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White-Collar Crime

Expert Analysis

Implications of 'Countrywide' for Mail and Wire Fraud Prosecutions

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Prosecutors tend to extend the reach of white-collar criminal statutes until the judiciary, at some point, pushes back—the Supreme Court's decision vacating the conviction of former Virginia Governor Robert McDonnell being the most recent high-profile example.[1]

In this article, we discuss another case in which the government's expansive interpretation of federal statutes was narrowed by judicial interpretation—the Second Circuit's May 23, 2016, decision reversing the $1.2 billion judgment against Bank of America's Countrywide mortgage unit and a former Countrywide executive under the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). In *United States ex rel. Edward O'Donnell v. Countrywide*,[2] the U.S. Court of Appeals for the Second Circuit held that the Department of Justice's civil prosecution, premised on violations of the mail and wire fraud statutes,[3] was flawed because it established, at most, a breach of contract. The government failed to allege or prove that the defendants acted with fraudulent intent.

> The Second Circuit held that the Justice Department's civil prosecution, premised on violations of the mail and wire fraud statutes, was flawed because it established, at most, a breach of contract.

The Second Circuit's decision turned on a relatively obscure principle of statutory interpretation, the "common law canon," under which common law terms in a statute presumptively—but not always—retain their well-established common law meaning. Below we examine this principle of statutory interpretation and its significant role in earlier decisions construing the federal fraud statutes. We then come back to the Countrywide case, explaining how the principle led to the unexpected result in that case.

Canons of Interpretation

In statutory interpretation, context is everything,[4] though significant disagreement exists about what counts as relevant context and the priority of various contextual data, such as the definition of statutory terms, legislative history, the purpose of the statute and policy consequences.[5] In the background, but very important to the task of interpretation, are the principles, or canons, of construction that courts are expected to apply. The canons are not absolute and can point in different directions.

Some canons, which scholars refer to as "semantic canons," are intended to help courts draw inferences about the meaning of statutory language. For example, according to the principle of noscitur a sociis, words grouped together in a list should be given a related meaning.[6] Other canons, which scholars refer to as "substantive

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canons," provide guidance for choosing between plausible interpretations based on substantive value judgments. For example, under the rule of lenity, ambiguities in criminal statutes are resolved in favor of the accused to protect the principle of fair notice of when an act is criminal in nature.

Common Law Canon

Under the common law canon, central to the Countrywide decision, words in statutes are to be given the meaning they have at common law unless the statute dictates otherwise.[7] The canon thus has both semantic and substantive qualities: it is intended to help courts interpret specific words in statutes, and it expresses a substantive preference for stability and continuity in the law. As Justice Felix Frankfurter put it, "if a word is obviously transplanted from another legal source, whether the common law or other legislation, it brings the old soil with it."[8] The common law canon promotes "the importance of reading a new statute against the legal landscape and, in doing so, of recognizing the value of minimal disruption of existing arrangements consistent with the language and purpose of the new law."[9]

Application of the common law canon is nicely illustrated in the Second Circuit's 2014 decision in *United States v. Soler*.[10] That case involved the federal carjacking statute, which criminalizes the forcible taking of an automobile "from the person or presence" of the victim. The defendants robbed the victim in her home, demanded her car keys and then stole her car, which was parked outside her house. The defendants argued that their conduct did not violate the statute because the term "presence" means within the immediate vicinity of the car.

The court rejected the defendants' narrow interpretation and adopted the meaning of presence in the context of the common law crime of robbery. At common law, property is within the presence of a robbery victim when it is "so within her reach, inspection, observation, or control that he or she could, if not overcome by violence or prevented by fear, retain possession of it." The court held that a car parked outside a robbery victim's house falls within that standard.

Fraud Statutes

Invocation of the common law canon in *Countrywide* was not novel. The Supreme Court has repeatedly interpreted the federal fraud statutes in light of common law fraud principles.

In *United States v. Durland*,[11] the first Supreme Court decision to construe the mail fraud statute in 1896, the court held that a "scheme or artifice to defraud" was not restricted to the common law meaning of the crime of false pretenses. The defendant sold bonds to his victims with no intent to honor his promise of future payment. He argued that the mail fraud statute did not apply to his conduct because the statute criminalized only the common law crime of false pretenses, which required misrepresentation of an existing fact. At common law, a false promise about future conduct, as opposed to an existing fact, was actionable only as a breach of contract.

Because the defendant made misrepresentations to his victims about what he would do in the future—not present facts—he argued that his conduct did not constitute mail fraud. The court held that the plain meaning of "scheme or artifice to defraud" applies to misrepresentations about the past and the future, and therefore sweeps more broadly than the common law crime of false pretenses.

In *United States v. Neder*,[12] the Supreme Court in 1991 invoked the common law canon to hold that the mail, wire and bank fraud statutes require a showing of materiality—that is, the misstatement or omission would be relevant to a reasonable person—even though the statutes do not expressly refer to materiality. At trial, the government convinced the district court not to include a materiality element in its jury charge on the fraud statutes, and the U.S. Court of Appeals for the Eleventh Circuit affirmed. The Supreme Court held that the phrase "scheme or artifice to defraud" incorporates the common law meaning of fraud, including a materiality requirement, and remanded for consideration of whether the omission was harmless error.

The Neder court explained that, under the common law canon, terms incorporate their common law meaning unless the meaning would be "inconsistent" with the language of the statute. Thus, the fraud statutes' failure to address materiality one way or the other supported the application of the common law materiality requirement. By contrast, because the common law elements of reliance and injury are

inconsistent with the terms of the fraud statutes—which prohibit "schemes to defraud" regardless of actual reliance or injury— the Neder Court recognized that the common law canon does not incorporate a reliance or injury requirement into the fraud statutes.

Countrywide's Alleged Fraud

In the Countrywide case, the Justice Department charged Countrywide and an executive with violating FIRREA, premised on mail and wire fraud violations, for selling risky mortgage loans to two government-sponsored entities (GSEs), Fannie Mae and Freddie Mac, under false pretenses. The government claimed that Countrywide made affirmative misrepresentations regarding the quality of the loans it was selling to the GSEs.

The evidence at trial, and accepted by the Second Circuit for purposes of its decision, established the following conduct. After the collapse of the market for subprime residential mortgages in 2007, Countrywide began originating and selling prime, or high-quality, loans to the GSEs. Countrywide entered into purchase agreements representing that, "as of the date [of] transfer," the mortgages sold by Countrywide to the GSEs would be of high investment quality. After the purchasing agreements were executed, Countrywide instituted a program called the High Speed Swim Lane, or HSSL, to increase the amount of loans it originated.

The HSSL substantially reduced the time spent underwriting and processing loans, and removed quality safeguards to ensure that borrowers could repay them. After the HSSL began, Countrywide knew that a substantial portion of the loans it sold to the GSEs did not meet quality standards required by the purchasing agreements, and that it was not feasible for the GSEs to individually scrutinize the loans they purchased from Countrywide. Over time, as the HSSL loans were originated, Countrywide was not required to make further representations about the quality of the loans it sold to the GSEs.

At trial, the government presented evidence that roughly 42 percent of the loans Countrywide sold to the GSEs fell below the agreed-upon standards, and that the GSEs paid roughly $1.2 billion for these defective loans.[13] The jury found that Countrywide and the head of its loan origination division violated the mail and wire fraud statutes, and Southern District Judge Jed Rakoff imposed a roughly $1.2 billion penalty on Countrywide to account for the amount the GSEs paid for defective loans.

> The court called this temporal link between fraudulent contractual representations and fraudulent intent the "contemporaneity principle." Without fraudulent intent at the time of execution, a willful breach of contract cannot satisfy the contemporaneity principle, and therefore amounts only to a breach of contract.

In pre- and post-trial motions, Countrywide invoked the common law canon to argue that the government could not prove that it had violated the fraud statutes. Specifically, Countrywide argued that, at common law, a breach of a representation or warranty in a contract—here, Countrywide's promise to sell the GSEs quality loans—does not amount to fraud. Further, Countrywide argued that, under the common law canon, the fraud statutes incorporate that limitation, and therefore it was only liable for breach of contract—not mail and wire fraud. Rakoff rejected Countrywide's argument, holding that the Supreme Court's Durland decision established that the fraud statutes are not "subject to the same arcane limitations as common law fraud."[14]

Second Circuit Decision

The Second Circuit reversed the judgment against Countrywide and dismissed the government's case. The court based its decision on the critical fact that, as the government conceded, the only misrepresentations Countrywide made to the GSEs were in the underlying purchasing agreements. These misrepresentations were Countrywide's promise of future performance—namely, that it would sell the GSEs quality loans. The court framed the question as follows: "What is required to prove a scheme to defraud when alleged misrepresentations concerning future performance are contained within a contract?"

The Second Circuit held that, at common law, when allegedly fraudulent misrepresentations are promises in a contract, fraud requires a showing of fraudulent intent at the time of entering into

the contract. Fraudulent intent, in turn, requires a showing that a contracting party had no intention of fulfilling its contractual obligations at the time of execution. The court called this temporal link between fraudulent contractual representations and fraudulent intent the "contemporaneity principle." Without fraudulent intent at the time of execution, a willful breach of contract cannot satisfy the contemporaneity principle, and therefore amounts only to a breach of contract.

In distinguishing fraud from breaches of contract, the contemporaneity principle reflects Justice Oliver Wendell Holmes' classic explanation of common law contracts as "simply a set of alternative promises either to perform or to pay damages for nonperformance," as well as the common law's acceptance of intentional "efficient breaches" that increase overall wealth.[15]

Because the contemporaneity principle is not inconsistent with the language of the fraud statutes, the Second Circuit held that, under the common law canon, it is incorporated into the fraud statutes. The contemporaneity principle required the reversal of the fraud judgment against Countrywide because the government did not present evidence that Countrywide intended to defraud the GSEs at the time it entered into the purchasing agreements. The government merely showed that Countrywide knowingly breached the agreements after it implemented the HSSL.

The government argued that, under the terms of the purchasing agreements, Countrywide made representations at the point of sale—that is, not just at the outset of the arrangement but each time it sold a loan to the GSEs. But the court rejected the government's interpretation of the purchasing agreements. The Second Circuit held that Countrywide did not promise "to make future representations as to [the] quality" of each loan it sold going forward. Rather, it promised at the outset "to provide investment-quality loans at the future delivery date" and later knowingly breached that promise.

Conclusion

The Countrywide case is a reminder of the practical importance of statutory interpretation, particularly in the context of the broadly worded federal white-collar criminal statutes. On the specific issue of when a breach of contract can give rise to a fraud charge, important issues remain. Because the government brought claims against Countrywide on an affirmative misstatement theory, the court explicitly declined to address how the fraud statutes apply to fraud by omission in the context of a contractual relationship. Whatever the answer, it will turn on the common law canon.

1. *McDonnell v. United States*, No. 15-474 (June 27, 2016) (slip opinion); see also Elkan Abramowitz and Jonathan Sack, "Are We Criminalizing Politics as Usual? Case Against Former Virginia Governor," NYLJ (March 5, 2014).

2. 2016 WL 2956743 (2d Cir. May 23, 2016).

3. The mail fraud statute, titled "Fraud and Swindles," is 18 U.S.C. §1341. The wire fraud statute, titled "Fraud by wire, radio, or television," is 18 U.S.C. §1343.

4. Antonin Scalia, "A Matter of Interpretation: Federal Courts and the Law" (Princeton University Press 1997), at 37.

5. See Elkan Abramowitz and Jonathan Sack, "Justice Scalia's Approach to Textualism in White-Collar Law," NYLJ (March 1, 2016).

6. See *Jarecki v. G.D. Searle & Co*., 367 U.S. 303, 307 (1961) (holding that "discovery" in the phrase "exploration, discovery, or prospecting" applies only to activities in the oil, gas, and mining industries).

7. *Neder v. United States*, 527 U.S. 1, 21 (1999).

8. Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 527, 537 (1947).

9. David L. Shapiro, "Continuity and Change in Statutory Interpretation," 67 N.Y.U. L. Rev. 921, 937 (1992).

10. *United States v. Soler*, 759 F.3d 226 (2d Cir. 2014).

11. 161 U.S. 306 (1896).

12. 527 U.S. 1 (1999).

13. *U.S. ex rel. O'Donnell v. Countrywide Home Loans, Inc.*, 33 F.Supp.3d 494, 502 (SDNY 2014).

14. *United States v. Countrywide Fin. Corp.*, 961 F.Supp.2d 598, 607 (S.D.N.Y. 2013).

15. *Countrywide*, 2016 WL 2956743, at *8 (internal quotations and citations omitted).