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False Claims Act

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Second Circuit Affirms Dismissal of Mortgage-Backed Securities New York State False Claims Act Case Against Wells Fargo

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In *New York ex rel. Jacobson v. Wells Fargo National Bank, N.A.*, 824 F.3d 308 (2d Cir. 2016), the Second Circuit affirmed the dismissal of a relator's tax fraud-based claim against Wells Fargo under the New York False Claims Act ("NYFCA"). Unlike the Federal False Claims Act, the New York state act allows relators to pursue theories based on tax fraud or tax evasion. The relator, a former subprime loan officer at Wells Fargo, alleged that Wells Fargo filed fraudulent federal tax forms to claim exemptions under New York State and City tax law for trusts used to issue mortgage-backed securities known as real estate mortgage investment conduits ("REMICs"). In upholding the lower court's decision, the Second Circuit rejected the relator's contention that Wells Fargo filed fraudulent federal tax forms, and was unsympathetic to relator's effort to have the case remanded to state court.

Background

Relator Elizabeth Jacobson ("Jacobson") alleged that Wells Fargo filed fraudulent federal tax forms to claim REMIC tax exemptions for trusts used to issue mortgage-backed securities and that, because New York law exempts from state and city taxation any entity that is treated as a REMIC under federal tax law, Wells Fargo fraudulently avoided paying New York state and city taxes. A REMIC is exempt from taxation only as long as the mortgages deposited in the REMIC are "qualified mortgages" under federal tax law and regulation. *Jacobson*, 824 F.3d at 311 (citing 26 U.S.C. § 860D(a)(4)). A "qualified mortgage" is defined in the Internal Revenue Code as "any obligation . . . which is principally secured by an interest in real property." *Id.* (citing 26 U.S.C. § 860G(a)(3)).

Jacobson alleged that subprime loans securitized by Wells Fargo did not quality as REMICs because defaults on those mortgages were reasonably foreseeable, rendering them "defective obligations" under the pertinent regulations. According to the complaint, Wells Fargo falsified the financial conditions of unqualified borrowers who could not actually afford the loans. Moreover, the mortgages did not conform to the customary representations provided with regard to the mortgages' characteristics.

The district court denied a motion by Jacobson to remand the action to state court for lack of subject matter jurisdiction, ruling that the complaint raised federal law issues that supported jurisdiction, even though Jacobson asserted claims only under the NYFCA. The court then dismissed Jacobson's complaint, holding that the alleged fraudulent conduct was insufficient to deprive the trusts of REMIC status for federal income tax purposes. The complaint thus failed to plausibly allege that the trusts were not entitled to the New York tax exemptions and, accordingly, failed to state a claim under the NYFCA.

The Second Circuit's Holding

A unanimous panel of the Second Circuit affirmed the district court on the jurisdictional question and on the motion to dismiss. The court held that to establish a false statement under the NYFCA, Jacobson had to prove that Wells Fargo's trusts did not quality for the REMIC status they obtained under federal law. This question of federal law thus represented the central issue in the case and provided a basis for federal jurisdiction. The court rejected Jacobson's argument that New York had an overriding interest in determining the meaning of its own tax laws, pointing to the fact that New York had specifically declined to intervene in the case and had shown no interest in regulating REMICs that deviate from the Internal Revenue Code.

Turning to the motion to dismiss, the Second Circuit largely adopted the lower court's reasoning. The court held that the complaint did not plausibly allege that the Wells Fargo trusts were not qualified to be treated as REMICs. The REMIC statute requires that substantially all of the mortgages be "qualified mortgages" and the Second Circuit held that a mortgage is qualified under federal tax law if it is secured by real property – a factor not disputed in Jacobson's complaint. The Second Circuit rejected Jacobson's argument that the mortgages in question did not quality as REMICs because defaults on the loans were "eminently foreseeable" and Wells Fargo's conduct did not conform to the required "customary representation[s]" with respect to such mortgages. Those alleged defects did not deprive the mortgages of qualified-mortgage status under the Internal Revenue Code. Accordingly, the complaint failed to plausibly allege that Wells Fargo submitted any false statement or record affecting the trusts' entitlement to exemption from income tax under the New York tax laws and failed to state a claim under the NYFCA.

Implications

This case is one of the latest in a growing line in which courts have rejected attempts by enterprising relators to turn "bubble-era" lending practices into a False Claims Act claim. The trend is encouraging for financial institutions laboring to put litigation arising from that time period in the rearview mirror once and for all.

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