15-496-cv(L)

15-499-cv (CON)

In the United States Court of Appeals for the Second Circuit

UNITED STATES OF AMERICA; EDWARD O'DONNELL,
PLAINTIFFS-APPELLEES

v.

BANK OF AMERICA, N.A.; COUNTRYWIDE BANK, FSB;
COUNTRYWIDE HOME LOANS, INC.; REBECCA MAIRONE,
DEFENDANTS-APPELLANTS

(*additional parties on inside cover*)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK (CIV. NO. 12-1422)
(THE HONORABLE JED S. RAKOFF, J.)

REPLY BRIEF OF DEFENDANTS-APPELLANTS
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AND COUNTRYWIDE HOME LOANS, INC.

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BANK OF AMERICA CORPORATION, SUCCESSOR TO
COUNTRYWIDE FINANCIAL CORPORATION AND FULL SPECTRUM
LENDING; COUNTRYWIDE FINANCIAL CORPORATION,
DEFENDANTS

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PRELIMINARY STATEMENT

For all of its rhetoric, the government does not dispute that it is pursuing a novel theory of liability. The government seeks to break new ground by using a provision of FIRREA that authorizes civil penalties for mail or wire fraud "affecting a federally insured financial institution" to sue a financial institution for "affecting" itself. By its own concession, the government is seeking to premise its fraud claim on breaches of Countrywide's *contractual* warranties that the loans it sold to Fannie and Freddie would be investment quality—breaches which all parties expected and for which the contracts provided a repurchase remedy. For those reasons, the government could not make out a valid claim against the bank defendants under FIRREA.

Attempting to distract from these considerable legal flaws, the government paints defendants as bad actors who engaged in systematic malfeasance. But the government cannot disguise that its evidence was insufficient on a core element of its claim, nor can it deny that the district court made numerous rulings preventing defendants from offering a meaningful defense. And the government cannot seriously defend the district court's preposterous award of more than $1.2 billion in civil penalties—an award that flouts basic legal principles and is unsupported by the evidence. When the government's rhetoric about the financial crisis is put to one side, it is left with nothing. The judgment below should be reversed.

ARGUMENT

I. THE DISTRICT COURT ERRED BY PERMITTING THE FIRREA CLAIM AGAINST THE BANK DEFENDANTS TO PROCEED BECAUSE THE BANK DEFENDANTS CANNOT BE LIABLE FOR 'AFFECTING' THEMSELVES

A. Federally Insured Financial Institutions Cannot Be Liable Under Section 1833a(c)(2) On The Theory That They Engaged In Conduct 'Affecting' Themselves

To establish liability under the civil-penalties provision of FIRREA based on the predicate offense of mail or wire fraud, the government was required to prove that the bank defendants committed mail or wire fraud "affecting a federally insured financial institution." 12 U.S.C. § 1833a(c)(2). Like the district court, the government reads that statutory language to cover situations where the only connection between the fraud and a federally insured financial institution is that the defendant *is* a federally insured financial institution. As the government seemingly acknowledges, that interpretation would make *every* fraud committed by a federally insured financial institution punishable under the statute.

Ironically, the government's interpretation would render federally insured financial institutions a particularly disfavored class of defendants under Section 1833a. Any defendant other than a bank can be liable under FIRREA only if its fraud "affects" someone other than the defendant itself. It would be hard to imagine a more perverse interpretation of a statute that was indisputably intended to *protect* federally insured financial institutions.

In all events, the government's interpretation cannot be reconciled with the text, history, or context of FIRREA. This Court should reject that interpretation, and, on that basis, reverse the judgment below.

1. As to the text: the government focuses almost exclusively on the statutory term "whoever." *See* U.S. Br. 26-27. There is no debate that, in isolation, the term "[w]hoever" reaches broadly to cover any and all persons. The critical point, however, is that the statute expressly contemplates that the defendant and the affected financial institution are *different* persons. Section 1833a(c)(2) imposes penalties on a defendant—"whoever"—whose conduct affects an object—a "federally insured financial institution." By identifying the object of the fraud's "effect" as distinct from the defendant, the statute naturally implies that the defendant is someone other than the "affected" entity. The government's contrary interpretation would permit two persons who are separately identified in the statute to be the same person.

Unsurprisingly, the government cites no similarly worded statute that has been interpreted in such a counterintuitive manner. In fact, the Supreme Court reached the opposite conclusion in interpreting the RICO statute, 18 U.S.C. § 1962(c). Similar to Section 1833a, RICO imposes liability on "any person employed by or associated with any enterprise" who commits a pattern of racketeering offenses through the "enterprise." Construing that

statutory language, the Supreme Court held that the "person" and the "enterprise" must be different; the defendant cannot be the enterprise. *Cedric Kushner Promotions, Ltd.* v. *King*, 533 U.S. 158, 161-162 (2001). So too here, the defendant cannot be the federally insured financial institution that is affected by the defendant's fraud.

The government misleadingly suggests that cases interpreting similar language in FIRREA's criminal limitations provision support its position. *See* U.S. Br. 28-29. In interpreting that language, however, neither this Court nor any other court of appeals has encountered a situation in which the defendant is also the affected financial institution. In all of the cases the government cites, the defendant was a separate party. To be sure, courts have held that defendants who use financial institutions in their fraudulent schemes can be subjected to FIRREA's lengthened limitations period for "affecting" those institutions, even if the institutions were also participants in the fraud. *See*, *e.g.*, *United States* v. *Heinz*, 790 F.3d 365, 367 (2d Cir. 2015) (per curiam); *United States* v. *Serpico*, 320 F.3d 691, 695 (7th Cir. 2003). As a textual matter, there is no difficulty in saying that an individual defendant committed a fraud "affecting" a financial institution, regardless of whether the institution participated in the fraud. But the same cannot be said when the defendant *is* the financial institution, which is accused of "affecting" itself. And it makes sense to treat those two situations differently, because

"the whole purpose of [the statute] is to protect financial institutions, a goal it tries to accomplish in large part by deterring would-be criminals from including financial institutions in their schemes." *Serpico*, 320 F.3d at 694.

What is more, even the cases cited by the government do not go as far as the district court did here, because they require proof of "actual financial loss" or "realistic prospect of loss" to the institution. *United States* v. *Agne*, 214 F.3d 47, 53 (1st Cir. 2000). Perhaps recognizing that disparity, the government appears not to defend the district court's view that any conduct by a federally insured financial institution could be considered to "affect" the institution itself. Instead, the government claims to have *proven* the requisite "effect" at trial—even though the jury was never asked to decide whether the "affecting" element was satisfied, and even though some of the evidence on which the government relies (such as settlement agreements and litigation costs) was not introduced at trial. *See* U.S. Br. 39-40.

At a minimum, the seeming divergence between the district court's interpretation and the government's underscores that the statutory language is ambiguous—and thus that this case implicates the familiar principle that "[p]unitive statutes, such as FIRREA, are to be narrowly construed." *United States* v. *Vanoosterhout*, 898 F. Supp. 25, 30 (D.D.C. 1995), *aff'd*, 96 F.3d 1491 (D.C. Cir. 1996). That principle is especially important here, where the district court adopted a novel interpretation of the statute to penalize feder-

ally insured financial institutions for *any* mail or wire fraud on the ground that the fraud poses the theoretical possibility of a risk of loss to the institution itself. *See* S.A. 84.

2. As to the statutory purpose and history: even if it were linguistically possible, the government's interpretation contravenes the purpose and history of the statute. *See, e.g.*, *Yates* v. *United States*, 135 S. Ct. 1074, 1083-1085 (2015). FIRREA's penalty provisions were expressly intended to protect financial institutions from fraud or other misconduct by insiders or third parties. *See* BofA Br. 34-36.

The government attempts to obscure that purpose by plucking out of context pieces of FIRREA's legislative history that are entirely unrelated to the penalty provisions. For example, the government notes concerns about thrifts engaging in "risky activities . . . which would lead to their ultimate failure." U.S. Br. 36 (quoting H.R. Rep. No. 101-54, Pt. I, at 301-302 (1989)). But the government omits to mention that this language appears in a section of the House Report entitled "Inadequate Supervision of Thrifts" that addressed the role of deregulation in the crisis—an issue ultimately addressed by an entirely different part of FIRREA. H.R. Rep. No. 101-54, Pt. I, at 301-302. The government also highlights a discussion of "poor underwriting and loan administration standards." U.S. Br. 37-38 (quoting H.R. Rep. No. 101-54, Pt. I, at 299-300). Again, however, the government fails to provide the

context: the very next sentence in the House Report explains that "[t]hese problems are the result of poor management," H.R. Rep. No. 101-54, Pt. I, at 299—an issue addressed not in FIRREA's penalty provisions, but rather in its separate regulatory-oversight provisions.

3. As to the broader context of FIRREA: in another provision of FIRREA, Section 1818(i), Congress expressly created a carefully calibrated system of regulatory penalties against federally insured financial institutions for engaging in misconduct that redounds to their own harm. *See* BofA Br. 36-38. Congress cannot have intended to disrupt that calibrated regulatory system by conferring unfettered authority on the Department of Justice to penalize "self-affecting" conduct by federally insured financial institutions under Section 1833a(c)(2).

In response, the government simply asserts that Section 1818(i) need not be an exclusive remedy. *See* U.S. Br. 33-35. True enough: like any other defendant, financial institutions may be liable for violating Section 1833a when they commit any of the predicate offenses—including fraud "affecting" another institution—and may also be subject to regulatory penalties under Section 1818(i) when they engage in misconduct covered by that section. But Congress's decision to include, in the same statute that included Section 1833a, a detailed system of regulatory penalties and offsetting considerations for conduct by federally insured financial institutions which affects their own

well-being is strong evidence that Congress did not mean to authorize civil penalties under Section 1833a against those same institutions for the same conduct.

In short, the government's interpretation of Section 1833a, like the district court's, finds no support in the statutory text, history, or context. The Court should reject the government's novel attempt to convert a decades-old statute intended to *protect* financial institutions into a new font of authority to *punish* those institutions.

B. Federally Insured Financial Institutions Cannot Be Liable Under Section 1833a(c)(2) On The Theory That They 'Affected' A Corporate Successor Through A Subsequent Merger

After trial, the district court offered an alternative theory, asserting that Countrywide's fraud necessarily "affected" Bank of America by virtue of the subsequent merger. S.A. 82-83. While the government pays lip service to that theory, *see* U.S. Br. 42-43, it makes no real effort to defend it—perhaps not surprisingly, in the face of settled law that an effect on a financial institution must be "sufficiently direct," *United States* v. *Bouyea*, 152 F.3d 192, 195 (2d Cir. 1998). Nor does the government offer any answer to the bank defendants' argument that "affecting" a subsequent merger partner or successor in interest is the same as "self-affecting." *See* BofA Br. 38-39. The government merely asserts that harm to "a subsequent purchaser of Countrywide" was "foreseeable to Countrywide and Mairone when the fraud

was perpetrated." U.S. Br. 43. But the government cites nothing to support that assertion, and there was no such evidence at trial. Insofar as the government suggests that it is *always* foreseeable that one financial institution will someday be acquired by another, that is simply another way of saying that the requisite "effect" always exists. Because there is no legally valid basis for concluding that the "affecting" element was satisfied here, the judgment against the bank defendants should be reversed.

II. THE DISTRICT COURT ERRED BY PERMITTING THE FIRREA CLAIM AGAINST THE BANK DEFENDANTS TO PROCEED BECAUSE THE CLAIMED PREDICATE OFFENSES OF MAIL AND WIRE FRAUD WERE BASED EXCLUSIVELY ON BREACHES OF PREEXISTING CONTRACTS

A. A Claim Of Mail Or Wire Fraud May Not Be Based Exclusively On A Breach Of Contract

1. At common law, "[i]t [was] undoubtedly true that failure to perform a promise cannot amount to fraud." 3 Samuel Williston, *The Law of Contracts* § 1496, at 2661 (1920) (citing cases); *see*, *e.g.*, *Bridgestone/Firestone, Inc.* v. *Recovery Credit Services, Inc.*, 98 F.3d 13, 19-20 (2d Cir. 1996) (discussing general rule and narrow exceptions). Courts interpreting the mail- and wire-fraud statutes must apply that settled understanding "unless the statute otherwise dictates." *Neder* v. *United States*, 527 U.S. 1, 21 (1999) (internal quotation marks and citation omitted) (interpreting mail- and wire-fraud statutes). Because there is no indication in the mail- and wire-fraud

statutes that Congress intended to deviate from that common-law understanding, every court of appeals to have addressed the issue—including this one—has correctly concluded that a mail- or wire-fraud claim based only on breach of a contract cannot lie. *See*, *e.g.*, *United States* v. *D'Amato*, 39 F.3d 1249, 1261 n.8 (2d Cir. 1994); *McEvoy Travel Bureau, Inc.* v. *Heritage Travel, Inc.*, 904 F.2d 786, 791-792 (1st Cir. 1990); *Kolar* v. *Preferred Real Estate Investments, Inc.*, 361 Fed. Appx. 354, 363 (3d Cir. 2010); *Corley* v. *Rosewood Care Center, Inc.*, 388 F.3d 990, 1007 (7th Cir. 2004).

Contrary to the government's assertion, *see* U.S. Br. 43, the bank defendants are not arguing for any sort of "[i]mmuni[ty]" or "exempt[ion]" from fraud liability. Instead, the principle that a breach of contract does not constitute fraud is part of the definition of what it means to "defraud" in the first place. Parties in a contractual relationship, like anyone else, may be liable for fraud if they lie or deceive. As a matter of law, however, there is nothing false or deceptive about a failure to deliver on a contractual promise. That principle applies with particular force here, where breaches of the contractual "investment quality" warranties were expected and subject to a specific contractual repurchase remedy. *See* pp. 16-25, 30-36, *infra*. Because breaches of contract are not by their nature deceptive, courts require that a claim of fraud, including mail or wire fraud, show a false statement or deception apart from a violation of a preexisting contract. *See*, *e.g.*, *Kehr Packages,*

Inc. v. *Fidelcor, Inc.*, 926 F.2d 1406, 1417 (3d Cir. 1991); *McEvoy*, 904 F.2d at 791-792.

2. In this case, there was no evidence of a distinct false statement or deception. The *only* basis on which the jury was permitted to find a "scheme to defraud" was that defendants misrepresented the quality of the loans Countrywide sold to Fannie and Freddie. *See* J.A. 5219. There was no evidence of any "misrepresentation," other than Countrywide's presentment of non-investment-quality loans for sale where the preexisting contracts warranted that all loans would be investment quality.

While the government cites a variety of alleged "misrepresentations," *see* U.S. Br. 46, a review of the government's record citations illustrates that there was not a single extracontractual false or misleading statement to Fannie or Freddie about loan quality, much less a false statement made by any of the three individuals at Countrywide (Rebecca Mairone, Cliff Kitashima, and Greg Lumsden) who allegedly had fraudulent intent. The government cites (1) testimony from Fannie and Freddie witnesses about the representations and warranties *in the parties' contracts*, *see* J.A. 2977, 4746-4747, 4819-4820, (2) provisions in the contracts themselves, *see* J.A. 5905, 5908, 5935, 5938, and (3) a bulletin from Freddie updating the parties' agreement in 2006 (before the HSSL process began), *see* J.A. 6366, 6368.

At bottom, therefore, the government seeks to recast contract terms negotiated in the early 1980s as affirmative misrepresentations made in 2007 and 2008. In fact, there was no evidence at trial of even a single allegedly fraudulent statement made by any Countrywide employee at any time.

3. The complete absence of evidence of a distinct false statement or deception distinguishes this case from all of the cases cited by the government in which courts allowed fraud claims to proceed where the parties had a contractual relationship. In each case, there was some fraudulent representation *outside the contract*. For example, in *United States* v. *Frank*, 156 F.3d 332, 335 (2d Cir. 1998) (per curiam), the defendants actively "participated in the falsification of billing-related records." In *United States* v. *Naiman*, 211 F.3d 40, 49 (2d Cir. 2000), the defendant lied to the State of New York about which employees had performed work under a state contract. And in *First Bank of the Americas* v. *Motor Car Funding*, 257 A.D.2d 287, 289 (N.Y. App. Div. 1999), a seller of loans made extracontractual misrepresentations "about the quality of the collateral, the individual borrowers' credit history and the amount of the borrowers' down payments." *See also MBIA Insurance Corp.* v. *Countrywide Home Loans, Inc.*, 87 A.D.3d 287, 293-294 (N.Y. App. Div. 2011) (holding that representations made outside of contract were actionable in fraud). Those cases stand for the unremarkable, and undisputed, proposi-

tion that a fraud claim can lie for a "misrepresentation collateral or extraneous to the contract." *Bridgestone/Firestone*, 98 F.3d at 20.

This case is entirely different. As the government candidly told the jury, the "misrepresentations" that were "the kernel of the [government's] case" arose from the contractual warranties. J.A. 5147. And when "the *exact* representations made . . . in [a] warranty" form the basis of the fraud claim, or the fraud claim is based on nothing but a promise of future performance, the fraud claim is "wholly duplicative" of a breach-of-contract claim and thus must fail. *Kriegel* v. *Donelli*, Civ. No. 11-9160, 2014 WL 2936000, at *14 (S.D.N.Y. June 30, 2014); *see also* BofA Br. 49-50 (citing cases).

B. The Principle That A Claim Of Fraud May Not Be Based Exclusively On A Breach Of Contract Applies Here

Lacking any evidence of a distinct false statement or deception, the government echoes the district court's reasoning that the principle that a breach of contract does not constitute fraud is inapplicable to claims of mail or wire fraud. The government contends that this is so because "absence-of-contract" was not "an established element of common-law fraud." U.S. Br. 47. That argument is a non-starter. To begin with, the government all but ignores the Supreme Court's decision in *Durland* v. *United States*, 161 U.S. 306 (1896), which reaffirms what courts at common law had long held: without more, breach of a contract "entered in good faith" cannot sustain a con-

viction for fraud, "no matter how visionary might seem the scheme." *Id.* at 314; *accord*, *e.g.*, *Burrill* v. *Stevens*, 73 Me. 395, 397-398 (1882).

The government does not even attempt to defend the district court's misreading of *Durland*. *See* BofA Br. 43-46. Instead, the government cherry-picks language from a handful of common-law fraud decisions. *See* U.S. Br. 47-49. But those decisions actually undermine the government's argument. Take *Rich* v. *New York Central & Hudson River Railroad Co.*, 87 N.Y. 382 (1882). There, the New York Court of Appeals held that the plaintiff's tort suit could proceed because it alleged "something more than a mere breach of contract." *Id.* at 398. According to the court, "[t]hat breach was not the tort; it was only one of the elements which constituted it." *Id.* *Stock* v. *City of Boston*, 149 Mass. 410 (1889), is to the same effect. That court explained that, although "[a] mere breach of contract cannot be sued on as a tort," tort claims based on "tortious acts, independent of the contract" may lie. *Id.* at 414. Applying that logic, the court held that the claim could proceed because "the tortious acts of the city had no connection with or reference to its contract." *Id.*

In a third case, *Brick* v. *Cohn-Hall-Marx Co.*, 276 N.Y. 259 (1937), the plaintiff alleged that the defendant made false entries in its books and "falsely and fraudulently represented" that it had performed under the parties' contract. *Id.* at 263. The question was whether the action sounded in fraud

and was, therefore, subject to an extended limitations period. *Id.* The New York Court of Appeals answered in the negative, reasoning that "[t]he claim of the plaintiffs is based upon the contract; in other words, if the defendant owes the plaintiffs any money it is because of the agreement." *Id.*

Those cases, and the others cited by the government, simply confirm that the decision below cannot stand. They reaffirm the general principle that "[a] mere failure to perform . . . a contract-obligation is not a tort." *Mobile Life Insurance Co.* v. *Randall*, 74 Ala. 170, 177 (1883). And insofar as they permit fraud claims to go forward, they do so under limited exceptions to that general principle—exceptions that the bank defendants have recognized, *see* BofA Br. 47-48, but that are inapplicable here. *See*, *e.g.*, *Grynberg* v. *Citation Oil & Gas Corp.*, 573 N.W.2d 493, 501 (S.D. 1997) (holding that the defendant "had a duty to the plaintiffs which arose outside the contract obligation"); *Robinson Helicopter Co.* v. *Dana Corp.*, 102 P.3d 268, 276 (Cal. 2004) (noting that the defendant "had not only breached its contract . . . but *also* had made false misrepresentations of fact" (emphasis added)).

The common law is, and long has been, clear: fraud claims based exclusively on breaches of contract cannot survive. The mail- and wire-fraud statutes incorporate that common-law rule. Because the government's predicate mail- and wire-fraud claims are based entirely on purported breaches of

representations and warranties contained in preexisting contracts, they are invalid, and the judgment below should be reversed.

III. THE DISTRICT COURT ERRED BY EXCLUDING EVIDENCE ABOUT THE COMPARATIVE QUALITY OF HSSL AND NON-HSSL LOANS

The government's theory at trial was that Countrywide "rolled out a new mortgage loan-origination process, called the High Speed Swim Lane . . . , that caused a precipitous drop in the quality of its loans." U.S. Br. 2. That theory is inherently comparative: HSSL loans were allegedly fraudulent because they were of materially worse quality than other loans. But the district court repeatedly precluded the bank defendants from rebutting the government's theory by offering evidence that loans originated through the HSSL process were of no lower quality than other loans. The district court's rulings were erroneous and severely prejudicial. This Court should therefore vacate the judgment below and remand for a new trial.

A. Evidence About The Comparative Quality Of HSSL And Non-HSSL Loans Was Relevant To Several Elements Of Liability

The government persists in arguing that defendants' evidence was irrelevant to any issue in dispute. *See* U.S. Br. 52-55. On the contrary, the evidence was relevant—and highly probative—regarding multiple elements of the government's claim.

1. *Scheme to defraud.* — That the HSSL process produced loans of the same quality as other Countrywide processes negates the government's claim that Countrywide engaged in a "*scheme to defraud*" Fannie and Freddie by selling them HSSL loans. *See* BofA Br. 52-54. The government mischaracterizes this argument as "blaming the[] victims," U.S. Br. 53, but the bank defendants are not arguing that Fannie and Freddie bought loans that they should not have bought. To the contrary, the evidence would have shown that the HSSL loans were just as saleable as the other loans Fannie and Freddie (properly) bought.

Indisputably, no one expected every loan to be investment quality: that is why Fannie and Freddie bought the loans subject to a contractual right of repurchase. *See* BofA Br. 53, 72-73. Recognizing this, the government claimed that HSSL loans were fraudulent not because *some* of them were below investment quality, but because *more* of them were below investment quality than should have been the case—because they were originated through a process that "caused a precipitous drop in the quality of [Countrywide's] loans." U.S. Br. 2. Defendants' evidence would have shown that the government's claim was factually inaccurate, because the defect and delinquency rates for HSSL and non-HSSL loans were indistinguishable. *See*, *e.g.*, J.A. 1462-1463, 1570; Dkt. 208, ¶ 6 (Sept. 17, 2013) (declaration of Arnold Barnett).

For the first time in its brief on appeal, the government argues that the evidence concerning the quality of non-HSSL loans shows that they too were fraudulent. *See* U.S. Br. 53-54. But there is absolutely no evidentiary basis for that assertion. Indeed, it completely contradicts the government's theory at trial—namely, that HSSL loans were fraudulent precisely *because* they were of lower quality than other Countrywide loans.

2. *Materiality.* — If the HSSL loans were of the same quality as other loans Fannie and Freddie willingly bought, the jury could have concluded that the allegedly "poor" quality of the HSSL loans was immaterial: that is, it would not have been important to a reasonable person in the position of Fannie and Freddie. *See* BofA Br. 54. The government contends that contractual representations that loans were investment quality "were important" to Fannie and Freddie. U.S. Br. 55. As noted above, however, it was undisputed that Fannie and Freddie expected that many of the loans would not actually be investment quality, which means that not every deviation from investment quality could be material. Rather, what "mattered" to a reasonable purchaser was whether the loans were of significantly lower quality than other loans.

3. *Fraudulent intent.* — The evidence that HSSL loans were of the same quality as, or higher quality than, non-HSSL loans tends to show that defendants did not intend to harm Fannie and Freddie. *See* BofA Br. 54-55.

The government contends that the HSSL loans actually caused harm. *See* U.S. Br. 54. There was no such evidence, much less evidence that the HSSL loans caused more harm than other loans. And in any event, that is beside the point: if defendants had been allowed to prove that HSSL loans were no different in quality from non-HSSL loans, it would have supported their defense that they did not intend for the HSSL process to worsen, let alone "produce a precipitous drop" in, the quality of Countrywide's loans. U.S. Br. 2.

B. Defendants' Evidence About The Comparative Quality Of HSSL And Non-HSSL Loans Was Also Relevant To Rebut The Government's Contrary Evidence

Even as the district court prevented defendants from presenting evidence about the quality of non-HSSL loans, it allowed the government to introduce a substantial amount of the same type of evidence. That evidence was, in fact, the foundation of the government's affirmative case. "[A]lmost immediately after [HSSL] began," the government told the jury in its opening statement, "quality began to decline." J.A. 1740, 1744. In its case in chief, government witness Michael Thomas compared the quality of HSSL loans to the quality of loans produced through a previous non-HSSL process, J.A. 1834, 1836-1841, 1931-1932, and testified that defect rates from FSL were "more than twice" as high as defect rates from other Countrywide divisions during the time that the HSSL was in operation, J.A. 1910. In closing,

the government emphasized that Countrywide's pre-HSSL process "produced quality loans." J.A. 5011. And as noted above, in its brief on appeal, the government argues that the HSSL "caused a precipitous drop in the quality" of loans sold to Fannie and Freddie. U.S. Br. 2.

The government does not dispute that it introduced evidence of the comparative quality of non-HSSL loans. It nevertheless argues that *its* evidence, unlike defendants' proffered evidence, was relevant. *See* U.S. Br. 55-57. The government asserts that, while defendants' evidence would have compared HSSL loans to non-HSSL loans originated by FSL during the same time period, the government's evidence compared HSSL loans to loans originated by FSL *before* the HSSL period (and loans originated by *other* Countrywide divisions during the HSSL period). *See id.* at 55-56. The government argues that its evidence was relevant because it showed: (1) why government witnesses Edward O'Donnell and Michael Thomas were concerned about the HSSL process; (2) that Mr. O'Donnell initially supported the HSSL process, but withdrew his support because it produced low-quality loans; and (3) that Countrywide knew it was selling lower-quality loans to Fannie and Freddie because of the HSSL process. *See id.* at 56-57.

Notwithstanding the government's impossibly fine distinction between its evidence and defendants' excluded evidence, all of the government's arguments apply with equal weight to both. If the government's evidence com-

paring HSSL to non-HSSL loans was relevant to show that Mr. O'Donnell and Mr. Thomas were concerned about the quality of HSSL loans, then defendants were entitled to show that those concerns were unfounded because there was no difference in quality between HSSL and non-HSSL loans. If the government's evidence was relevant to show that Mr. O'Donnell withdrew his support for the HSSL process because he believed it produced low-quality loans, then defendants were entitled to show that Mr. O'Donnell was mistaken and that those who disagreed with him and continued to support the HSSL process acted in good faith. And if the government's evidence was relevant to show that Countrywide personnel knew the bank was selling lower quality loans to Fannie and Freddie, then defendants were entitled to show that they "knew" nothing of the kind, because in fact the HSSL loans were of the same quality as other loans Countrywide sold.

The government's theory and evidence put the quality of non-HSSL loans squarely at issue. The district court's decision to deny defendants the opportunity directly to rebut the government's evidence was simply indefensible.

C. The District Court Further Erred By Preventing Defendants From Cross-Examining The Government's Experts Concerning Non-HSSL Loans

The district court compounded its errors when it prevented defendants from cross-examining the government's experts concerning non-HSSL loans.

During the *Daubert* hearing, outside the presence of the jury, government statistics expert Charles Cowan admitted that he ordered government underwriting expert Ira Holt to stop reviewing loans because he concluded that the data would "never be able to demonstrate that the [HSSL] [defect rate] was larger than the [non-HSSL], which was the claim being made by the government." J.A. 2609. Dr. Cowan admitted that, if he had allowed Mr. Holt to complete his review, the evidence might have shown that non-HSSL loans actually had a significantly higher defect rate than HSSL loans. J.A. 2609-2610. In front of the jury, however, Dr. Cowan told a different story. He testified that he ordered Mr. Holt to stop his review because the remaining data would not change his results and he was running out of time to submit his report. J.A. 3091. The district court did not allow defendants to cross-examine Dr. Cowan about his examination of non-HSSL loans or to impeach Dr. Cowan with his prior testimony. That ruling, too, was erroneous.

In defending the district court's ruling, the government misstates the record. It says that Dr. Cowan did not testify inconsistently, because, at the *Daubert* hearing, he merely gave "answers to hypothetical questions" about an analysis of non-HSSL loans that he never conducted. U.S. Br. 58. That is incorrect. Dr. Cowan and Mr. Holt *did* analyze the relative quality of HSSL and non-HSSL loans—at least until Dr. Cowan ordered Mr. Holt to stop. In

response to direct questioning from the district judge, Dr. Cowan admitted that he ordered Mr. Holt to stop reviewing the loans because "we hadn't found a difference between Hustle, non-Hustle." J.A. 2606. And upon further questioning by defense counsel, Dr. Cowan reiterated that he ordered Mr. Holt to stop his review because "[o]ur own numbers are supporting the fact that even if I did the rest of the loans, I would only wind up concluding that the non-Hustle loans had a higher defect [rate] than the Hustle loans." J.A. 2609-2610.

By his own testimony, therefore, Dr. Cowan knew that a comparison of HSSL and non-HSSL loans would not be favorable to the government. That evidence was highly relevant both to the reliability of Dr. Cowan's conclusions and to his bias. It was also classic impeachment evidence, given Dr. Cowan's contradictory testimony at trial. The district court's refusal to allow defendants to question Dr. Cowan about his work on non-HSSL loans was erroneous.

D. The District Court's Exclusion Of Evidence About The Comparative Quality Of HSSL And Non-HSSL Loans Was Highly Prejudicial

The government makes only a passing effort to argue that the district court's exclusion of comparative evidence of loan quality was harmless. *See* U.S. Br. 59-60. The government does not dispute that the exclusion of evidence requires a new trial unless it is "highly probable that the error did not

affect the verdict." *United States* v. *Vayner*, 769 F.3d 125, 133 (2d Cir. 2014) (internal quotation marks and citation omitted).

Here, the evidence of comparative quality went to the heart of the government's case. Consider, for example, the government's response to defendants' peach-farmer hypothetical. The government claims that the HSSL process is analogous to the farmer "replac[ing] [fruit inspectors] with an ineffective fruit-inspection machine, causing the incidence of unsaleable peaches to skyrocket." U.S. Br. 54 n.9. But without knowing how many peaches were unsaleable under a manual process, the jury could never determine whether the fruit-inspection machine caused the number of unsaleable peaches to "skyrocket." *Id.* So too here: the government's entire case was based on the premise that the HSSL process produced poorer-quality loans than other processes. Defendants should have been permitted to prove otherwise.

The government argues that, if defendants had been allowed to introduce comparative evidence, the government would have responded by introducing evidence showing that non-HSSL Countrywide loans went through a process similar to HSSL loans. *See* U.S. Br. 59-60. But the government has never before claimed that Countrywide's non-HSSL loans were of fraudulent quality; to the contrary, at trial, the government used non-HSSL loans as the benchmark for quality. *See*, *e.g.*, J.A. 1910, 2248, 5019. In any event, even assuming that the government had non-speculative evidence to support that

proposition, it would have been up to the jury to evaluate that evidence and decide whether to infer that the non-HSSL loans were fraudulent, or rather that the HSSL loans were not.

Evidence of non-HSSL loan quality went to the heart of the government's case and was therefore precisely "the sort of evidence that might well sway a jury," *Vayner*, 769 F.3d at 134 (internal quotation marks and citation omitted), especially in a case that the district court described as "one of the closer cases I've seen in a long time," J.A. 4868. The district court's exclusion of that evidence was both erroneous and highly prejudicial, and thus warrants vacatur and a new trial.

IV. THE DISTRICT COURT ERRED BY PRECLUDING DEFENSE WITNESSES FROM TESTIFYING THAT THEY BELIEVED THE HSSL PROCESS WAS PROPER

One of the central issues at trial was fraudulent intent. On that issue, the government's evidence of the intent of the three alleged wrongdoers at Countrywide was concededly circumstantial. The government introduced testimony from other Countrywide employees about their subjective opinions that the HSSL process produced poor quality loans, asking the jury to infer that Ms. Mairone, Mr. Kitashima, and Mr. Lumsden must also have reached that same conclusion. But when defendants sought to introduce similar testimony from other witnesses who were equally knowledgeable about the HSSL process—and who did not share the government's witnesses' opin-

ions—the district court excluded those witnesses' opinions as irrelevant on the ground that they were not communicated directly to the alleged wrongdoers. That ruling was erroneous—and devastating to the defense on the critical disputed issue of intent.

A. The Defense Witnesses' Testimony Was Relevant And Should Not Have Been Excluded

1. While the government persists in claiming that the defense witnesses' testimony was irrelevant, it does not seriously dispute the law: a witness's testimony about his own state of mind can be probative of the defendant's state of mind when the witness reaches his impression based on the same information available to the defendant. *See* BofA Br. 68 (citing cases).

The government instead contends that, "to the extent that is correct," a witness's state of mind is admissible only if it would show an "obvious and widely-known" fact that the defendant also must have known. U.S. Br. 72. That limitation does not appear in the case law, but even if it did, it would be satisfied here. The government's very first example of the sort of "obvious fact" that makes a witness's perception admissible is evidence that "widespread and blatant fraud was being conducted at an office." *Id.* at 73. That was precisely the government's theory at trial in this case. *See*, *e.g.*, J.A. 5013-5014 (closing argument). The only difference between the government's example and this case is that there the evidence of the witness's perception was offered to prove a guilty mental state, while here the evidence

was being offered to prove an innocent one. It cannot be the law that a witness's knowledge of a fraudulent scheme qualifies as an "obvious fact" that is admissible, U.S. Br. 73, but a witness's contrary knowledge does not.

2. The government concedes that it introduced a great deal of testimony from its own witnesses about their subjective impressions that the HSSL process would produce poor-quality loans. *See* U.S. Br. 71. Yet the government asserts that, in contrast to defendants' witnesses, all of the government's witnesses communicated their perceptions about the HSSL process to the alleged wrongdoers. *See id.* That simply is not true. For example:

- Mr. Thomas testified that he had concerns about the HSSL process, but he did not testify that he shared those concerns with the alleged wrongdoers. J.A. 1865, 1899, 1939, 2124-2125.
- Mr. O'Donnell testified that he heard concerns from other Countrywide employees who reported to him, including Mr. Thomas, but he did not testify that he shared those concerns with anyone else. J.A. 2238-2240, 2294.
- Mr. Boland testified that he heard concerns from his subordinates and formed his own opinion about the HSSL process, but he did not testify that he communicated those concerns or his opinion to anyone. J.A. 3366, 3371-3373.
- Mr. Price testified that he expressed concerns, and heard others express concerns about the HSSL process, but not in the presence of the alleged wrongdoers. J.A. 3486-3491.

To be sure, there was evidence that *some* concerns about the HSSL process were passed on to Ms. Mairone, Mr. Kitashima, or Mr. Lumsden—but the above concerns were not.

The evidence defendants sought to introduce, which the district court excluded, was legally indistinguishable from the government's evidence. Defense witnesses Mark Barnett and Ron Gillet reviewed the very same internal reports and loan files that the government offered as evidence of the fraud. *See* J.A. 4019-4020, 4107, 4552, 4574, 4578. Mr. Barnett and Mr. Gillet were directly responsible for designing, implementing, and monitoring the HSSL process. In those roles, like the government's witnesses, they formed impressions of the HSSL process; but unlike the government's witnesses, Mr. Barnett's and Mr. Gillet's impressions were that the HSSL process was appropriate and produced good quality loans. Their testimony did not constitute an improper effort to "tell the jury what result to reach," as the government argues, U.S. Br. 72, but rather circumstantial evidence that the alleged wrongdoers reached the same conclusion.

The government also argues that defendants have "forfeited" this argument because they did not object to the testimony of the government's witnesses. U.S. Br. 71. But defendants have never argued that the testimony the government introduced should have been *excluded*; instead, defendants' position is that the defense evidence the district court excluded was

equally relevant and therefore should have been admitted. Defendants vociferously made that argument in the district court. *See*, *e.g.*, J.A. 4014, 4555-4564.

3. The government contends that the testimony defendants proffered from Mark Barnett and Ron Gillet was expert testimony based on their "specialized knowledge." U.S. Br. 73. That contention—which the government did not make below—can readily be dispatched. Mr. Barnett and Mr. Gillet would have testified concerning their own perceptions at the relevant time regarding, among other things, whether the HSSL process fostered quality loan underwriting. A witness's testimony about his own state of mind is not an expert opinion; it is admissible fact testimony. *See*, *e.g.*, *United States* v. *Munoz-Franco*, 487 F.3d 25, 35-36 (1st Cir. 2007). And if the government's contention were correct, it is hard to see how the government's own witnesses' opinions were not also improper "expert" testimony.

B. The District Court's Exclusion Of The Defense Witnesses' Testimony Was Highly Prejudicial

The government contends that the district court's error was harmless, because of what it says was the supposedly "overwhelming evidence" of fraudulent intent. U.S. Br. 74. To the contrary, the evidence of intent was exceedingly thin and circumstantial, leading the district court itself to conclude that this was "one of the closer cases I've seen in a long time." J.A. 4868. And as discussed above, the government's case on intent depended

largely on the same type of subjective testimony from government witnesses that the district court denied to the defense. In a trial where defendants' intent was one of the most hotly disputed issues, it is outlandish for the government to suggest that it is "highly probable" that this excluded category of defense testimony "did not affect the verdict." *Vayner*, 769 F.3d at 133 (internal quotation marks and citation omitted).

V. THE GOVERNMENT PRESENTED INSUFFICIENT EVIDENCE TO SHOW THAT DEFENDANTS MADE ANY MATERIAL MISREPRESENTATION TO FANNIE OR FREDDIE

The evidence at trial did not permit a reasonable juror to conclude that the actual quality of HSSL loans was materially worse than Fannie or Freddie could reasonably have expected—and thus that defendants engaged in a scheme to defraud. For that additional reason, this Court should reverse the judgment below.

A. It Was Undisputed That Fannie And Freddie Reasonably Expected That A Significant Percentage Of The Loans Sold To Them Would Not Be Investment Quality

The government concedes, as it must, that Fannie and Freddie knew and reasonably expected that not all loans purchased pursuant to contractual "investment quality" warranties would in fact be investment quality. *See* U.S. Br. 62. In contemplation of that very situation, the parties' contracts gave Fannie and Freddie the right to require repurchase of any non-conforming loans. J.A. 2761, 2994, 4747.

Indisputably, therefore, selling a non-investment-quality loan did not automatically give rise to a material misrepresentation or a "scheme to defraud." If it were otherwise, every loan seller in the industry would be guilty of mail and wire fraud on a daily basis. Thus, the government's focus on the supposed "importance" of the contractual warranties is a red herring: because some amount of deviations from investment quality was anticipated, the quality of the HSSL loans could be materially misrepresented only if it was lower than a reasonable purchaser in Fannie's and Freddie's position would have expected.

By definition, any issue of relative quality requires a benchmark. The questions for this case are, what was the expected rate of material defects, and did the HSSL loans' defect rate exceed that benchmark? On that point, the government persists in arguing that the "industry standard" rate of material defects in loans sold to Fannie and Freddie was 4%. U.S. Br. 64. But there is no evidence in the record to support that proposition. The testimony cited by the government relates either to Countrywide's own internal quality goals, J.A. 1907, 2152, 2511, 2517, or to Countrywide witnesses' beliefs about the "acceptable" rate, J.A. 1924, 1956. In contrast, Fannie and Freddie executives, testifying as government witnesses, stated that their post-purchase reviews found that 18% to 25% of all loans that they bought industry-wide had material defects. J.A. 3004, 3268. *That* is the rate Fannie and Freddie

expected, and it is the only benchmark for loan quality that the record supports.

B. The Government Presented Insufficient Evidence To Show That HSSL Loans Were Of A Lower Quality Than Fannie And Freddie Expected

1. Countrywide's Quality Control Results Showed That HSSL Loans Were Well Within Industry Standards For Quality

The government's evidence did not establish that the HSSL loans were materially defective at a rate higher than 18% to 25%. Countrywide's only contemporaneous measure of loan quality showed a much lower defect rate: Countrywide's independent Quality Control group found that only 4.4% to 9.8% of loans sold by FSL while the HSSL process was in operation were materially defective. J.A. 3588-3589, 4301, 5469. The evidence at trial, moreover, established that the findings of the Quality Control group were the definitive internal measure of whether the loans Countrywide sold were investment quality. J.A. 1903, 2390-2398, 3589, 3779, 6389.

Echoing the district court's error, the government asserts that, in the first quarter of 2008, the Quality Control material-defect rate was approximately 30%. *See* U.S. Br. 65; S.A. 113. As the bank defendants explained in their opening brief, *see* BofA Br. 75, that is incorrect: the document cited for that proposition shows a *preliminary* finding for a *small subset* of FSL loans. J.A. 6355. The evidence was undisputed that the *final* Quality Control

rating for the first quarter of 2008 was only 9.8%—well within industry standards. J.A. 2400-2401, 5469.

2. The Government Offered Insufficient Evidence To Cast Doubt On The Reliability Of Countrywide's Quality Control Results

While the government renews its assertion that the Quality Control results were unreliable, *see* U.S. Br. 65, it has no evidence to back it up. The government concedes that Countrywide's Quality Control group was a separate and independent division from FSL, and that there was no evidence that anyone in that division participated in any fraud or even knew about the HSSL process. *See id.* at 65-66; J.A. 1901-1902, 3586. The government claims that the rebuttal process, by which FSL responded to preliminary Quality Control ratings, somehow tainted the final results. U.S. Br. 65. The evidence, however, does not remotely support that claim. To be sure, the government offered evidence that certain *FSL* employees were incentivized to demonstrate to the Quality Control group that the loans were of investment quality. J.A. 2313. But the FSL employees did not have authority to decide whether to rate a loan as materially defective; that authority belonged to the independent Quality Control group, which did not receive any such incentive. J.A. 3590. And, even on the FSL side, there was no evidence that the incentives caused the employees to do anything improper. J.A. 4463, 7386.

3. ***FSL's Quality Assurance Results Did Not Show That HSSL Loans Were Below Industry Standards For Quality***

The government tries to distract from the definitive Quality Control results by pointing to FSL's internal "Quality Assurance" process. *See* U.S. Br. 66. Critically, however, the government concedes that the Quality Assurance process provided only a *pre-funding* "preview" of defect rates, *not* a measure of loan quality at the time of sale. *See id.* That "preview" provided no basis for the jury to conclude that the Quality Control findings—which actually measured the quality of loans post-funding—were inaccurate.

4. ***The Government's Experts' Testimony Did Not Show That HSSL Loans Were Below Industry Standards For Quality***

The only remaining evidence the government offered regarding the quality of the HSSL loans was the testimony of its experts. That testimony proved nothing about the quality of HSSL loans, because the experts opined about a population of 28,882 "HSSL" loans that in fact included at least 11,000 *non*-HSSL loans. *See* BofA Br. 78-80. Those 11,000 loans were not HSSL loans because they were originated by Countrywide's "field branches," which did not use the HSSL process. J.A. 2026, 2255, 3923.

The government effectively concedes that, if these 11,000 loans were not HSSL loans, the experts' testimony would not be probative. *See* U.S. Br. 67-69; J.A. 3110. The government also concedes, as it must, that the 11,000

loans were originated by field branches. *See* U.S. Br. 69 & n.13. The government argues only that the 11,000 loans *were* HSSL loans and, accordingly, its loan population was correct. *See id.* at 67 & n.11.

That argument is entirely without merit, because the evidence was crystal clear that field branches did not use the HSSL process. The Countrywide bulletin announcing the rollout of the "Central Fulfillment" model (which processed HSSL loans) noted that it would be deployed only in certain national sales centers and that field branches would "continue to use the existing model." J.A. 5441. Mr. O'Donnell and Ms. Mairone both testified that field branches were separate from "Central Fulfillment." J.A. 2255, 4238. In support of its argument, the government can point only to Mr. Thomas's speculation that, because of "workload balancing," Countrywide "could move volume from one place to another," so he "c[ould]n't say for sure" that no field branch loans were HSSL loans. J.A. 2026. But the hypothetical possibility that a field branch loan might have been processed through HSSL is hardly proof that any particular loan processed by a field branch was an HSSL loan—much less that all 11,000 of them were.

Indeed, in its penalty opinion, the district court itself found that the HSSL population "include[d] only those loans processed or funded by CF ['Central Fulfillment'] branches rather than by field branches." S.A. 94. While the government contends that this finding does not mean that the dis-

trict court specifically determined its experts were unreliable, *see* U.S. Br. 69, the district court plainly found that the 11,000 loans should have been excluded from the loan population.

Because the government's experts used the wrong loan population, their analysis did not prove a material misrepresentation concerning loan quality. And because the government had no other evidence from which a reasonable juror could have concluded that HSSL loans were materially defective at a rate higher than the industry-standard rate, there was insufficient evidence of a material misrepresentation to sustain the jury's verdict.

VI. THE DISTRICT COURT ERRED IN IMPOSING A PENALTY OF OVER $1.2 BILLION ON THE BANK DEFENDANTS

In addition to committing numerous errors during the liability phase, the district court further erred in imposing a grossly excessive penalty on the bank defendants. The government's principal argument in support of that penalty is that FIRREA was designed to be punitive and should be construed to maximize the severity of punishment. *See* U.S. Br. 77. But that gets it exactly backwards: punitive statutes are supposed to be construed narrowly, not broadly. And under any canon of construction, the district court's interpretation simply makes no sense.

FIRREA establishes a "general[]" maximum penalty of $1.1 million (which the government entirely disregards), subject to a "[s]pecial rule for violations creating gain or loss" that permits courts to award higher penalties

but only up to the amount of the "pecuniary gain" or "pecuniary loss" resulting from the violation. 12 U.S.C. § 1833a(b)(1), (b)(3). The government argues that the district court correctly interpreted "pecuniary gain" and "pecuniary loss" in Section 1833a(b)(3) to refer to the "gross amounts" that Fannie and Freddie paid to Countrywide for the HSSL loans, and it faults defendants for adopting what it calls a "net" approach. U.S. Br. 75. But the district court's interpretation fails for a more fundamental reason: it cannot be squared with the ordinary meaning of the terms "gain" and "loss." Not a single authority cited by the government supports the proposition that "pecuniary gain" means anything other than a monetary excess above cost, or that "pecuniary loss" means anything other than actual monetary diminution, after accounting for value received.

Perhaps for that reason, the government spends little time on the ordinary meaning of the words "gain" and "loss." *See* U.S. Br. 76. Instead, the government merely points out that Congress could have used the adjective "net" in the statute. *Id.* Of course, Congress could also have used the adjective "gross" to modify "gain" and "loss," as it has done elsewhere. *See*, *e.g.*, 7 U.S.C. §§ 7734(b)(1)(B), 8313(b)(1)(B); 15 U.S.C. § 77t(d)(2); 18 U.S.C. §§ 1031(b)(1), 3571(d). And in the absence of a modifier, a "net" measure is presumed. *See* BofA Br. 86-87; *United States* v. *Anchor Mortgage Corp.*, 711 F.3d 745, 749 (7th Cir. 2013). The critical point, however, is that, regardless

of how they could be modified, the terms "gain" and "loss" cannot be understood to mean the full amount that Fannie and Freddie paid Countrywide for the HSSL loans. Because the government's interpretation cannot stand, and because the government presented no valid evidence of a gain or loss in excess of the statutory maximum, this Court should vacate the district court's award of over $1.2 billion against the bank defendants.

A. The District Court's Interpretation Of 'Gain' Is Invalid

The government cites no authority, and defendants are aware of none, for the proposition that the principal amount that a bank lent to a borrower for purposes of generating a loan may be included in a calculation of "gain" to the bank from the sale of the loan. The government dismisses the principal amount as an "expense[] Countrywide incurred in perpetrating its fraud," U.S. Br. 78, but in doing so acknowledges that lending that amount to the borrower is the very thing that created a loan to sell. By that reasoning, one who incurs the "expense" of buying a house for $500,000 and then sells it for $520,000 has "gained" $520,000. It defies common sense to conceive of "gain" as divorced from one's original outlay, and the law unsurprisingly does not support it.

The government seeks to draw an analogy to forfeiture in RICO cases, where the Court has approved a "gross profit" measure as consistent with the statute's purposes. *See* U.S. Br. 78-79 (discussing *United States* v. *Lizza*

Industries, Inc., 775 F.2d 492 (2d Cir. 1985)). But even assuming that RICO's forfeiture provision (which applies to "any interest . . . acquired or maintained in violation" of the statute, 18 U.S.C. § 1963(a)(1)) had anything in common with FIRREA's civil-penalties provision, that analogy does not support the government's position. In adopting a "gross profit" measure there, this Court "deduct[ed] from the money received on the illegal contracts . . . the direct costs incurred in performing those contracts." *Lizza Industries*, 775 F.2d at 498. The Court considered whether the measure should be "gross profits" or "net profits," which would mean deducting not only the direct costs from each contract but also "an allocated portion of the overall indirect operating expenses" and "taxes paid on the profits." *Id.* The Court never adopted the government's view here that the entire amount received in the sale was the proper measure. Thus, even if the "gross profit" measure applied in the FIRREA context, it would still require deducting direct costs, such as the principal lent to borrowers to generate the loans, from the gain calculation.

The government's reliance on disgorgement more generally, *see* U.S. Br. 79, also misses the mark. Disgorgement is a flexible equitable remedy that is not bounded by any statutory limitation such as "pecuniary gain." *See CFTC* v. *Vartuli*, 228 F.3d 94, 113 (2d Cir. 2000) (describing the "wide latitude" of the court's "discretion" in calculating disgorgement (internal quota-

tion marks and citation omitted)). In any event, even courts awarding disgorgement remedies measured by "revenue," as opposed to "profit," do not require defendants to disgorge amounts analogous to the principal amounts of the loans in this case. For example, in one of the cases cited by the government, *FTC* v. *Bronson Partners, LLC*, 654 F.3d 359 (2d Cir. 2011), the Court reduced the revenue figure by the amount the defendant had returned to consumers. *Id.* at 369. The disgorgement analogy, like the forfeiture analogy, thus does not aid the government.

B. The District Court's Interpretation Of 'Loss' Is Also Invalid

1. Fannie And Freddie Did Not Lose The Entire Amounts They Paid For The HSSL Loans

The government's primary argument in support of the district court's approach is that "pecuniary loss" should not take into account a victim's efforts to reduce the loss through mitigation. *See* U.S. Br. 79-80. That argument is a red herring. The bank defendants are not arguing that Fannie and Freddie had a duty to "mitigate" their losses; instead, they are arguing that any value that Fannie and Freddie *actually received* as part of the allegedly fraudulent transactions should count against any calculation of "loss." That value should take into account not just the amount that the borrowers actually repaid on the loans, but also the collateral whose proceeds Fannie and Freddie would receive in the event of foreclosure, because Fannie and Freddie simply did not lose those amounts. The district court's interpretation

would count the full value of a loan as a "loss" even where a borrower repaid the entire loan. That interpretation is nonsensical, and the government offers no valid defense of it.

Remedial principles in both the civil and the criminal context support a measure of "loss" that deducts amounts that the victim received (and thus did not actually lose). For example, the Sentencing Guidelines require courts, "in the case of a fraud involving a mortgage loan," to reduce the loss by "the amount the victim has recovered at the time of sentencing from disposition of the collateral," or, if the collateral has not been disposed of, by "the fair market value of the collateral as of the date on which the guilt of the defendant has been established." U.S.S.G. § 2B1.1 app. n. 3(E)(ii), (iii). Courts, including one cited by the government for the opposite proposition, *see* U.S. Br. 80, routinely apply that principle by "subtract[ing] the value of any assets pledged to secure the loan" from "the amount of the loans outstanding at the time the fraud was discovered." *United States* v. *Lane*, 194 F. Supp. 2d 758, 771 (N.D. Ill. 2002).

The government also asserts that requiring courts to determine actual losses and gains would be an "unreasonable burden" involving "speculative calculations." U.S. Br. 81-82. But Fannie's and Freddie's actual losses are a matter of record in this case and are but a small fraction of the amount that they paid for the HSSL loans. *See* BofA Br. 85-86. Indeed, the government's

expert purported to calculate Fannie's and Freddie's losses on these loans. J.A. 180-181. What is more, in the very cases on which the government relies, courts approved precisely the type of "netting" exercise that the government disclaims. *See, e.g.*, *Lizza Industries*, 775 F.2d at 498; *United States* v. *Kumar*, 617 F.3d 612, 632 (2d Cir. 2010).

2. *Under Section 1833a, A 'Loss' Must Be Proximately Caused By The Violation*

The government belatedly agrees with the bank defendants that Section 1833a requires the government to prove that the violation proximately caused the "loss." U.S. Br. 83. It argues, however, that defendants advance an "untenably stringent standard of causation" that is only used "sometimes . . . to determine loss in securities fraud cases." *Id.* at 83, 86. Quite to the contrary. "[W]hat securities lawyers call 'loss causation' . . . is an instance of the common law's universal requirement that the tort plaintiff prove causation." *Moore* v. *PaineWebber, Inc.*, 189 F.3d 165, 174 (2d Cir. 1999) (citation omitted). In fraud cases of all stripes, including cases predicated on mail and wire fraud, this Court has required plaintiffs to prove both transaction causation and loss causation. *See McLaughlin* v. *American Tobacco Co.*, 522 F.3d 215, 222 (2d Cir. 2008); *First Nationwide Bank* v. *Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994). To obtain an enhanced penalty based on "pecuniary loss," therefore, the government was required to show that Fannie

and Freddie suffered actual losses *because of the fraud*—not, for example, because the mortgage crisis caused borrowers to default.

The one case the government cites says nothing to the contrary. *See* U.S. Br. 84, 85-86. In *United States* v. *Turk*, 626 F.3d 743 (2d Cir. 2010), the defendant persuaded individuals to lend her money, purportedly for renovating apartment buildings. *Id.* at 745. The defendant promised the individual investors that, as collateral for their loans, they would hold recorded first mortgages in the buildings, but in reality she did not record their mortgages. *Id.* When the scheme unraveled, the depreciated value of the buildings was sufficient to repay only the secured interests of the banks, and the unsecured investors lost nearly their entire investment. *Id.* at 746. This Court rejected the defendant's argument that the proper measure of the investors' loss was the declining value of the buildings, on the ground that the defendant had never collateralized the investors' loans. *Id.* at 750-751.

Turk is nothing like this case, where Fannie and Freddie received not just "a promise to repay," 626 F.3d at 751, but also held a secured interest in the residences collateralizing the HSSL loans they purchased, and numerous factors unrelated to the alleged fraud affected whether those loans were repaid in full (and, in fact, Fannie and Freddie were largely repaid by borrowers or via the collateral). *Turk* does not relieve the government from its bur-

den of proving that the claimed loss was proximately caused by the fraud—a burden that the government did not carry and the district court ignored.

The government advocates a standard that would penalize a defendant for all potential losses that are "reasonably foreseeable," regardless of whether such losses actually occurred or were caused by the defendant's conduct. U.S. Br. 85-87. But a penalty under Section 1833a based on loss is permissible only "if the violation results in pecuniary loss," and "may not exceed the amount of such . . . loss." 12 U.S.C. § 1833a(b)(3)(A). FIRREA thus caps the allowable penalty at the amount of *actual losses* resulting from the violation, not the amount of potential "foreseeable" losses that did not materialize or were not caused by the offense.

Because the government proved neither "pecuniary gain" nor "pecuniary loss" resulting from the alleged fraud, the district court should have capped the penalties at the ordinary statutory maximum of $1.1 million.

* * * * *

In their opening brief, the bank defendants requested that, in the event the Court remands this case to the district court for any reason, it should reassign the case to a new district judge. In response, the government offers only the most tepid defense of the district judge's impartiality, instead primarily arguing that defendants "forfeited" their request for reassignment by not raising it below. U.S. Br. 88-89. The government confuses reassignment

on remand with the separate procedure for recusal pursuant to statute. *See Liteky* v. *United States*, 510 U.S. 540, 554 (1994). Reassignment is a matter of this Court's discretion and need not be raised in the district court; indeed, this Court has exercised that discretion even where reassignment is not raised by the parties. *See In re Reassignment of Cases*, 736 F.3d 118, 129 (2d Cir. 2013) (per curiam), *vacated in part on other grounds*, 743 F.3d 362 (2d Cir. 2014).

The district judge's record of publications and speeches advocating criminal prosecution of bank executives speaks for itself. *See* BofA Br. 21-22. In light of the district judge's statements, reassignment would be "advisable to preserve the appearance of justice," *United States* v. *Robin*, 553 F.2d 8, 10 (2d Cir. 1977) (en banc) (per curiam), in the event that the Court does not reverse the district court's judgment outright.

CONCLUSION

The judgment of the district court should be reversed. In the alternative, the judgment should be vacated and the case remanded for a new trial. At a minimum, the damages award should be vacated and the case remanded with instructions to award penalties no higher than the statutory maximum of $1.1 million.

Respectfully submitted,

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SEPTEMBER 2, 2015

CERTIFICATE OF COMPLIANCE WITH TYPEFACE AND WORD-COUNT LIMITATIONS

I, Kannon K. Shanmugam, counsel for defendant-appellant Bank of America, N.A., and a member of the Bar of this Court, certify, pursuant to Federal Rule of Appellate Procedure 32(a)(7)(B), that the attached Reply Brief of Defendants-Appellants Bank of America, N.A., et al., is proportionately spaced, has a typeface of 14 points or more, and contains 10,491 words.

/s/ Kannon K. Shanmugam
KANNON K. SHANMUGAM

SEPTEMBER 2, 2015

CERTIFICATE OF SERVICE

I, Kannon K. Shanmugam, counsel for defendant-appellant Bank of America, N.A., and a member of the Bar of this Court, certify that, on September 2, 2015, a copy of the attached Reply Brief of Defendants-Appellants Bank of America, N.A., et al., was filed with the Clerk through the Court's electronic filing system. In addition, I certify that copies of the attached brief were sent, via third-party commercial carrier for delivery overnight, to the Clerk and to the following counsel:

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