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Prosecutors Using FIRREA to Investigate Pandemic Conduct

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") is a powerful tool in the prosecutorial arsenal. Due to its long statute of limitations, expansive penalty provision, and low civil burden of proof, prosecutors used FIRREA to aggressively pursue banks for conduct relating to the 2008 financial crisis, securing billions of dollars in civil penalties. Now, prosecutors may apply it to pandemic-related conduct ranging from fraudulent schemes to obtain relief funding, to losses resulting from volatility in the commercial mortgage-backed securities ("CMBS") market.

FIRREA BASICS

Originally enacted to protect banks from destabilizing financial frauds,[1] FIRREA imposes civil penalties if the government proves by a preponderance of the evidence a violation of any of fourteen specified predicate offenses, including bank fraud and mail or wire fraud "affecting a federally insured financial institution."[2] With a lower standard of proof than criminal charges, a 10-year statute of limitations period, whistleblower provisions, and significant monetary penalties, FIRREA is a powerful statute.[3]

In the years following the 2008 financial crisis, the federal government faced mounting scrutiny over its perceived failure to hold accountable the banks alleged to have acted improperly in the lead up to the crisis. The Department of Justice turned to civil statutes for enforcement, and in particular, the arguably dormant FIRREA. Eventually, through a series of cases brought by the United States Attorney's Office for the Southern District of New York and other offices,[4] DOJ tested the waters for using FIRREA as an enforcement tool against financial institutions—the very institutions that FIRREA was enacted to protect. These cases were premised on the "self-affecting" theory of liability, a construction of FIRREA's requirement that the statutory language "affecting a federally insured financial institution" includes conduct by a financial institution that affects itself.[5] Whereas FIRREA was initially enacted to protect banks from the negative effects of fraud, prosecutors used the "self-affecting" theory to pursue banks alleged to have profited from such conduct. This novel application of a relatively infrequently-used statute laid the groundwork for dozens of cases relating to the 2008 crisis, and we are certain to see this play out again over the coming years as DOJ investigates pandemic-related conduct.

CARES ACT LENDING RISK

One key area to watch for FIRREA enforcement is CARES Act funding.[6] The high demand for these loans, the urgency with which the applications were made, and the evolving Small Business Association and Treasury Department guidance for borrowers and lenders all increase the risk of misconduct and government scrutiny. We expect to see an uptick in government enforcement around not only fraud—but potentially willful blindness to red flags— in connection with that funding.

Enforcement linked to the CARES Act—and more generally, pandemic-related government money—has already commenced. In January, the United States Attorney's Office for the Eastern District of California announced the first civil settlement resolving FIRREA and FCA claims related to PPP funding.[7] In that settlement, an internet fashion retail company and its president and CEO admitted to making false statements to federally insured banks to obtain a PPP loan, and agreed to pay $100,000 in damages and penalties.[8] In addition to FCA allegations, prosecutors contended that the company and its president and CEO violated five FIRREA predicate offenses that increased damages and penalties: in total the government alleged that the defendants were liable for over $4 million dollars (according to the settlement agreement, the government accepted a lower settlement amount due to the financial condition of the defendants).[9] With FIRREA allowing prosecutors to significantly ramp up penalties, we expect to see FIRREA in the mix on FCA prosecutions going forward.

To minimize risk of enforcement down the line, financial institutions must remain vigilant in processing loan applications. While lenders are allowed to rely on information provided by borrowers and are not required to conduct their own verification of the borrowers' certifications, they are required to certify that they have reviewed the borrower's documentation.[10] Thus, lenders could potentially face scrutiny under FIRREA and FCA for approving loans if there are "red flags" in the information provided by the borrower. For example, prosecutors could contend that red flags in the file include information provided by the borrower that would alert the bank to the fact that a loan certification was improper, such as information inconsistent with:

- Certifications that the loans were "necessary" due to the coronavirus outbreak, and
- Certifications regarding the number of employees on payroll, average costs of that payroll, and the nature of the applicant's business or financial status (including whether the applicant is in bankruptcy[11]).

Any lender involved in the CARES Act loan programs should carefully review application files for red flags that could be used post hoc—by regulators or *qui tam* relators—to allege that the lender was willfully blind to abuses of the programs by borrowers.

COMMERCIAL REAL ESTATE VOLATILITY

Another key area to watch for FIRREA enforcement is the commercial real estate market.[12] Even before the pandemic, commercial real estate was facing a reckoning as brick-and-mortar retail struggled, investors shorted the market,[13] and whistleblowers alleged manipulation of CMBS.[14] The pandemic has exacerbated those issues. Commercial mortgage delinquencies are increasing,[15] ratings agencies have downgraded CMBS deals,[16] and the SEC recently filed an enforcement action against Morningstar for ratings inflation concerning CMBS.[17] Moreover, nearly $430 billion in commercial and multifamily real estate debt matures in 2021, forcing lenders and borrowers to consider what these buildings are worth in a post-pandemic world.[18]

We expect losses on CMBS issuances to result in investigations that mirror the DOJ's approach to residential mortgage-backed securities ("RMBS") after the last financial crisis, including the use of FIRREA. In 2012, President Obama created a working group—the Financial Fraud Enforcement Task Force's RMBS Working Group—focused on the conduct of financial institutions perceived to have contributed to the financial crisis. The working group ultimately secured tens of billions of dollars for claims against large financial institutions. President Biden could potentially create a similar working group focused on CMBS. Like the RMBS working group, this new group would likely be composed of various U.S. Attorneys, Civil Division leadership, and Criminal Division leadership, with various U.S. Attorney's Offices leading individual investigations.

For a number of reasons, however, enforcement of CMBS-related fraud may not rise to RMBS levels. For example, whereas RMBS were heavily blamed for causing losses that contributed to the 2008 crisis, fraud in CMBS is not presently seen as a cause of widespread economic harm. Nonetheless, fraud relating to CMBS can be easily pursued by prosecutors using FIRREA, with the RMBS investigations providing a playbook.

Financial institutions should pay particular attention to CMBS transactions to ensure compliance with applicable laws and regulations and avoid the increased risk of whistleblower complaints and government enforcement. In particular, institutions should:

- Carefully scrutinize CMBS disclosures for accuracy;
- Be vigilant in assessing and reviewing CMBS due diligence materials and loan quality;
- Appropriately address red flags in loan documents and other diligence materials;
- Ensure communication among teams working on CMBS deals, including those conducting the due diligence and those drafting disclosures; and
- Reassess policies and procedures surrounding CMBS transactions, due diligence, and disclosures and ensure the appropriate teams and supervisors have been trained.

CONCLUSION

The DOJ aggressively used FIRREA to pursue financial institutions perceived to have contributed to the 2008 financial crisis, and it may be equally aggressive in its investigations of potential fraud relating to the pandemic. Under President Biden and Attorney General Merrick Garland, the DOJ may use the "self-affecting" theory of liability where financial institutions are alleged to have profited from fraudulent conduct, including in connection with CARES Act funding and the CMBS market.

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[1] *See generally* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 852, 853 (1989).

[2] 112 U.S.C. § 1833a (2012).

[3] *Id*.

[4] *See, e.g*., United States v. Countrywide Fin. Corp., 961 F. Supp 2d 598, 605 (S.D.N.Y. 2013); United States v. Bank of New York Mellon, 941 F. Supp. 2d 438, 454-56 (S.D.N.Y. 2013); United States v. Bogucki, No. 18-cr-00021-CRB-1 (N.D. Cal. Mar. 4, 2019).

[5] *See id.*

[6] The CARES Act was enacted in March 2020 to provide emergency financial assistance to the millions of individuals, families, and businesses affected by the COVID-19 pandemic and shutdowns. The Act provided over $1 trillion in loans for small and mid-size businesses affected by COVID-19 through the Main Street Lending Program and the SBA's Paycheck Protection Program ("PPP"). The PPP loans were the most popular, and the SBA ran out of funds almost immediately, prompting Congress to nearly double the appropriation.

[7] *See* Press Release, U.S. Attorney's Office, E. Dist. of Cal., Eastern District of California Obtains Nation's First Civil Settlement for Fraud on Cares Act Paycheck Protection Program (Jan. 12, 2021) [hereinafter E. Dist. of Cal. Press Release], available at https://www.justice.gov/usao-edca/pr/eastern-district-california-obtains-nation-s-first-civil-settlement-fraud-cares-act; Settlement Agreement, United States v. Slidebelts, Inc., (E.D. Cal. Jan. 12, 2021) [hereinafter Slidebelts Settlement Agreement], available at https://www.justice.gov/usao-edca/press-release/file/1352931/download.

[8] *See* E. Dist. of Cal. Press Release, *supra* note 7.

[9] *See* Slidebelts Settlement Agreement, *supra* note 7 at 3, 11.

[10] *See* 13 C.F.R. 120 (Feb. 3, 2021); U.S. Dept. of Treasury*, Paycheck Protection Program Loans, Frequently Asked Questions* (Mar. 3, 2021), https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf (last visited Mar. 10, 2021).

[11] Interestingly, Congress allowed PPP funding to go to debtors in bankruptcy, but the SBA took the position that those debtors are ineligible. *See* Ronald A. Spinner et al., *Congress Permits SBA to Make PPP Loans to Debtors in Bankruptcy, SBA Says "No"*, NAT'L L. REV. (Jan. 15, 2021) ("Although the CARES Act did not discuss whether companies who have filed for bankruptcy protection are eligible to participate in the PPP, the SBA took the position that they are not. A number of bankrupt debtors sued the SBA over this bankruptcy exclusion. Although a few were successful, both Appellate Courts that have weighed in on the issue have determined that the SBA can properly exclude debtors from the PPP program."), https://www.natlawreview.com/article/congress-permits-sba-to-make-ppp-loans-to-debtors-bankruptcy-sba-says-no (last visited Mar. 10, 2021).

[12] This enforcement is particularly interesting given that FIRREA established the Resolution Trust Corporation to resolve failed thrift institutions, which helped increase demand for CMBS.

[13] *See* Erik Dolan-Del Vecchio, *Investors Bet Against CBMS As Retail Weakens, But Retailers Are Fighting Back*, SEEKING ALPHA (Apr. 28, 2017, 5:43 PM), https://seekingalpha.com/article/4066936-investors-bet-against-cmbs-retail-weakens-retailers-are-fighting-back (last visited Mar. 10, 2021).

[14] *See* Heather Vogell, *Whistleblower: Wall Street Has Engaged in Widespread Manipulation of Mortgage Funds*, PROPUBLICA (May 15, 2020, 7:00 AM), https://www.propublica.org/article/whistleblower-wall-street-has-engaged-in-widespread-manipulation-of-mortgage-funds (last visited Mar. 10, 2021).

[15] *See* Press Release, Mortgage Brokers Ass'n, Commercial and Multifamily Mortgage Delinquencies Rise in December (Jan. 8, 2021), https://www.mba.org/2021-press-releases/january/commercial-and-multifamily-mortgage-delinquencies-rise-in-december (last visited Mar. 10, 2021).

[16] *See*, *e.g.*, Press Release, Moody's Inv'rs Serv., Moody's Downgrades Four CBMS Classes of Palisades Center 2016-PLSD (July 9, 2020), https://www.moodys.com/research/Moodys-downgrades-four-CMBS-classes-of-Palisades-Center-2016-PLSD--PR_427908 (last visited Mar. 10, 2021); Joe Rennison, *Pandemic Exposes "Severe Stress" in Commercial Property Financing*, FIN. TIMES (Aug. 30, 2020), https://www.ft.com/content/e4b2302b-76c5-494a-8560-e6d24de9358f (last visited Mar. 10, 2021).

[17] *See* Press Release, U. S. Secs. & Exch. Comm'n, SEC Charges Ratings Agency with Disclosure and Internal Controls Failures Relating to Undisclosed Model Adjustments (Feb. 16, 2021), available at https://www.sec.gov/news/press-release/2021-29/.

[18] *See* Noah Buhayar et al., *Commercial Real Estate's Pandemic Pain is Only Just Beginning*, BLOOMBERG (Dec. 22, 2020), https://www.bloomberg.com/graphics/2020-commercial-real-estate/?srnd=premium (last visited Mar. 10, 2021).