15-2449-cv

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

PAUL BISHOP, ROBERT KRAUS, UNITED STATES OF AMERICA, ex rel Paul Bishop, ex rel Robert Kraus,

Plaintiffs-Appellants,

STATE OF NEW YORK, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF DELAWARE, ex rel Paul Bishop, ex rel Robert Kraus, DISTRICT OF COLUMBIA, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF FLORIDA, ex rel Paul Bishop, ex rel Robert Kraus,

(Caption continued on inside cover)

On appeal from the United States District Court for the Eastern District of New York

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APPELLANTS' SUPPLEMENTAL BRIEF

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STATE OF HAWAII, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF CALIFORNIA, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF INDIANA, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF ILLINOIS, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF MINNESOTA, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF NEVADA, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF NEW HAMPSHIRE, ex rel Paul Bishop, ex rel Robert Kraus, COMMONWEALTH OF MASSACHUSETTS, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF NEW MEXICO, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF MONTANA, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF NORTH CAROLINA, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF NEW JERSEY, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF OKLAHOMA, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF RHODE ISLAND, ex rel Paul Bishop, ex rel Robert Kraus, STATE OF TENNESSEE, ex rel Paul Bishop, ex rel Robert Kraus, COMMONWEALTH OF VIRGINIA, ex rel Paul Bishop, ex rel Robert Kraus,

Plaintiffs,

—against—

WELLS FARGO & COMPANY, WELLS FARGO BANK, N.A.,

Defendants-Appellees.

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INTRODUCTION

Prior to the Supreme Court's decision in *Universal Health Services, Inc. v. U.S. ex rel. Escobar*, 136 S. Ct. 1989 (2016), this Court took a narrow view of what makes a claim "false" under the False Claims Act (FCA) in an effort to cabin defendants' FCA liability for regulatory violations. *Escobar* rejected that approach in favor of a broader understanding of falsity tempered by the statute's materiality requirement. *Escobar* also endorsed additional theories of FCA liability—including liability based on violations of conditions of participation in Government programs—that this circuit had not recognized. Here, the defendant banks obtained credit on favorable terms by misrepresenting their eligibility for Government loan programs and misrepresenting their compliance with material requirements for individual loans. In light of the Supreme Court's intervening precedent, the decision dismissing the complaint should be reversed. At a minimum, this Court should vacate and remand so that relators can amend their complaint to bring it into line with *Escobar*.

ARGUMENT

I. *Escobar* Requires Substantial Changes in this Court's False Claims Act Jurisprudence.

Courts adjudicating FCA cases have strived and sometimes struggled to effect Congress's objective of protecting the Government from fraud without converting every minor regulatory violation into a qui tam lawsuit. In *Mikes v. Straus*, 274 F.3d 687, 697 (2d Cir. 2001), this Court addressed that problem by conditioning liability

on the specificity of the underlying legal requirements. The Court held that the violation of a legal requirement can only give rise to a false claim if the requirement is clearly a condition of payment (as opposed to a general requirement, or a condition of eligibility to participate in a Government program). *Id*. The Court stressed that this rule was "distinct from a requirement imposed by some courts that a false statement or claim must be material to the government's funding decision." *Id*. While a "materiality requirement holds that only a subset of admittedly false claims is subject to False Claims Act liability," this Court held instead "that not all instances of regulatory noncompliance will cause a claim to become false." *Id*. *Mikes* shaped FCA jurisprudence in this circuit for fifteen years. Its reasoning was indispensable to the prior decisions in this case, which cited *Mikes* and its progeny dozens of times.

In *Escobar*, the Supreme Court rejected the analytical framework of *Mikes*, holding that "[i]nstead of adopting a circumscribed view of what it means for a claim to be false or fraudulent, concerns about fair notice and open-ended liability can be effectively addressed through strict enforcement of the Act's materiality and scienter requirements." 136 S. Ct. at 2002 (quotation marks omitted). Under *Escobar*, a claim is "false" or "fraudulent" if, consistent with common-law understandings of those terms, it is based on a statement that is untrue or misleading. *Id*. at 1999. Such false claims are actionable under the FCA if made with scienter, and if material to the Government's decision to pay. *Id*. at 2002.

Escobar itself was an implied certification case about reimbursements for mental health care. Applying the foregoing precepts to those facts, the Court held that implied false certification claims are permissible "at least" where a defendant makes specific representations about the goods or services provided, while failing to disclose noncompliance with material statutory, regulatory, or contractual requirements that makes those representations misleading. *Id*. at 2001. The payment requests in *Escobar*, which sought reimbursement for health services while failing to disclose violations of "core" regulatory requirements, met that standard because anybody reviewing the reimbursement requests "would probably—but wrongly—conclude that the clinic had complied" with the law. *Id*. at 2000.

Consistent with its broad understanding of what constitutes a false claim, *Escobar* rejected the restriction—adopted in *Mikes*—that a violation is only actionable under the FCA if it involves a "provision that the Government expressly designated a condition of payment." *Id*. at 2001. The Supreme Court found that this limitation lacked any textual basis, and "would create . . . arbitrariness" by effectively abolishing liability for false certifications of "compliance with a condition of eligibility to even participate in a federal program." *Id*. at 2002.

By rejecting the "express condition" requirement, *Escobar* overruled this Court's principal limitation on implied certification claims, including the relators' claim here. But actually, the Court did far more than that. It also rejected the

premises underlying that limitation, admonishing lower courts to: (1) resist engrafting atextual limitations onto the cause of action, *see* 136 S. Ct. at 2001; (2) refrain from treating violations of conditions of participation differently from conditions of payment, *see id.* at 2002; and (3) interpret the element of falsity broadly, consistent with the common law, *see id.* at 1999.

The Court also discussed the statutory materiality requirement. It described the standard as "demanding," and gave examples—including if a misstatement goes "to the very essence of the bargain," *id*. at 2003 n.5 (quotation omitted), or "the Government consistently refuses to pay claims in the mine run of cases based on noncompliance with" a requirement, *id*. at 2003. On the other hand, materiality "cannot be found where noncompliance is minor or insubstantial." *Id*.

In the wake of *Escobar*, this Court should recognize that *Mikes* has been substantially overruled and adopt the following rule consistent with the Supreme Court's decision: Liability under the FCA attaches when (1) a defendant knowingly makes a statement to the Government that is false or misleading—including but not limited to the concealment or nondisclosure of a statutory, regulatory, or contractual violation; (2) in connection with a claim for payment *or* a request to participate in a Government program; (3) if the misrepresentation is material to the Government's decision to pay or to permit participation.

II. Under *Escobar*, the Relators' Complaint States Valid Claims.

As relevant to this appeal, the relators' complaint alleges that Wells Fargo's subsidiary, Wachovia Bank, misrepresented its compliance with material legal requirements each time it sought certain loans and advances from the Federal Reserve (Fed). The complaint further alleges that even though Wachovia knew that it was ineligible for these desirable credit programs—which are restricted to adequately capitalized institutions in generally sound financial condition—it knowingly misled the Government into deeming it eligible. These misrepresentations were material because they caused the Government to extend credit on unduly favorable terms, at significant cost to American taxpayers.

A. The Banks Engaged in Rampant Fraud and Misconduct.

The false claims in this case rest atop a broad and deep foundation of other frauds. Specifically, Wachovia and its subsidiary World Savings Bank respectively made reckless and risky commercial and residential loans, principally to accrue fees from the origination of the loans and from their securitization. A-48-107 ¶¶ 71-192; A-122-24 ¶¶ 219-26. The banks' management thus perpetrated a "control fraud," subverting the banks' statutory, regulatory, and internal control procedures (including but not limited to the banks' obligation to maintain adequate capitalization) by engaging in risky lending and deceptive financial accounting while simultaneously presenting the banks to customers, investors, and regulators (through

the filing of Call Reports and other financial information) as well-managed, well-capitalized, sound financial institutions. A-48-49 ¶ 71 & n.1. The resulting loan portfolio was toxic: it was doomed to collapse when the borrowers inevitably defaulted, thus imperiling the banks' solvency. A-52 ¶ 76; A-57 ¶ 87; A-124 ¶¶ 224, 227. Knowing all of this, the banks deliberately concealed their lending practices from the Government, and Wachovia hid its commercial real estate loans in off-balance-sheet special purpose vehicles. A-55-60 ¶¶ 83-90; A-107 ¶¶ 191-92. Through accounting gimmicks and deception, the banks obscured their exposure to tremendous risk, as well as the fact that they were severely undercapitalized. When the bad loans failed, the banks veered toward insolvency. The complaint alleges that in the course of this widespread systemic fraud, the banks violated multiple critically important banking laws, including safety and soundness laws and financial reporting laws. A-18-19 ¶¶ 6-7; A-49-50 ¶ 72; A-122 ¶ 218.

B. The Banks Violated the False Claims Act by Fraudulently Obtaining Credit from the Federal Reserve.

The false claims arose when Wachovia and later Wells Fargo sought to access the Fed's discount window and Term Auction Facility (TAF), in the process making false "specific representations" about creditworthiness, and also misleading the Government about material violations of the Fed's eligibility criteria. *Escobar*, 136 S. Ct. at 1995. The discount window lends money through its "primary credit program," which offers loans at extremely low interest rates, but only to eligible

institutions. A-27 ¶ 25. The TAF provided credit on an auction basis—but only to institutions that were eligible for primary credit. A-35 ¶ 39.

1. The Banks Falsely Made the Representations and Warranties in the Federal Reserve's Lending Agreement.

The Fed's discount window programs are governed by Operating Circular 10, also known as the Lending Agreement. Section 9.1(b) of the applicable 2006 version requires the borrower to represent that it "is not in violation of any laws or regulations in any respect which could have any adverse effect whatsoever upon the validity, performance or enforceability of any of the terms of the Lending Agreement." A-204.[1] And Section 9.2 provides that "[e]ach time" the borrower requests funds, it "is deemed to make all of the foregoing representations and warranties." A-205. The Lending Agreement also requires borrowers to covenant that they will "promptly notify the Bank" if they are "about to become an undercapitalized depository institution or a critically undercapitalized depository institution, as such terms are defined in" the Fed's "Regulation A." A-206.

The complaint alleges that defendants falsely made the representation in Section

[1] The complaint also alleges that defendants falsely made the representation and warranty in Section 9.1(g) that all information contained in any document furnished by the borrower to the Fed is true as of the date furnished, and in Section 9.1(i) that no Event of Default, defined to include both failure to perform obligations and also the falsity of representations and warranties, was occurring. A-196; A-205. These constitute additional violations, and the inclusion of these provisions in the Lending Agreement also reinforces the materiality of defendants' other violations.

9.1(b) each time they sought credit from the discount window because they knew that they were violating multiple core banking laws (the aforementioned safety and soundness and financial reporting laws), but they nevertheless sought credit without disclosing the violations. The district court held that this misrepresentation could not support an "express false certification" claim because Section 9.1(b) was "too broad to give rise to a false claim under *Mikes*." SPA-8. The court held instead that a false contractual representation can only give rise to an FCA violation if the representation "refer[s] to compliance with a particular law." SPA-7. The district court adopted this limitation out of concern—taken from *Mikes*—about expanding FCA liability too broadly. Citing those same concerns, this Court affirmed. Op. 23.

Like the artificial limitations on FCA liability rejected in *Escobar*, there is no basis for the district court's atextual "particular law" limitation. Indeed, *Escobar* admonished courts to construe the element of falsity broadly, consistent with its ordinary meaning. False representations of blanket compliance have long been held actionable as fraud. *See, e.g.*, *In re BioScrip, Inc. Sec. Litig.*, 95 F. Supp. 3d 711, 728 (S.D.N.Y. 2015) (allowing fraud claim to proceed with respect to statement that a company believed it was "in substantial compliance with all laws, rules and regulations that affects its business and operations"); *State Farm Mut. Auto. Ins. Co. v. Pointe Physical Therapy, LLC*, 107 F. Supp. 3d 772, 798 (E.D. Mich. 2015) (holding that when defendants falsely "represented that the services were rendered

in compliance with all applicable laws," they committed fraud); *United States v. Two Hundred Fifty-Six Thousand Two Hundred Thirty-Five Dollars & Ninety-Seven Cents*, 691 F. Supp. 2d 932, 935 (N.D. Iowa 2010) (noting criminal fraud conviction for defendant who "falsely stat[ed] that [the company] was in compliance with all laws"). Moreover, arbitrarily limiting the scope of the FCA to ignore the violation of core contractual terms merely because they do not cite individual laws runs directly contrary to the Supreme Court's admonition that the FCA "was intended to reach all types of fraud, without qualification, that might result in financial loss to the Government," *United States v. Neifert-White Co.*, 390 U.S. 228, 232 (1968)—and its further holding that a misleading omission "is a misrepresentation irrespective of whether the other party has expressly signaled the importance" of the omitted information, *Escobar*, 136 S. Ct. at 2001.

On the other hand, the mere fact that the Lending Agreement requires a blanket certification of compliance does not mean that any time a borrowing bank violates any law, it will face FCA liability. The FCA's "materiality and scienter requirements" allay that concern. *Id.* at 2002 (quotation omitted). Indeed, the Court expressly stated that "if the Government required contractors to aver their compliance with the entire U.S. Code and Code of Federal Regulations," it would not be correct to hold that failure "to mention noncompliance with any of those requirements would *always* be material." *Id.* at 2004 (emphasis added). Under

Escobar, the proper inquiry is whether the defendants' misrepresentations related to requirements that were material to the Government's decision to pay through the primary credit program and the TAF.

The complaint alleges that the fraud here was material. *See* A-32-34 ¶¶ 36-36; A-35-37 ¶¶ 42-44. As the complaint explains, the representations and warranties in the Lending Agreement were designed to shift the burden of due diligence from the Fed onto the borrowing banks. A-32 ¶ 34; A-43 ¶ 43. Thus, if the banks had not been able to make the required representations, they would not have been able to borrow funds from the discount window—let alone at the primary credit rate. Moreover, the lies in this case did not relate to trivial violations with no effect on the banks' creditworthiness; on the contrary, they related to the core of the banks' business.

2. The Banks Misrepresented Their Eligibility—and Concealed their Ineligibility—for the Primary Credit Program and TAF.

The complaint also states an implied certification claim under *Escobar* because the banks' fraud, which compromised their financial condition, went directly to their eligibility for the primary credit rate, *i.e.*, "to the very essence of the bargain" the banks struck with the Government. 136 S. Ct. at 2003 n.5 (quotation marks omitted).[2] To qualify for primary credit, a bank must show the Fed that it is "at least

[2] The relators previously argued that the banks' misrepresentations "went to the heart of the bargain they negotiated with the Government." Op. 30. This Court rejected that argument as a matter of law, stating that it had "never adopted the relators' 'heart of the bargain' test." *Id*. After *Escobar*, that holding cannot stand.

adequately capitalized" and in "generally sound financial condition," based on a review of the bank's capitalization data and its supervisory rating. *See* 12 C.F.R. § 201.4(a).[3] These eligibility criteria are objective and quantifiable. To determine whether a bank is adequately capitalized, the Fed asks whether it meets the minimum levels for each relevant capital measure set by its regulator. *See* 12 U.S.C. § 1831o(b)(1)(B). For national banks prior to 2015, the relevant measures were total risk-based capital, Tier 1 risk-based capital, and leverage. *See* 12 C.F.R. § 6.4(a)(1). Roughly speaking, these are ratios of the bank's equity capital to its total assets. Equity capital is designed to absorb losses the bank might incur, insulating depositors, the FDIC, and lenders such as the Fed from such losses. The regulations require banks seeking primary credit to hold specific ratios of equity capital to balance sheet assets to be deemed "well" or "adequately" capitalized. *See id.* § 6.4(b). The ratios are calculated principally by reference to a bank's balance sheet.

When the banks artificially inflated these ratios by engaging in deceptive

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See 136 S. Ct. at 2000-01 (holding that misrepresentations regarding "core" regulatory requirements "constituted misrepresentations"); *id*. at 2004 (holding that claims were likely meritorious because the petitioner "misrepresented its compliance" with "requirements that are so central to the provision of mental health counseling that the Medicaid program would not have paid these claims had it known of these violations").

[3] *See also* The Federal Reserve Discount Window § 5, https://www.frbdiscountwindow.org/en/Pages/General-Information/The-Discount-Window.aspx#eligibilityps (last visited May 30, 2017).

accounting and loan underwriting schemes, and then reported these inflated ratios to bank regulators, they knowingly gave the impression that they were better capitalized—and therefore better candidates for the Fed's credit programs—than they actually were. A-49 ¶ 72. Such misrepresentations give rise to an implied certification claim because by applying for the primary credit program and then drawing funds from that program, the banks implicitly represented that they were at least adequately capitalized, when in fact they knew otherwise, and they knew that this was a condition of their eligibility for the primary credit program.

Concealment of inadequate capitalization is sufficient to state a claim, but it is not the defendants' only eligibility problem. In addition to its effect on capitalization, the fact that the defendants were running an extremely risky lending program, concealed by widespread control fraud, would have been material to whether they were in "generally sound financial condition," and therefore eligible for primary credit. A-32-33 ¶ 35. For example, the defendants' fraud and misrepresentations almost certainly misled their regulators into issuing them unduly high supervisory ratings—also known as CAMELS ratings. The CAMELS rating is a composite comprising: Capital adequacy, Assets, Management capability, Earnings, Liquidity, and Sensitivity to market risk. *See* OCC, Comptroller's Handbook, Bank Supervision Process 9 (2007). Ratings for each category range from 1 (best) to 5 (worst), and a composite rating is then issued based on the category ratings. *Id*. at 9-

10. Usually, "the management component is given special consideration when assigning a composite rating" because management's ability to respond to adverse conditions and risks is frequently critical to a bank's success. *Id*. at 46. CAMELS ratings are not disclosed to the public, but are used by regulators and by the Fed to determine eligibility for the discount window.

Generally, banks with a CAMELS rating of 4 or 5 are ineligible to participate in the primary credit program, and therefore also the TAF. *See* The Federal Reserve Discount Window, *supra*, at § 5. A rating of 4 means there "are serious financial or managerial deficiencies that result in unsatisfactory performance," including potentially "significant noncompliance with laws and regulations," and "[r]isk management practices" that "are generally unacceptable relative to the institution's size, complexity, and risk profile." Comptroller's Handbook, *supra*, at 48. This rating is also warranted if the "weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management." *Id*. A rating of 5 is critically deficient performance indicating a high probability of failure and liquidation. *Id*. Although we cannot know without discovery what the defendants' ratings were, it is highly unlikely that banks where the senior management perpetrates a control fraud on the scale described in the complaint would be eligible for a rating better than 4—and that is especially true in light of these banks' undercapitalization and exposure to extremely risky assets. Thus, it is only by

concealing their misdeeds through false financial statements and reports, A-49 ¶ 72, that defendants were able to maintain their eligibility for the Fed's lending programs. The complaint alleges that those misrepresentations were made knowingly, and their materiality is plain.[4] Indeed, the district court itself acknowledged that the underlying fraud in this case "would be a serious matter." SPA-8.

Because the complaint states a claim under *Escobar*, the district court's decision granting the motion to dismiss should be reversed outright.

III. At the Absolute Minimum, the District Court's Denial of Leave to Amend Must Be Reversed in Light of *Escobar*.

At a minimum, this Court should vacate the decision below with instructions to permit amendment of the complaint. Federal Rule of Civil Procedure 15(a)(2) provides that leave to amend should be "freely give[n] when justice so requires." The district court denied leave because it concluded—in an opinion relying

[4] The district court and this Court previously held that any misrepresentations made to the banks' regulators, as opposed to the Fed itself, were not actionable under the FCA because Section 9.1(g) of the Lending Agreement only obligates borrowers not to lie in documents that they "furnish" to the Fed. SPA-11-12; Op. 27-28. But if the banks' argument is that they are not liable because they submitted false information to other Government agencies (but not the Fed), then they would be guilty of exactly the sort of "half-truths" that gave rise to liability in *Escobar*. 136 S. Ct. at 2000. Moreover, even if these misrepresentations are not actionable as express certifications under the Lending Agreement, they are actionable as implied certifications: by seeking to participate in the primary credit program, the banks implicitly certified that they were in generally sound financial condition despite knowing otherwise. As long as the misrepresentations were made with knowledge that they would be relevant to the Fed's decision to pay, they are actionable under *Escobar*. *See id*. at 2001.

overwhelmingly on *Mikes*—that the relators' "theory of FCA liability simply is not viable," and so amendment was futile. SPA-19. But as the Supreme Court's GVR order signals, the law has changed, and with it the relators' ability to state a claim.

Indeed, both this Court and the district court noted that implied certification claims were not previously the relators' primary focus. Op. 29; SPA-10. That is understandable, as *Mikes* had erected a barrier to any such claim by both requiring an express condition of payment and prohibiting claims based on conditions of participation. *Escobar* removed both of those impediments. Thus, to the extent the complaint does not already state an implied certification claim, or a claim based on violations of conditions of participation in the Fed's programs, this Court should permit the relators to amend their complaint to allege claims consistent with *Escobar*. *See United States v. N. Adult Daily Health Care Ctr.*, 205 F. Supp. 3d 276, 296 (E.D.N.Y. 2016) (granting leave to amend to re-plead implied certification claim in light of the fact that *Mikes* has been overruled); *see also Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 71 (2d Cir. 2012) (remanding to permit amendment in light of intervening Supreme Court precedent); *McGuire v. Warren*, 207 F. App'x 34, 37 (2d Cir. 2006) (same).

CONCLUSION

The district court's decision should be reversed. At a minimum, the denial of leave to amend should be reversed, and the case remanded.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that on May 31, 2017, I filed the foregoing brief with the Clerk of the Court and served counsel for all parties using the CM/ECF system.

/s/Tejinder Singh
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