Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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A Small Step Forward on Addressing the Problem of False Claims Cases*

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In an earlier issue of ***Our Perspectives***, we raised the possibility that the harmful effect of inappropriate actions under the False Claims Act could be mitigated administratively without creating opportunities for bad actors to use that mitigation to violate the intentions of the Act. Now the Secretary of Housing and Urban Development has made comments before a major housing trade group that reflects the same desire to administratively resolve some of the great uncertainty associated with FHA lending because of the litigation risks implicit in False Claims Act litigation.[1]

While the ideas we expressed would not cure all of the problems of the risks of False Claims Act litigation, they would ameliorate them by clarifying that there would be categories of loans under the Defect Taxonomy of the FHA that would not be subject to claims under that Act. It would be a beginning.

The FHA Defect Taxonomy

After the results of the uncertainty that it and DOJ had created among lenders, the FHA issued a new loan level certification and a Quality Assurance Defect Taxonomy in June of 2015 in an attempt to encourage lenders to wholeheartedly support lending under its programs. That effort did not make a substantial difference primarily because the risk of litigation under the FCA was not mitigated by its actions. In the words of the document itself, the Taxonomy "does not establish standards for administrative or civil enforcement action," nor "address fraud of misrepresentation in connection with any FHA-insured loan."[2] This statement was made notwithstanding that the agency had concluded that in certain recognized circumstances the fact that if there were errors in the submission by the lenders they were immaterial. Small comfort, then was the Taxonomy because it did not prevent FCA litigation.

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1]Comments of Secretary of HUD Dr. Ben Carson, Mortgage Bankers Association Convention, October 23, 2017

[2]FHA's Single Family Housing Loan Quality Assessment Methodology (Defect Taxonomy), June 18, 2015, p. 7

The Escobar case and its effect

At about the same time that the FHA published its Defect Taxonomy, the United States Supreme Court decided a *qui tam* False Claims Act case which has become known as the Escobar case.[3] The FCA imposes significant penalties on anyone who knowingly presents a false or fraudulent claim for payment or approval to the Federal Government. Defendants over time have been held to accountability under what is known as the implied certification theory, namely a theory which treats a payment request as a claimant's implied certification of compliance with relevant statutes, regulations, or contract requirements that are a material condition of payment, and treats a failure to disclose a violation as a misrepresentation that renders the claim false. The Escobar case endorsed the implied certification theory, but placed major limits on the implied certification that had developed under the Act, and courts since then have generally looked very closely at the need for materiality required to permit the implication of certification. While a full understanding of the meaning of the Escobar case remains in flux, it seems clear that the Supreme Court in the Escobar case placed a burden on the parties to explore what any actual payment by the government to the defendant meant in the context of the entire situation.

The court in Escobar had said, fairly clearly, that payment by the government knowing the facts prior to payment is strong evidence that the certification cannot be implied based on the submission of that claim.

> "In sum, when evaluating materiality under the False Claims Act, the Government's decision to expressly identify a provision as a condition of payment is relevant, but not automatically dispositive. Likewise, proof of materiality can include, but is not necessarily limited to, evidence that the defendant knows that the Government consistently refuses to pay claims in the mine [sic] run of cases based on noncompliance with the particular statutory, regulatory, or contractual requirement. Conversely, if the Government pays a particular claim in full despite its actual knowledge that certain requirements were violated, that is very strong evidence that those requirements are not material. Or, if the government regularly pays a particular type of claim in full despite actual knowledge that certain requirements were violated, and has signaled no change in position, that is strong evidence that the requirements are not material." at 16. (Emphasis added).

This, of course, does not permit defendants to obscure the facts so that the government does not have knowledge before payment, and many of the cases that have followed the decision in Escobar have been engaged in determining if the government had knowledge when the payment was made.

Position of FHA and DOJ on the issue

In his remarks before the Mortgage Bankers convention, Secretary Carson announced a way to expand the desirability of FHA lending to bankers.

> "Without lenders willing to offer FHA-insured loans, or serve as Ginnie Mae issuers, the path to affordable credit access is undermined.

[3]Universal Health Services, Inc. v. United States *ex rel* Escobar, 136 S. Ct. 1989 (2016).

> We have heard concerns on the part of some in the lender community about participating fully in our programs because of the undue risks they perceive from a lack of clarity in what we expect and exposure to outsized liability from immaterial errors.
>
> Lenders have rightly pointed out that absolute perfection in the lending process cannot be achieved, and that borrowers bear the costs of compliance through higher mortgage rates. Other sectors off the market have made real progress in addressing these issues, creating more confidence to lend.
>
> We have heard these concerns and today I am very pleased to announce that HUD, in consultation with the Department of Justice, is committed to reviewing and addressing them.
>
> Part of the process will entail a review by FHA of its lender certifications and the implementation of the defect taxonomy."

It is notable that he said his comments were made after consultation with the Department of Justice. General Sessions has been seen as a supporter of FCA cases in part due to his strong comments at his nomination hearing that he believed they were a useful tool to root out fraud and corruption. In that hearing, he also stated that he had brought a qui tam case as a private attorney. Yet, there is no inconsistency between prosecuting fraud claims and not prosecuting cases that the primary supervising agency finds are founded on claims that are immaterial to the question of whether or not to pay the defendant.

What can be done administratively and quickly to begin the process of rationalizing FCA litigation in the housing finance market?

The steps that could quickly be taken by HUD and DOJ are these:

1. HUD should clarify that errors in loan files for loans in Tier 4 are immaterial errors and will not lead the loans to be unapprovable by HUD or be the basis for claims under the False Claims Act.

2. HUD should remove or modify any language in the Loan Defect Taxonomy documents that leave that question unsettled or subject to debate.

3. In consultation with HUD, DOJ should promulgate guidance at least as strong as a principle of federal prosecution that materiality under its guidelines in FCA cases will be absent in cases if the agency responsible for administering a federal law whose violation is the basis of the DOJ suit has concluded that the actions of a party are acceptable to it in its administration of that law, notwithstanding that there may have been mistakes or errors made by that third party in complying with the law. That principle will be followed in cases brought directly by the Department or as intervenors in qui tam cases.

If the DOJ does not want to make such a sweeping declaration, it could limit its guidance to HUD and to other agencies in which it has confidence that the errors tolerated by those agencies are truly immaterial.

These actions would be in complete accord with the Supreme Court's decision in Escobar. They would provide a sense of certainty to a small number of loans and would encourage lenders to again enter the FHA market. These changes are, of course, only a first step, and there is no illusion that with such a change the floodgates would open and regulated institutions would return fully to FHA lending. But it would be a beginning.

A more vigorous effort by FHA would be a reconsideration of Tier 3 definitions. If errors exceed approval limits only by a small margin, or a loan fails to comply with loan guidelines only to a small degree, (this is the language of Tier 3 examples) the potential claims to a FCA suit to which the lender would be exposed seems out of balance with the degree of the error. HUD should consider how to draft that Tier's definitions to provide a method for lenders to comply and avoid the risks inherent in the FCA. After all, the language of the example in Tier 3 makes it clear that the violation is "small." Perhaps as a start, HUD could list those kinds of cases in which a tolerance threshold would be appropriate, and if met, would cause those loans that meet those tolerances to be treated as Tier 4 loans.

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