THE NATIONAL
LAW JOURNAL
OCTOBER 21, 2019
An ALM Publication

'Hodge' Brings Circuits into Alignment on Mortgage Fraud Claims

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The False Claims Act imposes treble damages for any losses the federal government "sustains because of" fraud. But how do courts tell when the government suffers losses "because of" fraud? This question can prove surprisingly complex in mortgage fraud cases under the FCA, and it does not arise in other mortgage litigation, such as cases pursuing repurchase remedies under a pooling and servicing agreement.

Until recently, federal circuit courts appeared divided on the causation standard for mortgage fraud claims under the FCA. But a recent Fifth Circuit decision in *United States v. Hodge* clarifies the standard and brings the circuits into alignment. By allowing proof of causation at a higher level of generality, it also paves the way for the government and private relators to bring FCA claims in cases with large numbers of misstatements.

The Federal Housing Authority's Mortgage Insurance Program

The Department of Housing and Urban Development administers a mortgage insurance program. A mortgage only qualifies for insurance from HUD if it complies with extensive criteria relating to the buyer's finances and the value of the home. Lenders must certify that mortgages they submit meet HUD's requirements.

Unfortunately, lenders sometimes fraudulently submit loans that do not qualify. When those loans default, HUD must make insurance payments worth hundreds of thousands of dollars. HUD's ability to recover under the FCA depends

photo by Mike Scarcella / ALM Media

U.S. Court of Appeals for the Fifth Circuit in New Orleans.

on whether it suffered losses "because of" the lender's fraudulent statements.

The Law Before *United States v. Hodge*

When do false statements in an application for mortgage insurance "cause" HUD to suffer a loss? The U.S. Supreme Court has interpreted the FCA in light of common-law principles. At common law, causation had two elements, "but-for" and "proximate" causation. But-for causation is satisfied if a loss would not have occurred without a defendant's conduct. Proximate causation, in turn, requires the loss to have a direct and foreseeable relationship to the defendant's conduct and the type of risk it created.

Applying common-law principles, courts have reached a consensus that but-for causation, standing alone, does not meet the FCA's requirements. Thus, the mere fact that HUD would not have insured a mortgage if it had known the truth does not suffice. The government must also prove proximate causation.

The question of when a misstatement has a direct and foreseeable relationship to default appeared to divide circuit courts until recently. The Fifth Circuit, in a case called *United States v. Miller*, stated that the government must "show that the false statements in the application were the cause of subsequent defaults." The Ninth and D.C. Circuits, in contrast, held that a false statement has a direct and foreseeable relationship to HUD's loss if it concerns factors that affect the likelihood of repayment, such as the borrower's creditworthiness.

Many defendants interpreted the Fifth Circuit to apply a much stricter standard, thereby limiting the types of claims available. The government can satisfy the standard applied by the Ninth and D.C. Circuits through proof about the false statements and the types of risk they concealed. Defendants argued that the Fifth Circuit's standard, in contrast, required proof about the ultimate cause of default. Such proof is difficult, if not impossible. Defaults often have many causes, and no single factor alone is sufficient. Requiring detailed proof of a single cause would impose a significant barrier to cases based on a large number of loans.

United States v. Hodge

The Fifth Circuit's decision in *Hodge* rejected a restrictive interpretation of *Miller*. The government had alleged that a lender had fraudulently submitted mortgages for HUD insurance over a period of 10 years. At trial, it analyzed a statistical sample and found that 53.7% of the lender's defaulted loans contained misrepresentations about factors that significantly affected the likelihood of repayment. The government also showed that the lender's loans had defaulted at higher rates than those submitted by other lenders. Extrapolating from its sample, the government argued that the lender had submitted 1,196 fraudulent loans, causing HUD $86 million in losses.

The defendants contended that, under *Miller*, the government had not proved that any false statements "were the cause of subsequent defaults." The Fifth Circuit disagreed. It noted that proof on a loan-by-loan basis would not be feasible in a case involving over one thousand loans. Rather than demand such proof, it instead examined the risk created by the lender's conduct in the "aggregate." The lender's systematic disregard for HUD's requirements, which were designed to reduce the risk of default, bore a direct and foreseeable relationship with HUD's subsequent losses. Thus, regardless of whether the government had traced each default to a specific misstatement, it had proved that the lender's pattern of fraud concealed the very risks that had caused HUD to suffer losses.

Implications

Hodge has significant implications. First, it demonstrates that Fifth Circuit does not apply the restrictive causation standard some defendants had attributed to *Miller*. The Fifth Circuit's willingness to examine conduct in the aggregate confirms that, like the Ninth and D.C. Circuits, it permits the government to prove proximate causation by showing that false statements concealed the type of risk that ultimately materialized.

Hodge also confirms that the FCA is a powerful tool that the government and private relators can use to address sweeping frauds. The government need not submit endless proof about the loss attributable to each specific misstatement. Instead, it can prove the aggregate losses that result from a pattern of fraudulent conduct, including through statistical sampling. That flexibility demonstrates that the days of large, high-value FCA suits are far from over.

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