

Second Circuit Dismisses Sub-Prime Mortgage Crisis Complaint on Materiality Grounds Because Government Paid Claims Despite Notice of Alleged Fraud

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On March 2, 2017, the US District Court for the Southern District of **New York** applied the materiality standard announced by the **Supreme Court** of the United States in ***Universal Health Services, Inc. v. United States ex rel. Escobar*** to dismiss a relator's complaint because the relator, a former managing director of Moody's, failed to plead materiality as a matter of law.

In *United States ex rel. Kolchinsky v. Moody's Corp.*, the district court had previously dismissed with prejudice four of five categories of claims, and dismissed without prejudice the relator's "Ratings Delivery Service" claim, *i.e.*, that Moody's provided inaccurate ratings directly to subscribers, including government agencies. In his Second Amended Complaint, the relator attempted to cure the pleading defects of Ratings Delivery Service claim in a "124-page tome," but to no avail.

The court found that "Kolchinsky's claim is one of legal falsity—that its ratings differed in quality and accuracy from the ratings it promised to Government agencies." Drawing on *Escobar* to reject these allegations, the court held:

To plead materiality with the requisite particularity, a relator may draw inferences from various sources, including the Government's history of declining to pay claims for failure to comply with the applicable regulation. ... By contrast, materiality is absent at the pleading stage when the relator's chronology suggests that the Government knew of the alleged fraud, yet paid the contractor anyway. For this reason, *Universal Health* [*i.e.*, *Escobar*] defeats Kolchinsky's claims in this action because—as this Court has previously explained—credible public reports of inaccuracies in Moody's ratings spawned inquiries by the federal Government well before the May 27, 2009 statute-of-limitations cutoff."

This determination tracks the Supreme Court's instruction that materiality is a matter that is appropriately addressed at the pleadings stage. Indeed, courts need not unleash the discovery floodgates and defer a materiality determination until summary judgment if, as in this case, a relator (or the government) cannot sufficiently plead that alleged the falsity was material.

The district court further explained its rationale:

There is no serious dispute that Kolchinsky's allegations are substantially similar to stories previously reported in the media and investigated by Congressional committees. ... Accordingly, the sole surviving claims relate to a time period at which the Government—and the general public—was on notice of the very facts relied upon to support the fraud alleged here. And as the Second Amended Complaint and its spreadsheet appendix establish, the Government has nonetheless continued to pay Moody's for its credit-ratings products each year. Such allegations plead Kolchinsky out of court, because when the "Government pays a particular claim in full despite its actual knowledge that certain requirements were violated, that is very strong evidence that those requirements are not material." *Universal Health*, 136 S. Ct. at 2003–40. Kolchinsky provides no allegation giving rise to an inference that any listed agency could have been unaware of the alleged fraud during the proscribed time period.

The SDNY also observed, consistent with many other courts, that the False Claims Act is not a general enforcement device, but "a narrow statute focused on fraud against the Government."

This decision is undoubtedly helpful to and should be consulted by defendants seeking dismissal of complaints on materiality grounds based on *Escobar*.

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