For example, is the financial institution involved in the origination of the loans? Is it a financial intermediary in the securitization process — a sponsor, for instance, or a depositor? Is it the securities underwriter that sells the investments containing the fraudulent loans to investors or is it the servicer of the loans in the securitization?

Any revenue gains, once determined, would need to be (partially offset) by the additional costs associated with bringing these loans into the RMBS transaction. Such costs could be substantial depending on several factors, such as the financial institution's role in the securitization process.

From an economics perspective, these analytical approaches provide a potential defendant in an FCA matter with useful tools to respond to potential claims by the government [see Addendum]. These approaches can be employed using a combination of simple descriptive methods and more sophisticated statistical modeling techniques — tools that make it possible to isolate and estimate the amount of insurance payments that were made by the government due to the alleged fraud.

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## Addendum

### Third-Party Data Facilitates Economic Analyses

The importance of data analyses in False Claims Act cases involving residential mortgages cannot be overstated. Fortunately, a number of reliable third-party databases, such as ABSNet Loan and Blackbox Logic, contain loan-level information on millions of the mortgage loans that were originated since at least 2000.

These data sets contain loan and borrower characteristics as well as performance data — for example, information that tracks the payment status of each loan. These data may be paired with other publicly available resources, allowing economic experts to develop analyses (both simple and complex) to assess the extent to which default risk is affected by a range of relevant variables and to isolate the incremental effect (if any) of alleged misrepresentations of performance.

A simple yardstick approach can be useful in establishing default rates for a period in question: the analyst identifies a comparison set of loans during this time period that the government would have insured in lieu of the loans at issue. This “but-for” exercise can provide a benchmark default rate that can be compared to the default rate of the loans at issue.

More sophisticated regression models can also be developed and estimated to address issues of materiality. For example, a regression model could be designed to assess how the loans at issue (that is, the loans alleged to be fraudulent by the government) perform relative to the rest of the industry after controlling for relevant loan and borrower characteristics (such as loan-to-value ratios, documentation type and FICO score) as well as changes in macroeconomic performance.

Another type of regression model could be developed and estimated to include not only the loans alleged to be defective but other loans insured by the FHA that are not alleged to be defective. In this type of model, a variable indicating whether or not a loan is defective can be directly entered into the model as an explanatory factor and can, therefore, be used to test whether the “defect” increases the likelihood of default, all else being equal.

[1] [http://www.fha.com/fha\\_requirements\\_credit.cfm](http://www.fha.com/fha_requirements_credit.cfm)

[2] <http://fcablog.sidley.com/blog.aspx?entry=84>

[3] <http://www.gibsondunn.com/publications/Pages/2012MidYear-FalseClaimsActUpdate.aspx>

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