

[Securities Regulation Daily Wrap Up, TOP STORY—2d Cir.: Countrywide's Hustle wasn't fraud after all, \(May 23, 2016\)](#)

Securities Regulation Daily Wrap Up

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By Richard A. Roth, J.D.

Knowingly and intentionally selling to Fannie Mae and Freddie Mac mortgages that did not meet the agreed-on standards was not fraud, the U.S. Court of Appeals for the Second Circuit has decided. Since there was no proof that Countrywide Financial Corp. intended to sell substandard mortgages when they signed the contracts, the government had merely shown a subsequent intentional breach of contract, the court said. As a result, an award of more than \$1.2 billion in penalties was vacated (*U.S. v. Countrywide Home Loans, Inc.*, Wesley, R.).

According to the court, the events central to the case were part of the restructuring of Countrywide's subprime lending division after the financial crisis. The reorganization was intended to focus on selling prime loans to Fannie Mae and Freddie Mac. One component of the reorganization created a loan origination process referred to as the "High Speed Swim Lane"—HSSL, commonly pronounced "hustle."

Countrywide entered into contracts with the GSEs that required the mortgages it sold to meet standards that would make them "acceptable investments" or to have the characteristics of investment quality mortgages as of the date they were delivered. According to the court, there was no evidence that Countrywide intended to defraud the GSEs when the contracts were being negotiated or when they were signed.

Subsequently, however, Countrywide delivered many substandard mortgages to the GSEs without disclosing any problems.

Government's fraud theory. According to the government, Countrywide engaged in both mail fraud and wire fraud in selling the Hustle-originated loans. The court quoted the government's closing argument in outlining the case:

First, the Hustle loans were bad. Second, the defendants knew the Hustle loans were bad. And third, the defendants passed the Hustle loans off as good loans anyway to cheat Fannie and Freddie out of money.

The jury agreed and found in favor of the government. Under the Financial Institutions Reform, Recovery, and Enforcement Act, the federal district court judge imposed penalties of \$1 million against the sole executive who had been sued and \$1.27 billion against Countrywide.

Contemporaneous intent. The appellate court reversed the jury's decision after finding that the government had failed to prove fraud. The problem for the government was that the mail fraud and wire fraud statutes incorporate a principle from the common law that requires an intent to defraud at the time the misrepresentations were made.

Fraud can exist in the context of a contract, the court said, but a breach of contract—even an intentional breach—is not necessarily fraud. "What fraud in these instances turns on, however, is *when* the representations were made and the intent of the promisor *at that time*," the court said.

So, Countrywide and the executive would have engaged in mail and wire fraud only if they had intended to sell the GSEs substandard mortgages when the contracts were signed, the court decided. Deciding to do so at a later time would be an intentional breach of contract, but not fraud.

No contemporaneous intent. There was no evidence of fraudulent intent at the time the contracts were signed, the court then said. In fact, the government did not even try to prove that Countrywide signed the contracts with the intent to deliver substandard mortgages.

The contracts between Countrywide and the GSEs prevented the government from arguing that any misrepresentations that might have been made when the mortgages were delivered were relevant, the court also said. The contracts used the present tense, saying that Countrywide “makes” or “warrants and represents” statements about the quality of the mortgages. That meant the representations applied at that time, not in the future.

Also, the contractual representations were made “as of” the dates of the contracts. They were present representations, not representations about the future. None of the witnesses’ testimony changed that, the court added.

The consolidated cases are [Nos. 15-496 and 15-499](#).

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Companies: Bank of America Corp.; Bank of America, N.A.; Countrywide Bank, FSB; Countrywide Financial Corp.; Countrywide Home Loans, Inc.; Fannie Mae; Freddie Mac

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