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The DOJ’s Case Against Standard & Poor’s and the Continued Rise of FIRREA as a Tool for Government Enforcement

Introduction

On February 4, 2013, the Civil Division of the Department of Justice, together with the United States Attorney’s Office for the Central District of California in Los Angeles, commenced an action against S&P Financial Services LLC (S&P) and its parent, McGraw-Hill. The action, related to S&P’s rating of residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs) during the onset of the financial crisis in 2007, has attracted no small amount of press attention, with coverage ranging from speculation that the case is a harbinger of greater regulatory interest in the role of ratings agencies\(^1\) to analysis of the case’s potential to shutter McGraw-Hill if successful.\(^2\) Somewhat overlooked in this discussion, however, is the Attorney General’s use of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA or the Act) as the legal basis for its claims. While FIRREA has been around for over twenty years, it has not been featured as a tool for civil enforcement actions in the financial services and securities sector, as the Department of Justice has relied primarily on enforcement provisions contained in the Securities and Exchange Acts. Now, however, FIRREA may be coming into its own. The particular advantages that FIRREA offers to the government include longer statutes of limitations, a lower burden of proof as compared to criminal enforcement, and the prospect of significant monetary penalties. These benefits may lead to a new approach to civil enforcement actions generally, in which the government’s desire to impose criminal sanctions based on joint Justice Department/SEC investigations gives way to a regime focused on civil liability backed by the threat of sizeable damages. At present, the government appears to be moving slowly and opportunistically — seeking to broaden the reach of FIRREA to increasingly wider fact patterns. But, if the present action against S&P proves successful, FIRREA may play a new role in the next generation of enforcement actions.

Background of the Act

FIRREA was passed on August 9, 1989, in response to the savings-and-loan crisis and the resulting strain on the federal deposit insurance programs associated with the failure of such institutions.
The Act imposed regulatory requirements on covered banking institutions, set stricter capital maintenance requirements, prohibited the counting of unidentifiable intangible assets (such as goodwill) toward a bank's capital maintenance requirement, and shortened amortization periods. Notably, FIRREA also created new, harsh civil penalties for violating certain pre-existing federal laws that regulated or affected federally-insured financial institutions or other similar entities. These pre-existing laws include false-entries fraud (18 U.S.C. §§1005, 1006), false statements to federal officials (18 U.S.C. § #1001), mail fraud (18 U.S.C. § 1341), wire fraud (18 U.S.C. § 1343), bank fraud or concealment of assets and other frauds as against a federally-insured banking institution (18 U.S.C. § 1344), and violations of Section 16(a) of the Small Business Act.

The incorporation of these existing criminal statutes — particularly mail fraud and wire fraud — into a civil enforcement regime makes FIRREA a useful tool for regulatory action. These fraud statutes are very familiar to the Department of Justice, and allow FIRREA investigations to work in tandem with ongoing criminal investigations. At the same time, since FIRREA is a civil statute, the government need only establish its claim by a preponderance of the evidence, thereby avoiding the higher standard of “beyond a reasonable doubt” that applies to criminal enforcement actions. The statute also contains a lengthy limitations period (ten years after the cause of action accrues), giving the Department of Justice a longer time to develop its investigation, greater visibility into the effects of allegedly wrongful conduct before bringing suit, and the ability to reach back to past conduct other provisions may miss. FIRREA also allows for civil penalties of up to $1.1 million for each violation or up to $5.5 million for a continuing violation from persons who "violate any provision of law to which this section is made applicable," and possibly even greater recovery if a defendant “derives pecuniary gain from the violation, or if the violation results in pecuniary loss” to a person other than the defendant. As with criminal enforcement, the act allows regulators to seek million-dollar penalties for each transmission of a fraudulent statement or other discrete act. In sum, the sizable per-violation penalty, and the open-ended definition of “violation” under the Act, can lead to billion dollar aggregate potential penalties against alleged violators.

Notably, FIRREA claims may only be brought by the United States Attorney General, meaning that there is no private cause of action for individual plaintiffs. Likewise, securities regulators and state attorneys general or other regulatory entities are also foreclosed from using FIRREA.

FIRREA claims have often been paired with claims under the False Claims Act, 31 U.S.C. § 3729, et seq. and used with respect to federally insured loans and/or mortgages. However, until the past few years, FIRREA was seldom used against capital markets participants.

**Changing Times?**

In the wake of the financial crisis, as the Department of Justice has struggled to make significant criminal cases, it has increasingly turned to civil statutes such as FIRREA. For example, in October 2011, the U.S. Attorney for the Southern District of New York, which created a civil frauds enforcement unit in 2010, brought a civil fraud action against The Bank of New York Mellon Corporation (Bank of New York Mellon), one of the world’s largest custodial banks, alleging that from 2000 to the present the bank engaged in a scheme to defraud custodial clients who use its foreign exchange services. The federal government sought monetary penalties...
and injunctive relief based on a theory of mail and wire fraud related to currency transactions, citing the criminal statutes of mail and wire fraud but using FIRREA as the operative statute. With no criminal charges being filed, the US Attorney could use FIRREA to punish alleged wrongdoers without having to prove beyond a reasonable doubt that they acted fraudulently — creating a significant advantage for the prosecution.

The Bank of New York Mellon has vigorously denied the allegations and moved to dismiss the federal complaint, arguing that, *inter alia*, its actions did not cause a loss to any federally-insured financial institution and that the government had failed to allege fraudulent conduct sufficient to give rise to wire or mail fraud claims.⁹

**The S&P Complaint**

On February 4, 2013, the Department of Justice brought suit against S&P and its parent, McGraw-Hill, seeking recovery on the basis of violations of FIRREA. This action followed lengthy negotiations between the government and S&P, which resisted any settlement involving admission of fault or sizable penalties.¹⁰

The allegations contained in the government’s complaint assert that S&P’s ratings activities were undermined by its desire to maintain relationships with, and profit from, RMBS and CDO issuers. As a result, the government claims S&P failed to rate securities issued by these institutions objectively, and allowed issuers access to the ratings process to ensure favorable results. For instance, the complaint alleges that S&P did not update its RMBS ratings model to account for the growing role of lower quality Alt-A and subprime mortgages in securitizations.¹¹ Similarly, the complaint also asserts that S&P allegedly did not adopt an objective model with respect to the ratings of CDOs and instead created a model with heightened tolerance of “non-investment grade deals.”¹² S&P allegedly took input from issuers in testing and refining this new CDO model, resulting in further changes that benefitted issuers of riskier products.¹³

The S&P complaint alleges a growing disconnect between S&P’s public ratings and its internal sense of the market as 2007 progressed. For example, as the credit market declined throughout 2007 and evidence of mortgage underperformance began to grow, the government claims that S&P delayed revisiting its ratings of mortgage-backed securities. The complaint points to allegedly misleading statements made to federally-insured financial institutions during 2007 in connection with over 20 securities through mail, facsimile transmission, email, wire or internet.¹⁴ The Department of Justice uses these statements to argue that it possesses the necessary facts for claims on which a FIRREA violation may be predicated, including violations of the mail fraud and wire fraud statutes, 18 U.S.C. §§ 1341, 1343, and financial institution fraud, 18 U.S.C. § 1344.¹⁵

Notably, the government adopts the same approach that it would in ordinary criminal wire or mail fraud prosecutions in claiming that each “deposit of an item for delivery” through the mail and each “transmission… by means of wire communication” in furtherance of the fraud constitutes a separate violation of FIRREA. By doing so, the government raised the stakes significantly, with total claims that could reach $5 billion in penalties against S&P.¹⁶

The government’s tactics in the S&P case have much in common with those it used against the Bank of New York Mellon. First, even though it asserted wire and mail fraud claims in the Bank of New York Mellon case, the government opted not to bring a criminal prosecution based on those same claims, intentionally choosing to avail itself of the lower burden of proof in a civil action. Additionally, as with the
Bank of New York Mellon action, the Department of Justice’s suit is accompanied by parallel state action — in this case over a dozen separate state enforcement actions17 — although the rollout of the cases against S&P appears to have been more coordinated than in the Bank of New York Mellon litigation, where the Department and New York Attorney General Eric Schneiderman announced separate suits on the same day in what could have been viewed as a race to the courthouse.18 In the S&P case, the New York Attorney General chose a different approach, announcing his intention to begin an independent probe of S&P and other ratings agencies.19

While there are some similarities between the S&P and Bank of New York Mellon actions, there is much to suggest that this case foreshadows the government’s continued efforts to expand FIRREA as an enforcement tool. For example, unlike the Bank of New York Mellon action, no direct engagement between the affected, federally-insured financial institution and the defendants have been alleged. Instead, the S&P complaint claims that the company provided ratings output on behalf of issuers, and those ratings were, in turn, relied upon by financial institutions in their decision to acquire the securities at issue. In some cases, the government does not even appear to allege any direct communication between S&P and an injured party; indeed, the extent of such allegations is that S&P published its ratings on a website that the injured party viewed.20 Allegations of FIRREA violations without direct communication between the defendant and any aggrieved federally-insured financial services firm, if successful, could constitute a significant expansion of FIRREA’s reach in and of itself.

More broadly is the question of whether this action against S&P signals further actions against ratings agencies, and others, who supported the RMBS market. For a long time, ratings agencies have contended that their ratings were validly held opinions based on facts of which all market participants were aware. As such, these opinions were protected under the First Amendment, and fell outside fraud and misstatement.21 At the same time, the government has faced pressure to bring criminal prosecutions and other enforcement actions against those seen as responsible for the financial crisis.

The present action represents a middle course — the government seems ready to challenge the ratings agencies’ view that their actions did not rise to the level of actionable misrepresentations, and to seek sizable financial penalties for these perceived misstatements. At the same time, the government appears unwilling to seek criminal penalties against S&P — no individual officer or employee of S&P has been criminally charged.22 This approach may become the new norm, augmenting the civil enforcement authority of the SEC, or it may recede as the Department of Justice moves to criminal prosecutions against alleged wrongdoers. Given the Department’s apparent commitment to the use of FIRREA and the False Claims Act, however, the trend appears to favor the civil enforcement model.

If the government does continue to employ FIRREA as one of its principal tools in responding to the financial crisis, this approach raises new questions about the government’s long-term strategy. At present, it seems that the government is acting opportunistically by seeking to expand the reach of FIRREA to securities transactions and related activities that were previously the target of Securities and Exchange Act claims. Latham & Watkins expects the government to move slowly at first to test the courts’ willingness to allow expanded and unfamiliar FIRREA claims in these contexts. Should it prove successful, the temptation of such a powerful civil enforcement mechanism may prove difficult to resist.
Endnotes


4 See id.

5 See id.; see also 28 C.F.R. § 85.3 (inflation adjustments for civil monetary penalties).

6 See id.

7 See, e.g., United States v. MIC Dairy, Inc., No. 05-1613CCC, 2006 U.S. Dist. LEXIS 67258 (Sept. 18, 2006 D.P.R.); United States v. Buy-A-Home, LLC, No. 10 CV 9280 (Dec. 13, 2010 S.D.N.Y.). The False Claims Act (“FCA”), which allows recovery for any “false or fraudulent claim” made to the government (31 U.S.C. § 3729 (a)(1)(A) (2013)), was a common enforcement mechanism for fraud that affected the government, such as healthcare fraud or government procurement fraud. Unlike FIRREA, FCA claims may be brought by private qui tam relators — greatly expanding the use of the statute in civil litigation (See 31 U.S.C. § 3730(b) (2013)). However, its application in matters related to the financial crisis is less clear-cut than FIRREA, as the necessary predicate for an FCA claim — a claim to the government for payment — is less likely to arise in securities transactions.


9 See Motion to Dismiss the Second Amended Complaint, Dkt. No. 41, United States v. Bank of New York Mellon, 11 Civ. 6969 (S.D.N.Y.).


11 See note 5 supra.


14 (Compl. ¶ 277)

15 (Compl. ¶ 279-86)


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