Changes to the False Claims Act in Senate Bill 386:

A Review of Impacts on Mortgage Banking and TARP Spending

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Introduction

On May 20, 2009, President Obama signed into law Senate Bill 386, the Fraud Enforcement and Recovery Act ("FERA"),[2] which makes important amendments to the federal False Claims Act ("FCA")[3]. The President stressed the importance of protecting taxpayer dollars needed for economic recovery under the Troubled Asset Relief Plan ("TARP"), run by the U.S. Treasury to shore up financial institutions, and other stimulus programs. New

Under the new legislation, the FCA will have a greater role in protecting the federal government from fraud. With federal funds going to a range of projects—from state infrastructure "shovel ready" road building to Internet connectivity, green energy innovation and high-tech transportation solutions—there are far more federal expenditures in the pipeline for the FCA to cover.

A key amendment in S. 386 is to delete the requirement for a "claim" in 31 U.S.C. § 3729(c), and expand the definition of claim in a new section.[4] The problem the drafters of S. 386 had to overcome was that a claim, as included in § 3729(c), was deemed by some courts as bound by "the rule that a claim requires a request or demand for payment [exclusively] from government funds."[5] In response, S. 386 excises § 3729(c) and instead defines "claim" to include "any request or demand for money, whether or not the government has title to that money or property, and including situations where the defendant submits the request or demand either directly to the government or to a contractor, grantee, or any other recipient of government funds used to advance a government program."[6]

The bill also addresses recent court decisions, including the 2008 U.S. Supreme Court decision in *Allison Engine Co. v. U.S.*,[7] which narrowly interpreted the scope of the FCA to potentially exclude subcontractors and non-governmental entities from coverage. Importantly, S. 386 revises the liability provisions of the FCA to clarify and reaffirm that whistleblowers' suits for anti-fraud civil liability reach federal funds spent by non-governmental entities. The common theme in these legislative changes is a strengthening of the FCA in recognition of its importance as a tool to fight fraud, waste and abuse.

Legislative History of S. 386

The legislation moved through Congress on a fast-track, reflecting the importance of the FCA to the Obama administration. Although various iterations of the bill were introduced during the Bush administration, the most recent version of the bill was introduced February 5, 2009, by Senator Patrick Leahy (D-Vermont), Senator Charles Grassley (R-Iowa), and Senator Ted Kaufman (D-Delaware), and referred to the Senate Judiciary Committee.[8] The bill was reported, as amended, by that committee on March 5, 2009, by a voice vote, and subsequently placed on the Senate calendar. On April 28, 2009, the Senate passed the bill by a vote of 92 to 4, showing bi-partisan support. On May 18, 2009, the House amended and passed S. 386 by a count of 338 to 52. The Senate then agreed to the House amendments with one change, to which the House concurred.[9] On May 19, 2009, the bill was presented to the President, and he signed it the following day.[10]

Effect of S. 386 on Mortgage Lending Industry

The nation's editorial pages have reflected a palpable sense of frustration that the recent financial collapse has resulted in so few criminal indictments, with bad actors seemingly untouched by law enforcement and industry regulators.[11] In strengthening the ability of private attorneys general to enforce anti-fraud laws, S. 386 squarely extends the FCA to interstate mortgage lenders and other recipients of TARP and economic stimulus funds.

The problem of the doctoring of loan documents was widely noted in the press. Unwitting consumers declared that if they did not qualify for a home loan based on a legitimate credit analysis, the mortgage broker would help fill out the paperwork to make it pass.[12] As stated in a recent U.S. Senate report, shadowy financiers adopted practices that resulted in pushing mortgages on to consumers who could not afford them, so that short term speculators could generate profits by packaging the mortgages into securities sold on Wall Street. As residential home prices dipped, collateralized securities lost value, leading to a spiral of fraud and injury to investors.[13] Accordingly, S. 386 now defines a "false statement" to include mortgage application statements by mortgage brokers, as defined in 18 USC § 1014.

A White House press release explained that: "Over 50% of sub-prime mortgages issued as recently as 2005 involved private mortgage institutions and similar entities not currently covered under federal bank fraud criminal statutes. FERA amends the definition of a 'financial institution' in the criminal code (18 U.S.C. § 20). This will extend Federal laws to private mortgage brokers and companies that are not directly regulated or insured by the Federal Government."[14]

In S. 386, the definition of "financial institution" in 18 USC § 20, para. 10, was amended to include banks and mortgage lenders making "a federally related mortgage loan as defined in section 3 of the Real Estate Settlement Procedures Act of 1974."[15]

Finally, Section 5 of S. 386 creates a Financial Crisis Inquiry Commission, whose mandate is to investigate the causes of the financial crisis, including the worst practices of the mortgage industry. The Commission will examine "lending practices and securitization, including the originate-to-distribute model for extending credit and transferring risk," and will submit a report on its findings by December 15, 2010.[16]

The bill appropriates to the Attorney General the sum of $265 million, "which would go to hire 160 more FBI agents and

200 more Justice Department prosecutors to work on mortgage fraud cases."[17]

Effect of S. 386 on TARP Spending

In remarks made May 20, 2009, at the signing of S. 386, President Obama said that the law: "allows DOJ to prosecute anyone who fraudulently obtains Recovery Act or TARP funds -- precious taxpayer dollars we've carefully invested in order to turn this crisis around."[18]

TARP was created to purchase and insure up to $700 billion of troubled assets held by banks and other financial institutions in an effort to stabilize and otherwise bail out the financial markets. Since the inception of TARP in October 2008, there has been a push for oversight over the use of the funds by recipients. On November 17, 2008, Sen. Grassley suggested that those found to be using TARP funds under false pretenses should be subject to liability under the FCA.[19]

On June 22, 2009, The Office of Management and Budget ("OMB") released a memorandum giving guidance on reporting requirements included in Section 1512 of the Recovery Act.[20] Stimulus recipients and subrecipients must report a series of data, including, "names and compensation of the five highest paid employees." According to the OMB memorandum: "Section 1512 of the Recovery Act requires that prime recipients and delegated sub-recipients submit quarterly reports on their use of the funds not later than the 10th day following the end of each quarter beginning on October 10, 2009, and will be cumulative since enactment, or February 17, 2009."[21] Reports are entered at the www.FederalReporting.gov website and published at www.Recovery.gov within 30 days of filing.

The Emergency Economic Stabilization Act of 2008, which authorized TARP, established under Section 121 the Office of the Special Inspector General for TARP, which is commonly referred to as SIGTARP. On December 15, 2008, Neil Barofsky was appointed the inspector general, with the authority to "conduct, supervise, and coordinate audits and investigations of the purchase, management and sale of assets" under TARP.[22]

In the initial report to Congress of February 9, 2009, and a letter of January 7, 2008, Barofsky urged the Treasury to include language in all TARP contracts entered into after that date that requires the bank to, at a minimum, account for the use of TARP funds, provide internal controls to ensure compliance with the remainder of the TARP contract, and have a senior officer certify the accuracy of the information provided.[23]

One element of the government's response to the financial crisis is the Term Asset-backed Securities Loan Facility ("TALF") program, in which the Federal Reserve will give non-recourse loans totaling up to $20 billion upon the posting of collateral in the form of newly issued asset-backed securities. Barofsky has stated the need to extend the FCA to the program.[24]

In addition to recipients of government funds facing potential increased FCA liability, private sector contractors and agents providing services to the Treasury in connection with TARP may face increased potential liability under the FCA in connection with new conflict of interest and mandatory disclosure requirements under an interim rule issued by the Treasury.[25] False responses to these inquiries could subject TARP recipients to potential liability under the FCA.

S. 386 More Clearly Extends FCA to Government Contractors and Subs

The effect of S. 386 on the mortgage industry and TARP spending are significant enough. But S. 386 also reverses several recent judicial decisions limiting the scope of the FCA.

The key change in Section 4 of S. 386 is to the definition of "claim." The Senate Report explains the significance of the change, as follows:

> By removing the offending language from section 3729(a)(1), which requires a false claim be presented to 'an officer or employee of the Government, or to a member of the Armed Forces,' **the bill clarifies that direct presentment is not required for liability to attach.** This is consistent with the intent of Congress in amending the definition of 'claim' in the 1986 amendments to include 'any request or demand * * * for money or property which is made to a contractor, grantee, or other recipient if the United States Government provides any portion of the money or property which is requested or demanded, or if the Government will reimburse such contractor, grantee, or other recipient for any portion of the money or property which is requested or demanded.' 31 U.S.C. Sec. 3729(c) (2000).[26]

Further, the change to the definition of claim makes clear the FCA extends to funds administered by the United States, as follows:

> False claims made against Government-administered funds harm the ultimate goals and U.S. interests and reflect negatively on the United States. The FCA should extend to these administered funds to ensure that the bad acts of contractors do not harm the foreign policy goals or other objectives of the Government. Accordingly, this bill includes a clarification to the definition of the term 'claim' in new Section 3729(b)(2)(A) and attaches FCA liability to knowingly false requests or demands for money and property from the U.S. Government, without regard to whether the United States holds title to the funds under its administration.[27]

The statute removed the FCA's "by the Government" limitation and the "to get" verbiage in section 3729(a)(2). The same amendments are made to parallel language in sections 3729(a)(3) and (a)(7). The excised, narrow terms are replaced in the statute with "material," in a new Section 3729(a)(1)(B), which now imposes liability for knowingly making or using a false record or statement material to a false or fraudulent claim. The definition of "material" is amended to mean "having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property."[28] These changes solve the narrow interpretations of the FCA presented in the three cases discussed next.[29]

In a floor statement, Senator Grassley noted that the legislation would close a loophole in the law created as a result of the decision in *Allison Engine Co. v. U.S. ex rel. Sanders*, 123 S. Ct. 2128 (2008).[30] In *Allison Engine*, the Supreme Court limited liability to fraudulent statements that were specifically connected to government funds and designed "to get" false claims paid or approved by the government. For example, as opined by Justice Alito, the sub-contractor's false invoice was passed up the chain by the prime contractor to justify a payment by the government, the FCA applied. If, instead, the prime contractor, or sub-contractor above a lower sub-contractor, had a fixed amount of money, and paid the false claim from that pool of funds, the FCA would not apply.

In *U.S. ex rel. DRC, Inc. v. Custer Battles, LLC*,[31] a relator alleged that a contractor submitted false claims to the Coalition Provisional Authority ("CPA") in Iraq. The District Court for the Eastern District of Virginia dismissed the claims, reasoning that the CPA was a private contractor and the nexus to the federal government was too tenuous.

In *U.S. ex rel. Totten v. Bombardier Corp.*,[32] a relator brought a *qui tam* action against contractor under the FCA for allegedly submitting false claims to the National Railroad Passenger Corporation (Amtrak) to obtain payment for allegedly defective railroad cars. The trial court dismissed the case. In an opinion by circuit Judge John Roberts, now Chief Justice of the U.S. Supreme Court, the U.S. Court of Appeals for the District of Columbia affirmed the lower court's dismissal. Under the FCA, Amtrak is not a governmental entity, so the presentation of a false claim to Amtrak was not a presentation to the federal government, the appeals court ruled.

However, the U.S. Supreme Court in *Allison Engine* rejected the direct presentment requirement, and so neither *Totten* or *Custer Battles* is considered good law. Nevertheless, Congress felt it sufficiently important to clarify in S. 386 the language of the statute that the provenance of government funds, not the status of private contractor, is the key to the scope of the FCA. The amendment to the provision in the bill that corresponds to section 3729(a)(2) would specifically apply retroactively to all claims pending as of June 7, 2008, [33] which is the date of decision of *Allison Engine*. Section 4 of S. 386 limits liability to funds provided by the government "to be spent or used on the Government's behalf or to advance a Government program or interest."[34]

In a letter of April 21, 2009, from the U.S. Chamber of Commerce and allied business groups, to the U.S. Senate, the argument was advanced that S. 386 was unnecessary due to recent appellate reversals of *Custer Battles* and *Totten* by the Fourth Circuit. The business groups wrote that: "Fundamentally, we believe that recent court decisions have also eliminated the need for any changes to the Act."

H.B. 1788, a parallel bill to S. 386, had sought to undo the ruling in U.S. ex rel. *Stone v. Rockwell Int'l Corp.*.[35] In *Rockwell Int'l*, the Supreme Court held that the *qui tam* whistleblower was barred from receiving a share of any money recovered because under the "public disclosure bar" the whistleblower was not an original source with "independent knowledge of the information on which the allegations are based."[36] Senator Grassley noted that *Rockwell* provides a disincentive for a whistleblower to bring a case, even if the Justice Department is overloaded or does not chose to bring the case.[37] The proposed language in H.B. 1788, which was not included in S. 386, would have eliminated the procedural uncertainties by requiring the Justice Department to file a timely motion to dismiss claims that violate the "public disclosure bar."[38]

Conclusion

S. 386 makes important changes to the FCA that expand its powers to new arenas of interstate mortgage lending and TARP spending, and clarify jurisdictional questions raised by *Allison Engine* and related cases. The rapid adoption of the bill shows Congress' interest in protecting large federal stimulus expenditures from fraud and abuse. With the adoption of S. 386, the role of relators, as private attorney generals, is more important than ever.

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2 Public Law No. 111-021.

3 31 U.S.C. § 3729 *et seq*.

4 S. 386, § 4(a)(2), deleting 31 USC § 3729(c), and substituting § 3729(b)(2)(A).

5 FCA Liability Only Attaches to U.S. Government Funds, discussing *U.S. ex rel. DRC, Inc. v. Custer Battles, LLC*, 376 F. Supp. 2d 617 (E.D. Va. July 8, 2005), TAF Quarterly Review, v. 39 (Oct. 2005), at 11 ("While the court recognized that the definition in § 3729(c) is not exclusive, the court warned that the expanded definition outlined in Section 3729(c) 'does not explicitly overturn the rule that a claim requires a request or demand for payment from government funds.' Thus, the district court held that a 'claim' requires a request or payment for government property plainly survives the 1986 FCA amendment.") (*available at* http://www.taf.org/publications/ PDF/TAF_QR_v39.pdf).

6 Ronald A. Sarachan, Dee Spagnuolo & Tejal K. Mehta, Expansion of False Claims Act liability signed into law by the President, May 22, 2009, Ballard Spahr Andrews & Ingersoll, LLP (*available at* http://www.ballardspahr.com/press/article.asp?ID=2529).

7 123 S. Ct. 2128 (2008).

8 Many of the ideas in S. 386 had appeared in

a bill in the previous Congress that had not reached a vote. See S. 386 report, U.S. Senate Republican Policy Committee Legislative Notice, no. 9, Apr. 20, 2009, at 3 ("Section 4 of S. 386 incorporates a number of very similar provisions to S. 2041 from the 110th Congress. That bill was introduced on September 12, 2007, referred to the Committee on the Judiciary, and subsequently reported, as amended, by the committee to the full Senate. No further action was taken on the bill.") (*available at* http://rpc.senate.gov/public/_files/9S386FraudEnforcementandRecovery042009.pdf).

9 Roll Call #268 (Suspend Rules and Agree to S Adt to House Adts - Fraud Enforcement and Recovery Act). 111th United States Congress, 1st Session. Clerk of the U.S. House of Representatives (*available at* http://clerk.house.gov/evs/2009/roll268.xml); *also see*, History of S. 386, GPO Access (*available at* http://frwebgate6.access.gpo.gov/cgi-in/TEXTgate.cgi?WAISdocID=472376472841+0+1+0&WAISaction=retrieve); and see, Sen. Res. S. 386 EAS, May 14, 2009 (available at http://thomas.loc.gov/cgi-bin/query/D?c111:5:./temp/~c111VytoFn::).

10 John T. Boese, "The False Claims Act is amended for the first time in more than twenty years as the President signs the Fraud Enforcement and Recovery Act of 2009," *FraudMail Alert*, No. 09-05-21, May 21, 2009, Fried, Frank, Harris, Shriver & Jacobson LLP (available at http://www.ffhsj.com/siteFiles/Publications/96C624E1C1C818605ABF4C050E2677B9.pdf).

11 Editorial, "Wall Street follies," *L.A. Times*, Jan. 4, 2009 ("Lenders should be deterred from giving money to people with no reasonable ability to repay it, even if they plan to sell the loans to Wall Street as soon as the borrowers' signatures are dry.") (*available at* http://www.latimes.com/news/opinion/ editorials/la-ed-wallstreet4-2009jan04%2C0%2C7346014.story).

12 *See, e.g.*, Lisa Scherzer, "Subprime blame game," *SmartMoney*, Nov. 1, 2007 (available at http://www.smartmoney.com/investing/economy/subprime-blame-game-22074/).

13 *See* Senate Report 111-001, Joint Economic Report, Jan. 9, 2009, at 180-181 (*available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_reports&docid=f:sr001.111.pdf).

14 Press release, President Obama Signs the Helping Families Save Their Homes Act and the Fraud Enforcement and Recovery Act, May 20, 2009, White House archives (*available at* http://www.whitehouse.gov/the_press_office/ Reforms-for-American-Homeowners-and-Consumers-President-Obama-Signs-the-Helping-Families-Save-their-Homes-Act-and-the-Fraud-Enforcement-and-Recovery-Act/).

15 S. 386, § 2(a)(3).

16 S. 386, § 5(c)(1)(I).

17 Foon Rhee, "Obama signs mortgage bills," *Boston Globe*, May 20, 2009 (*available at* http://www.boston.com/news/politics/politicalintelligence/2009/05/ obama_back_on_e.html); and see Ronald D. Orol, "Obama to sign $490 million mortgage fraud bill into law," *MarketWatch.com*, May 20, 2009 ("The House voted Monday night, 338-52, to approve bipartisan legislation that would authorize $490 million over two years to hire fraud prosecutors, increase enforcement actions and add funds to the Secret Service and Housing and Urban Development Inspector General.") (*available at* http://www.marketwatch.com/story/obama-to-sign-490-million-mortgage-fraud-bill).

18 Remarks of Pres. Obama, May 20, 2009, White House archives (*available at* http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-at-Signing-of-the-Helping-Families-Save-Their-Homes-Act-and-the-Fraud-Enforcement-and-Recovery-Act/).

19 *See* Nov. 17, 2008, letter from Sen. Grassley to Treasury Secretary Paulson and Attorney General Mukasey (*available at* http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=18128).

20 M-09-21, Implementing Guidance for the Reports on Use of Funds Pursuant to the American Recovery and Reinvestment Act of 2009, OMB website, June 22, 2009 (*available at* http://www.whitehouse.gov/omb/memoranda_default/).

21 *Id.*, para. 3.2, at 16.

22 Emergency Economic Stabilization Act of 2008, Pub.L. 110-185, 122 Stat. 613, enacted Feb. 13, 2008, at 63.

23 *See* Jan. 7, 2009, letter of Neal Barofsky's to the U.S. Senate Committee on Finance (*available at* http://finance.senate.gov/press/Bpress/2009press/prb010709.pdf). Barofsky has written to the previous stimulus recipients to ask for a certification of information provided to the government. See Jan. 22, 2009, letter from Neal Barofsky to the U.S. Senate Committee on Finance (*available at* http://finance.senate.gov/press/Gpress/2009/ prg012209.pdf).

24 SIGTARP, Initial Report to Congress, Feb. 6, 2009, at 100-101 ("Fraud vulnerabilities in the Term Asset-backed Securities Loan Facility ('TALF') should be addressed before the program is initiated.") (*available at* http://www.sigtarp.gov/reports/congress/2009/SIGTARP_Initial_Report_to_the_Congress.pdf).

25 *See* Dep't of the Treasury, TARP Conflicts of Interest Interim Rule, 74 Fed. Reg. 3431 (Jan. 21, 2009) (to be codified at 31 C.F.R. pt. 31) (*available at* http://edocket.access.gpo.gov/2009/pdf/E9-1179.pdf).

26 Senate Report No. 111-010, Fraud Enforcement and Recovery Act of 2009, n. 4, citing S. Rpt. No. 99-345, at 5282-5301 (providing section-by-section analysis explaining that a false claim includes claims submitted to grantees and contractors if the payment ultimately results in a loss to the Government) (*available at* http://thomas.loc.gov/cgi-bin/cpquery/R?cp111:FLD010:@1(sr010):).

27 *Id.*, n.7.

28 S. 386, § 4(a), amending 31 U.S.C. § 3729(b)(4).

29 Democratic and Republican policy analysis reports describe the changes in Section 4 of S. 386, as follows:

S. 386 would restore the original intent of the *False Claims Act* (FCA) to expand beyond just those instances in which the defendant intends to directly defraud the federal government. Recent court decisions limited FCA's effectiveness by requiring the government to prove that a defendant intended to defraud the federal government, as opposed to another non-governmental entity. For example, a subcontractor in a large government contract could offer as a defense to their prosecution under FCA that they only meant to defraud their general contractor and not the federal government. The bill would also make clear that the government can recover for frauds committed by a defendant when the funds are expended by a government grantee, such as Amtrak.

Democratic Policy Committee, "S. 386, the Fraud Enforcement and Recovery Act of 2009," Apr. 21, 2009 (*available at* http://dpc.senate.gov/dpcdoc.cfm?doc_name=lb-111-1-58) The Republican analysis is substantially similar, and states in pertinent part:

Amends the False Claims Act (FCA) to overturn a number of recent court decisions that have narrowed its reach. In particular, section 4 amends the FCA in order to clarify that (1) liability attaches for fraud perpetrated against contractors and grantees of the U.S. government—not just for fraud directly committed against the U.S. government; (2) intent is not necessary for FCA liability to attach; (3) the scope of FCA applies to funds administered by the U.S. government; (4) conspiring liability can arise from any violation of the FCA; (5) a valid receipt from the U.S. government is not necessary to attach liability; and (6) liability exists for conduct to conceal, avoid or decrease an obligation owed to U.S. government. The section makes clear that liability does not apply to federal employment compensation or income subsidies, such as Social Security benefits. U.S. Senate Republican Policy Committee Legislative Notice, "S. 386 report," no. 9, Apr. 20, 2009, at 4 (*available at* http://rpc.senate.gov/public/_files/L9S386FraudEnforcementandRecovery042009.pdf).

30 Prepared Statement of Senator Chuck Grassley of Iowa, Senate Floor Debate on Fraud Enforcement and Recovery Act, Apr. 20, 2009 (*available at* http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=20209).

31 62 F.3d 295 (4th Cir. 2009).

32 380 F.3d 488 (D.C. Cir. 2004), *cert. den.*, 544 U.S. 1032 (2005).

33 S. 386, § 4(f)(1).

34 S. 386, § 4(b)(2)(A)(ii).

35 49 U.S. 457 (2007).

36 *Rockwell Int'l Corp.*, 549 U.S. at 477.

37 On June 23, 2009, the U.S. Supreme Court granted *certiorari* to hear a case on the public disclosure bar, specifically whether whistleblower lawsuits are restricted if the information behind the lawsuits came out in state or local agency reports or audits, rather than in a federal proceeding. *Graham County Soil & Water Conservation District v. U.S. ex rel. Wilson*, 528 F.3d 292 (4th Cir. Jun. 9, 2008), petition for cert. granted, 2009 WL 1738653 (mem.)(U.S. Jun. 22, 2009)(No. 08-304).

38 F. Joseph Warin, *et al.*, eds., "Proposed Legislation Amending False Claims Act," Feb. 26, 2009, Gibson Dunn & Crutcher LLP (*available at* http://www.gibsondunn.com/Publications/Pages/posedLegislationAmendingFalseClaimsAct.aspx).

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