

AN OVERVIEW OF THE FANNIE AND FREDDIE
CONSERVATORSHIP LITIGATION

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I.
INTRODUCTION

The fate of Fannie Mae and Freddie Mac are subject to the vagaries of politics, regulation, public opinion, the economy, and not least of all the numerous cases filed in 2013 against various government entities arising from the placement of the two companies into conservatorship. This short article will provide an overview of the last of these. The litigation surrounding Fannie and Freddie’s conservatorship raises all sorts of issues about the federal government’s involvement in housing finance. These issues are worth discussing as the proper role of these two companies in the housing finance system is still very much up in the air. The plaintiffs, in the main, argue that the federal government has breached its duties to preferred shareholders, common shareholders, and potential beneficiaries of a housing trust fund authorized by the same statute that authorized their conservatorships. At this early stage, it appears that the plaintiffs have a tough row to hoe.¹

Fannie Mae and Freddie Mac’s main business is to provide credit guarantees for residential mortgage-backed securities (“RMBS”). They are behemoths of the housing finance sector, owning or guaranteeing a combined forty seven per-

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1. This article was drafted after the complaints in the cases discussed below were filed, but before the parties began filing any additional papers in these cases, other than some purely procedural ones.

cent of all the residential mortgages in the United States.² This amounts to over \$5.3 trillion in mortgages.³ Fannie and Freddie are Government-Sponsored Enterprises (“GSEs”), neither government agencies nor fully private corporations. Historically, they have been owned by private shareholders but were chartered by the federal government. As a result of their hybrid nature, the government granted them all sorts of privileges, rights, and exemptions. I have exhaustively reviewed these privileges in an earlier article, but let me note one privilege at the outset.⁴ As a general rule, banks are barred from owning equity in for-profit corporations because they are considered to be overly risky investments. 12 U.S.C. Section 1464(c)(1)(E), however, allows federal savings and loans to buy Freddie Mac preferred stock.⁵ The implication of this exception is that this GSE preferred stock is a safe investment for a conservative investor.⁶ In other words, Congress has carved out an exception to the conservative rule it had regarding investments for federal savings and loans because of Freddie’s special relationship with the federal government. This preferred stock has taken on great significance in much of the post-conservatorship litigation.

2. See FEDERAL HOUSING FINANCE AGENCY (FHFA), ENTERPRISE SHARE OF RESIDENTIAL MORTGAGE DEBT OUTSTANDING: 1990–2010 [hereinafter FHFA CHART], available at <http://www.fhfa.gov/Default.aspx?Page=70> (showing outstanding mortgage debt through the end of 2010) (last visited Feb. 19, 2014). Fannie Mae is formally known as the “Federal National Mortgage Association” and Freddie Mac is formally known as the “Federal Home Loan Mortgage Corporation,” but they are universally referred to (even by themselves) by their nicknames.

3. See FHFA CHART, *supra* note 2.

4. See generally David Reiss, *The Federal Government’s Implied Guarantee of Fannie Mae and Freddie Mac’s Obligations: Uncle Sam Will Pick up the Tab*, 42 GA. L. REV. 1019 (2008).

5. Preferred stock receives dividends and/or liquidation distributions before, or in preference to, common shareholders.

6. The Treasury’s Office of Financial Research found that “[a]lthough equity securities are generally not permissible investments for depository institutions, regulators allowed banks to hold shares of Fannie Mae and Freddie Mac because of the perceived special status of the government-sponsored enterprises and the assumption of a government guarantee. Losses on those securities during the crisis played a role in an estimated 15 U.S. bank failures and two distressed mergers.” OFFICE OF FINANCIAL RESEARCH, ANNUAL REPORT TO CONGRESS, 41 (2013).

For most of their existence, Fannie and Freddie have been consistently and highly profitable. But, foreshadowing the 2008 financial crisis, the two companies began posting billions of dollars of losses in 2007. The losses jumped exponentially in 2008 to combined losses that well exceeded \$100 billion.⁷ Losses in 2009 approached \$100 billion again and then moderated to the low tens of billions in 2010 and 2011.⁸ At the same time, the United States Treasury was pumping billions of dollars into the two companies. The last of these draws occurred during the final quarter of 2011, which was the last time the companies saw losses. By the second quarter of 2012, the two companies saw a marked improvement in their financial performance. Indeed, Fannie had record profits of over \$17 billion in 2012 and Freddie recorded nearly \$11 billion in the same year.⁹ The likely fate of the two companies seems to change along with their financial condition, as proposals for them range from nationalization to liquidation to privatization.¹⁰

In this article, I will provide some background about Fannie and Freddie's regulatory environment. I will then review the events at the heart of the cases that were filed in 2013 arising from their placement in conservatorship. These events include those leading up to their conservatorship as well as those that occurred during their conservatorship. I will provide an overview of the claims made in the cases arising from those events and highlight some of their important features. Because these cases are at such an early stage, I will not go so far as to predict their outcomes or their ultimate impact on the federal housing finance system more generally. I will, however, offer some thoughts about how the federal government should be held accountable for its actions in the midst of a financial crisis and in its aftermath.

7. See N. Eric Weiss, CONG. RESEARCH SERV., R42760, Fannie Mae's and Freddie Mac's Financial Status: Frequently Asked Questions (2013), available at <http://www.fas.org/sgp/crs/misc/R42760.pdf> (last visited Feb. 19, 2014).

8. See *id.*

9. See *id.*

10. See, e.g., David Reiss, *Fannie Mae and Freddie Mac and the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege*, 61 ALA. L. REV. 907 (2010) (outlining various proposals).

II.

FANNIE AND FREDDIE IN CONSERVATORSHIP

I have reviewed the events leading up to Fannie and Freddie's conservatorship in an earlier article, but some of those events bear repeating.¹¹ After the two companies posted billions of dollars of quarterly losses beginning in 2007, their troubles were reflected in their sinking stock prices.¹² Congress enacted the Housing and Economic Recovery Act of 2008 ("HERA" or "the Act") in order to bail them out.¹³ Soon after HERA was enacted, the federal government placed the GSEs in conservatorship, pursuant to the Act.¹⁴ The federal government made it clear that debt holders would be made whole, but it gave no similar signal to shareholders.¹⁵

HERA provided a new regulatory regime for Fannie and Freddie. Most importantly for this article, it provided a roadmap to deal with insolvency by either or both companies. The relevant provisions of the Act for the purposes of this article are those that deal with (1) Fannie and Freddie's financial safety and soundness regulation; (2) government support for the two companies during the financial crisis; and (3) the creation of an affordable housing trust fund.

Safety and Soundness. The Act created a new regulator for the two companies, the Federal Housing Finance Agency ("the Agency" or "FHFA").¹⁶ The Agency is run by a Director appointed by the President.¹⁷ The Act identifies the actions that can be taken if either or both Fannie and Freddie become un-

11. *Id.*

12. *See id.* at 915.

13. *See* Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654.

14. *See infra* Part I (reviewing events leading up to Fannie and Freddie entering conservatorship).

15. *See* James R. Hagerty, *S&P Cuts Some Ratings on Fannie and Freddie*, WALL ST. J., Aug. 12, 2008, at C5 (noting that there is much uncertainty as to whether the federal government would protect holders of preferred stock and subordinated debt even if they were to back the companies' senior debt).

16. *See* Housing and Economic Recovery Act of 2008, *supra* note 13, § 1101. FHFA replaced the Office of Federal Housing Enterprise Oversight, a weak regulator. *See* Reiss, *supra* note 10, at 919-20.

17. *See* Housing and Economic Recovery Act of 2008, *supra* note 13, § 1312.

dercapitalized.¹⁸ Most relevant here, a critically undercapitalized entity may have the Agency named as conservator or receiver.¹⁹ HERA gives the Director the authority to appoint the FHFA as conservator or receiver for the regulated entity.²⁰ HERA states that the FHFA shall, “as a conservator or receiver, . . . succeed to . . . all rights, titles, powers and privileges of . . . any stockholder” of Fannie and Freddie.²¹ The Act also states that except “at the request of [the FHFA], no court may take any action to restrain or affect the exercise of powers or functions of [the FHFA] as conservator or receiver.”²²

Conservatorship and receivership are typically seen as quite similar, although the two statuses are distinct. A conservatorship is generally preferred where the entity is expected to return to sound and solvent condition at some point in the future.²³ Under Section 1145 of HERA, as conservator of the Entities, the Agency may “take such action as may be — (i) necessary to put the regulated entity in a sound and solvent condition, and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity.”²⁴ As conservator, the FHFA has the legal authority to enter into and nullify contracts on behalf of the companies while under conservatorship. Under this authority, FHFA entered into Preferred Stock Purchase Agreements (PSPAs) with the Treasury. The companies are bound by these agreements. In the case of Fannie, the Treasury’s authority to enter into the PSPA stems from Section 304(g) of the Federal National Mortgage Association Charter Act, under which Congress created Fannie Mae for the purpose of establishing secondary mortgage market facilities for residential mortgages.²⁵

18. *See id.* §§ 1143–45.

19. *See id.* § 1145.

20. *See id.* § 1147.

21. 12 U.S.C. § 4617(b)(2)(A)(i) (2008).

22. *Id.* § 4617(f).

23. *See, e.g.*, FDIC, RESOLUTIONS HANDBOOK 70–71 (2003), available at <http://www.fdic.gov/bank/historical/reshandbook/index.html> (last visited Feb. 19, 2014).

24. 12 U.S.C. § 4617(b).

25. *See* Federal National Mortgage Association Charter Act, 12 U.S.C.A. § 1716 (2008), available at <http://www.fhfa.gov/GetFile.aspx?FileID=29> (last visited Feb. 19, 2014).

Receivership, pursuant to the Act, would have the FHFA “place the regulated entity in liquidation and proceed to realize upon the assets of the regulated entity,” essentially winding the entity down.²⁶ The FHFA can place the companies into receivership if the Director makes a determination that for a period of 60 days: (1) their assets are less than their obligations (a net worth deficit), or (2) if they have not been paying their debts.²⁷ Additionally, the Director can place the Entities into receivership “at his discretion at any time for other reasons including conditions that FHFA has already asserted existed at the time the Director of FHFA placed [the companies] into conservatorship.”²⁸ Notwithstanding the overlap in roles between the FHFA as conservator and as receiver, one might say that the former focuses on ongoing operations and the latter on liquidation.

Government Support. HERA also authorized the Secretary of the Treasury to make unlimited equity and debt investments in the two companies’ securities through December 31, 2009.²⁹ This was to be done only by mutual agreement between the relevant GSE and the Secretary of the Treasury.³⁰ In order to purchase obligations or securities of the companies, an emergency determination must be made by the Secretary of the Treasury.³¹ This determination must address whether such actions are necessary to (i) provide stability to the financial markets, (ii) prevent disruptions in the availability of mortgage finance and (iii) protect the taxpayer.³² HERA further states:

To protect the taxpayers, the Secretary of the Treasury shall take into consideration the following in connection with exercising the authority contained in this paragraph:

(i) The need for preferences or priorities regarding payments to the Government.

26. *Id.* § 4617(b)(2)(E).

27. *See id.* § 4617(a)(4)(A)(i)-(ii).

28. Fannie Mae, Annual Report (Form 10-K) (Dec. 31, 2012), available at <http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-reports/2012/10k2012.pdf>. *See also* 12 U.S.C. § 4617(a)(2) (2008).

29. *See* Housing and Economic Recovery Act of 2008, *supra* note 13, § 1117.

30. *See id.*

31. *See id.*

32. *See id.* (amending 12 U.S.C. §§ 1719, 1455 (2010)).

(ii) Limits on maturity or disposition of obligations or securities to be purchased.

(iii) The Corporation's [Fannie or Freddie] plan for the orderly resumption of private market funding or capital market access.

(iv) The probability of the Corporation fulfilling the terms of any such obligation or other security, including repayment.

(v) The need to maintain the Corporation's status as a private shareholder-owned company.

(vi) Restrictions on the use of Corporation resources, including limitations on the payment of dividends and executive compensation and any such other terms and conditions as appropriate for those purposes.³³

Housing Trust Fund. HERA also established the Housing Trust Fund ("HTF"), which sought to increase rental and homeownership for extremely low- and very low- income families.³⁴ The Act required that Fannie and Freddie "set aside an amount equal to 4.2 basis points for each dollar of the unpaid principal balance of its total new business purchases" to support affordable housing initiatives.³⁵ When the Act was passed, it was understood that this set-aside would raise at least \$500 million each year for such initiatives.³⁶ The FHFA suspended these payments as soon as the two companies entered conservatorship.³⁷ In fact, no monies have been deposited into the fund.

33. 12 U.S.C. § 1455(1)(1)(C) (2010).

34. See Housing and Economic Recovery Act of 2008, *supra* note 13, § 1338(a)(1).

35. 12 U.S.C. § 4567(a)(1)(A) (2008).

36. See David M. Herszenhorn, *Approval Is Near for Bill To Help U.S. Homeowners*, N.Y. TIMES, June 25, 2008, at A1 (estimating \$500–\$900 million).

37. Letter from James B. Lockhart III, FHFA Director, to Herbert M. Allison Jr., Fannie Mae CEO, dated Nov. 13, 2008; Letter from James B. Lockhart III, FHFA Director, to David M. Moffett, Freddie Mac CEO, dated Nov. 13, 2008.

III.

THE PREFERRED STOCK PURCHASE AGREEMENTS³⁸

The Department of the Treasury purchased one million shares of so-called Government preferred stock from each company pursuant to the Preferred Stock Purchase Agreements (“PSPAs”) executed on September 26, 2008.³⁹ In exchange, the PSPAs allowed each company to draw up to \$100 billion from the Treasury to ensure that they maintained a net worth of at least zero. The PSPA and the conservatorships were part of a plan to stabilize the two companies⁴⁰ and make good on the implied guarantee that the companies had been benefiting from for so long.⁴¹

The Government preferred stock for each company has a liquidation preference equal to \$1 billion plus the sum of all draws by each company against the Treasury’s funding commitment. The PSPAs also grant the Treasury warrants to purchase up to 79.9% of each company’s common stock at a

38. The original Agreement and Amendments can be found at <http://www.fhfa.gov/Default.aspx?Page=364> (last visited Feb. 19, 2014).

39. Amended and Restated Senior Preferred Stock Purchase Agreement (Sept. 26, 2008), <http://www.fhfa.webfiles/23900seniorpreferredfrea.pdf>.

40. See Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), available at <http://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx> (“Since this difficult period for the GSEs began, I have clearly stated three critical objectives: providing stability to financial markets, supporting the availability of mortgage finance, and protecting taxpayers – both by minimizing the near term costs to the taxpayer and by setting policymakers on a course to resolve the systemic risk created by the inherent conflict in the GSE structure.”); see also, FHFA, *Report to Congress— 2012* (June 13, 2013) at iv, available at http://www.fhfa.gov/webfiles/25320/FHFA2012_AnnualReport.pdf.

41. See Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), available at <http://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx> (“These Preferred Stock Purchase Agreements were made necessary by the ambiguities in the GSE Congressional charters, which have been perceived to indicate government support for agency debt and guaranteed MBS. Our nation has tolerated these ambiguities for too long, and as a result GSE debt and MBS are held by central banks and investors throughout the United States and around the world who believe them to be virtually risk-free. Because the U.S. Government created these ambiguities, we have a responsibility to both avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings of GSE debt and MBS.”)

nominal price. Owners of preferred stock thus found themselves as holders of junior preferred stock, to the Government's senior preferred stock.⁴² The PSPAs also called for a dividend rate for the Treasury of 10% of the liquidation preference.⁴³ The liquidation preference is the amount that each company "has drawn from the Treasury each quarter to keep its liabilities from exceeding its assets, plus the initial \$1 billion commitment fee" for each company.⁴⁴ The two companies had trouble making these payments for the first couple of years that the PSPAs were in effect, thereby requiring them to borrow additional funds from the Treasury in order to pay the dividends as they became due.⁴⁵

Pursuant to the PSPAs, Fannie and Freddie were required to make certain covenants including that, "[w]ithout the prior consent of the Treasury, the GSEs shall not. . . [m]ake any payment to purchase or redeem its capital stock, or pay any dividends, including preferred dividends (other than dividends on the senior preferred stock)."⁴⁶

42. Preferred Stock Purchase Agreements, *available at* <http://www.fhfa.gov/Default.aspx?Page=364> (last visited Feb. 19, 2014).

43. This rate could be increased to 12% under certain circumstances. *See* Third Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement ¶ 3 (Aug. 17, 2012), *available at* <http://www.treasury.gov/press-center/press-releases/Documents/Fannie.Mae.Amendment.pdf>.

44. The 2012 Amendments significantly altered the structure of the dividend payment, such that the Enterprises are no longer required to draw funds from Treasury just to pay Treasury dividends. As of January 1, 2013, the dividend payment is no longer based on a fixed percentage of the liquidation preference. Instead, the dividend is based on the amount of positive net worth reported by each Enterprise. Net worth is the amount by which assets exceed liabilities. For 2013, each Enterprise must pay the Treasury the amount of its positive net worth over \$3 billion. As discussed above, this \$3 billion buffer will gradually decline—by \$600 million per year—until it disappears in 2018. FED. HOUS. FIN. AGENCY, OFFICE OF INSPECTOR GEN., ANALYSIS OF THE 2012 AMENDMENTS TO THE SENIOR PREFERRED STOCK PURCHASE AGREEMENTS, WPR-2013-002, 11-12 (Mar. 20, 2013), *available at* http://fhfa.oig.gov/Content/Files/WPR-2013-002_2.pdf.

45. *See, e.g.*, Nick Timiraos, *Fannie Mae Needs \$8.4 Billion More*, WALL ST. J. (May 11, 2010), <http://online.wsj.com/news/articles/SB10001424052748703880304575236030191182938?KEYWORDS=fannie+dividend>.

46. U.S. Treasury Dep't Office of Pub. Affairs, Fact Sheet: Treasury Senior Preferred Stock Purchase Agreement, Exhibit 99.3 (Sept. 7, 2008) *available at* <http://www.sec.gov/Archives/edgar/data/310522/0000950133080003096/w67133exv99w3.htm>.

The first two amendments to the PSPAs increased the ability of the two companies to borrow from the federal government. The First Amendment, executed on May 6, 2009, increased the Treasury's funding commitment to each of Fannie and Freddie from \$100 to \$200 billion.⁴⁷ The PSPA was amended again on December 24, 2009, one week before the Treasury's temporary authority under HERA expired. This Second Amendment again increased the Treasury's funding commitment. But rather than raising the maximum to a set number, the Second Amendment established a formula to allow the Treasury's total commitment to each company to exceed \$200 billion depending upon certain factors.⁴⁸

There is much speculation as to why the Treasury structured the conservatorships in the way that it did. Plausible hypotheses include: (1) that the Treasury did not want to signal to foreign and domestic investors in Fannie and Freddie securities that it had completely nationalized the two companies; (2) that the Treasury did not want to spur further fear among investors and the public more generally by implementing a wholesale takeover of the two companies; and (3) that the federal government did not want to have to consolidate the massive liabilities of Fannie and Freddie into its own budget, thereby triggering a political firestorm and various legal requirements that pertain to the federal budgetary process.⁴⁹

47. Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement (May 6, 2009), *available at* <http://www.fhfa.gov/webfiles/23892/FannieMae509Amendment.pdf> (Treasury and FHFA amend the PSPA for the purpose of increasing "the maximum aggregate amount permitted to be provided" to \$200,000,000).

48. *See* Second Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement (Dec. 24, 2009), *available at* <http://www.fhfa.gov/webfiles/23899/FanniesecondAmendment.pdf> ("[I]n no event shall the aggregate amount funded under the Commitment exceed the greater of (a) \$200,000,000,000 (two hundred billion dollars), or (b) \$200,000,000 plus the cumulative total of Deficiency Amounts determined for calendar quarters in calendar years 2010, 2011, 2012, less any Surplus Amount determined as of December 31, 2012. The liquidation preference of Senior Preferred Stock shall increase in connection with draws on the Commitment, as set forth in Section 3.3. . .)."

49. *See, e.g.*, Holman W. Jenkins, *Wall Street's Romance with Fannie & Freddie*, WALL ST. J. (Nov. 29, 2013), *available at* http://online.wsj.com/news/articles/SB10001424052702304017204579228123208520160?mod=ITP_opinion0.

Whatever the reason, the federal government did not wipe out the junior preferred shares at the outset of the conservatorships. In a 2008 statement then-Treasury Secretary Paulson explained that “conservatorship does not eliminate the outstanding preferred stock, but does place preferred shareholders second, after the common shareholders, in absorbing losses,” and he also noted that “[p]olicymakers must view this next period as a ‘time out’ where we have stabilized the GSEs while we decide their future role and structure.”⁵⁰ Then-FHFA Director James B. Lockhart stated, “FHFA will act as the conservator to operate [Fannie and Freddie] until they are stabilized,”⁵¹ all the while emphasizing the temporary nature of the conservatorship.⁵² Lockhart made clear that “in order to conserve over \$2 billion in capital every year, the common stock and preferred stock dividends will be eliminated, but the common and all preferred stocks will continue to remain outstanding.”⁵³ Indeed, even through 2012, the FHFA was discussing the temporary nature of the conservatorship⁵⁴ and the role of the FHFA in trying to bring the Entities to “sound financial condition.”⁵⁵

While the conservatorship was entered into with the understanding that the companies would likely not resurface in the pre-conservatorship structure or even as a “shareholder-owned company,” there was at least some evidence that the

50. WSJ Staff, *Officials’ Statements on Fannie Mae and Freddie Mac*, WALL ST. J. (Sept. 7, 2008, 11:51 AM), available at <http://blogs.wsj.com/economics/2008/09/07/officials-statements-on-fannie-mae-and-freddie-mac/>.

51. Statement of James B. Lockhart, Director, FHFA at 6 (Sept. 7, 2008) available at <http://www.fhfa.gov/webfiles/23/FHFASStatement9708final.pdf>.

52. “Upon the Director’s determination that the Conservator’s plan to restore the [Companies] to a safe and solvent condition has been completed successfully, the Director will issue an order terminating the conservatorship.” FHFA Fact Sheet, Questions and Answers on Conservatorship, available at <http://www.fhfa.gov/webfiles/35/FHFACONSERVQA.pdf>.

53. See Statement of James B. Lockhart, Director, FHFA (Sept. 7, 2008), available at <http://www.fhfa.gov/webfiles/23/FHFASStatement9708final.pdf>.

54. FHFA, *Report to Congress—2012*, *supra* note 37, at iv (“The Enterprises cannot remain in conservatorship permanently, and expanding private sector participation is essential for the long-term health of the mortgage market.”).

55. “The conservatorships of the Enterprises, combined with Treasury’s financial support, has stabilized the Enterprises but not restored them to a sound financial condition. The Enterprises remain exposed to credit, counterparty, and operational risks.” *Id.*

junior preferred shares could have some value.⁵⁶ This type of evidence might have been particularly compelling for preferred shareholders like Perry Capital which claims to have purchased many of its shares more than a year after the temporary authority of the Treasury to purchase Fannie and Freddie's securities had expired.⁵⁷ And so, it remained unclear for quite some time whether the equity owners would be wiped out by the events that led to the conservatorship in the first place.

Much of the litigation discussed below will address the explicit agreement contained in the documents that pertain to the preferred shares as well as the duties that the company has to preferred shareholders. The legal rights of the junior preferred shareholders are not clear cut, particularly because the relative rights of preferred stockholders may be contained in various documents. Looking at a sample Summary of Offering of Fannie preferred stock, one can see that the offering documents themselves offer a fair amount of additional wiggle room for the government:

Holders of Preferred Stock will be entitled to receive non-cumulative, quarterly cash dividends when, as and if declared by the Board of Directors. . . . Upon on any dissolution, liquidation or winding up of the Corporation, record holders of the outstanding shares of Preferred Stock will be entitled to receive, out of the assets of the Corporation available for distribution to stockholders, before any payment

56. FED. NAT'L MORTG. ASS'N ANN. REP. at 13-4 (2008), *available at* http://www.fanniemae.com/resources/file/ir/pdf/proxy-statements/form10k_022609.pdf ("We do not know when or how the conservatorship will be terminated or what changes to our business structure will be made during or following the termination of the conservatorship. We do not know whether we will exist in the same or a similar form or continue to conduct our business as we did before the conservatorship, or whether the conservatorship will end in receivership. We can give no assurance that we will remain a shareholder-owned company. At the time we were placed into conservatorship, the then Secretary of the Treasury indicated that there is a consensus that we and Freddie Mac pose a systemic risk and that we cannot continue in our current form.") (last visited Feb. 19, 2014).

57. Press Release, Gibson Dunn, Fannie, Freddie Investors File Suit Challenging U.S. Treasury's 2012 "Sweep Amendment" (July 7, 2013), http://images.politico.com/global/2013/07/07/treasury_suit_announcement.html.

or distribution is made on the common stock (or any other junior stock) of the Corporation, [a certain amount per share] . . . (but without accumulation of any dividends for prior dividend periods).⁵⁸

On June 20, 2011, the Federal Register published the FHFA's final rule "to establish procedures for conservatorship and receivership and priorities of claims for contract parties and other claimants" ⁵⁹ The final rule contained several provisions that address whether and to what extent claims against the regulated entities by current or former holders of their equity interests for rescission or damages arising from the purchase, sale, or retention of such equity interests will be paid while those entities are in conservatorship or receivership.⁶⁰

In retrospect, the rule seems to serve as a preemptive strike against the allegations contained in the 2013 litigation. It attempts to shield the FHFA with a defense that the statutory requirements protect it from paying any damages to investors: "The potential impact of such claims may be significant and may jeopardize FHFA's ability to fulfill its statutory mission to restore soundness and solvency" ⁶¹ It continues:

The rule clarifies that for the purposes of priority determinations, claims arising from rescission of a purchase or sale of an equity security of a regulated entity, or for damages arising from the purchase, sale, or retention of such a security, will be treated as would the underlying security that establishes the right to the claim. The rule also classifies a payment of these types of claims as a capital distribution, which is prohibited during the conservatorship, absent the express approval of the Director.⁶²

This rule appears to provide an additional regulatory basis to ban payments of dividends to the companies' shareholders. It remains to be seen whether courts will indeed treat share-

58. Offering Circular (Aug. 20, 1998), <http://www.fanniemae.com/resources/file/ir/pdf/stock-info/seriesd.pdf>.

59. FHFA, 12 C.F.R. pts. 1229 & 1237 (2011).

60. *Id.*

61. *Id.*

62. *Id.*

holder claims as prohibited capital distributions by another name.

In a 2012 press release, the Treasury announced the Third Amendment modifications to the PSPAs, going so far as to label their actions as “steps to expedite [the] wind down of Fannie Mae and Freddie Mac.”⁶³ Such language resonates more with a receivership than a conservatorship. The FHFA’s *2012 Report to Congress* made it clear that after the Third Amendment’s enactment, the Companies would not be building capital reserves.⁶⁴ The Third Amendment changed the structure of the dividend payments the companies were obligated to make to the Treasury. The dividend was no longer based on a fixed 10% of the liquidation preference, but instead is now based on the net worth of the companies.

According to the Treasury’s press release, “every dollar of earnings that Fannie Mae and Freddie Mac generate will be used to benefit taxpayers.”⁶⁵ This was to be achieved by replacing the 10% dividend with a 100% quarterly payment of the companies’ net worth.⁶⁶ This has become known as the “Net Worth Sweep.”⁶⁷ At the same time, those payments made to the Treasury will have no effect on the value of the government preferred stock, which will remain \$189 billion. Additionally, the companies “will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form.”⁶⁸ Then-Acting FHFA Director DeMarco appeared to agree with this outlook, indicating that

63. Press Release, U.S. DEP’T OF THE TREASURY, *Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac* (Aug. 17, 2012), <http://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx>.

64. FHFA, *Report to Congress—2012*, *supra* note 37, at iii (“Given that the Enterprises have depleted all of their shareholders’ equity, are operating with financial support from the Treasury, and are not able to retain their earnings, when considering safety and soundness, it is important to consider the risks associated with the Enterprises’ operations since being placed into conservatorship.”).

65. Press Release, U.S. DEP’T OF THE TREASURY, *supra* note 63.

66. Third Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement, *supra* note 43, ¶ 3 (modifying dividend rate of senior preferred stock).

67. This Net Worth Sweep excludes a relatively small capital reserve amount.

68. U.S. DEP’T OF THE TREASURY, *supra* note 63.

“[t]here seems to be broad consensus that Fannie Mae and Freddie Mac will not return to their previous corporate forms. The Obama Administration has since made clear that its preferred course of action is to wind down the Enterprises.”⁶⁹

IV. THE LITIGATION

At least nineteen cases have been filed by investors arising out of the placement of Fannie and Freddie into conservatorship.⁷⁰ The cases are in the most preliminary of stages, with case management orders having been issued as well as some preliminary motions filed. Ten cases have been filed in the United States District Court for the District of Columbia alleging a variety of causes of actions, including violations of the Administrative Procedures Act (“APA”), breach of contract, and breach of fiduciary duty. These ten cases have been consolidated into one proceeding.⁷¹ Eight cases have been filed in the United States Court of Claims, many by the same plaintiffs in the District Court proceedings.⁷² These cases have been as-

69. *An Update from the Federal Housing Finance Agency on Oversight of Fannie Mae, Freddie Mac and the Federal Home Loan Banks: Hearing Before the U.S. Senate Committee on Banking, Housing and Urban Affairs*, 113th Cong. 3 (2013) (statement of Edward J. DeMarco, Acting Director, FHFA), available at <http://www.fhfa.gov/webfiles/25114/DeMarcoSenateBankingTestimony41813.pdf>.

70. Jerry Stouck, *Presentation on the Fannie and Freddie Conservatorship Litigation* (Nov. 21, 2013).

71. These ten cases were filed in the second half of 2013. The cases are *Perry Capital LLC v. Lew*, No. 13-cv-1025 (D.D.C. July 7, 2013); *Fairholme Funds, Inc. v. Fed. Hous. Fin. Agency*, No. 13-cv-1053 (D.D.C. July 10, 2013); *Liao v. Lew*, No. 13-cv-1094 (D.D.C. July 16, 2013); *Cacciapelle v. Fed. Nat'l Mortg. Ass'n*, No. 13-cv-1149 (D.D.C. July 29, 2013); *Am. European Ins. Co. v. FNMA*, No. 13-cv-1169 (D.D.C. July 30, 2013); *Cane v. Fed. Hous. Fin. Agency*, No. 13-cv-1184 (D.D.C. Aug. 1, 2013); *Dennis v. Fed. Hous. Fin. Agency*, No. 13-cv-1208 (D.D.C. Aug. 1, 2013); *Marneu Holdings Co. v. Fed. Hous. Fin. Agency*, No. 13-cv-1421 (D.D.C. Sept. 18, 2013); *Arrowood Indemnity Co. v. Fed. Nat'l Mortg. Ass'n*, No. 13-cv-1439 (D.D.C. Sept. 20, 2013); *Borodkin v. Fed. Nat'l Mortg. Ass'n*, No. 13-cv-1443 (D.D.C. Sept. 20, 2013). Preliminary Case Management Order No. 1 in *The Fannie Mae/Freddie Mac Senior Preferred Stock Purchase Agreement Litigations*, No. 13-cv-1025 (D.D.C. Oct. 9, 2013) (Wilkins, J.), available at <http://www.restorefanniemaes.us/calendar>.

72. These eight cases were also filed in the second half of 2013. They are *Wash. Fed., v. United States*, No. 13-385 (S.D. Fla. June 10, 2013); *Fairholme Funds, Inc. v. United States*, No. 13-465 (S.D. Fla. July 9, 2013); *Cacciapelle v. United States*, No. 13-466 (S.D. Fla. July 10, 2013); *Am. European Ins. Co.*

signed to the same judge. These cases allege that the federal government is liable pursuant to the Takings Clause of the Fifth Amendment of the U.S. Constitution. Finally, one case alleging violations of HERA relating to the housing trust fund has been filed in the United States District Court for the Southern District of Florida.⁷³

While these cases concern the same set of facts, they vary in terms of their legal theories and remedies sought. Some seek to effectively invalidate the Third Amendment. Others seek damages for harm allegedly caused to shareholders by the Third Amendment. Some of the cases allege claims of individual plaintiffs, putative classes, and shareholders by means of derivative actions. The plaintiffs are also quite varied. Some are preferred or common shareholders before or after the Third Amendment was executed. All of the permutations of plaintiffs cannot be listed here. The defendants are also varied, including the FHFA, as conservator for Fannie and Freddie; the United States Department of the Treasury as the holder of the Senior Preferred Shares; Fannie and Freddie themselves; and the United States.

The plaintiffs in the District Court for the District of Columbia cases seek to enjoin the enforcement or invalidate the Third Amendment. They argue that, for the purposes of the APA, the government acted arbitrarily, capriciously, or in violation of law. The main claims are that: (i) the Third Amendment created a new security, which the Treasury was not authorized to acquire after January 31, 2009 pursuant to HERA; and (ii) the Third Amendment does not “conserve” the assets and business of the two GSEs, which violates the FHFA’s duties as conservator of the two companies. Some cases seek monetary compensation, alleging that the Third Amendment impaired the preferred and common stock of the two companies. Others seek monetary damages for a Fifth Amendment taking without just compensation. Finally, some seek damages for various breaches of contract and fiduciary duties.

v. United States, No. 13-496; (S.D. Fla. July 19, 2013); *Dennis v. United States*, No. 13-542; *Fisher v. United States*, No. 13-608 (S.D. Fla. Aug. 26, 2013); *Shipmon v. Fed. Nat’l Mortg. Ass’n*, No. 13-672 (S.D. Fla. Sept. 12, 2013); *Arrowood Indemnity Co. v. United States*, No. 13-698 (S.D. Fla. Sept. 18, 2013), *available at* <http://www.restorefanniemae.us/calendar>.

73. *Samuels v. Fed. Hous. Fin. Agency*, No. 1:13-cv-22399 (S. D. Fla. July 9, 2013).

Suing the federal government is typically harder than suing private parties. The government has sovereign immunity unless it is waived. And HERA itself gave the FHFA particular defenses, similar to those of the FDIC under FIRREA.⁷⁴ The APA claims, which are available for challenging “agency action,” are not available if a particular statute such as HERA precludes judicial review. As noted above, HERA states that the FHFA shall, “as a conservator or receiver, . . . succeed to . . . all rights, titles, powers and privileges of . . . any stockholder” of Fannie and Freddie.⁷⁵ Again, as previously noted, HERA states that except “at the request of [FHFA], no court may take any action to restrain or affect the exercise of powers or functions of [FHFA] as conservator or receiver.”⁷⁶ It is unclear how this language might apply to the Third Amendment, but it certainly may be read to give the government broad authority to address the financial situation of the two companies.

The allegations in the complaints should be read against this backdrop. More specifically, the main allegations in the complaints against the defendants include the following:

Treasury. The Treasury’s conduct exceeded its temporary statutory authority “to purchase securities issued by Fannie Mae and Freddie Mac.”⁷⁷ The Treasury acted arbitrarily and capriciously by failing to take required considerations into account.⁷⁸

FHFA. The FHFA acted arbitrarily and capriciously⁷⁹ in failing to act consistently with “its statutory duties as conserva-

74. Compare 12 U.S.C. § 4617(f). (“no court may take any action to restrain or affect the exercise of powers or functions of the [FHFA] as a conservator”) with 12 U.S.C. § 1821(j) (“no court may take any action, except at the request of the Board of Directors by regulation or order, to restrain or affect the exercise of powers or functions of the [FDIC] as a conservator or a receiver.”).

75. 12 U.S.C. § 4617(b)(2)(A)(i) (2012).

76. 12 U.S.C. § 4617(f) (2012).

77. Complaint and Prayer for Declaratory and Injunctive Relief, *Perry Capital LLC v. Lew*, No. 1:13-cv-01025, at *8 (D.D.C. July 7, 2013) (Bloomberg) (citing 12 U.S.C. §§ 1455(l)(4), 1719(g)(4)); see also *Fairholme Funds, Inc. v. FHFA*, No. 13-cv-1053 (D.D.C. July 10, 2013).

78. *Perry Capital*, No. 1:13-cv-01025, at *8 (D.D.C. July 7, 2013) (citing 12 USC §§ 1455, 1719(g)(1)(B)); *Fairholme Funds, Inc.*, No. 13-cv-1053 (D.D.C. July 10, 2013).

79. *Perry Capital*, No. 1:13-cv-01025, at *8 (D.D.C. July 7, 2013); *Fairholme Funds*, No. 13-cv-1053 (D.D.C. July 10, 2013).

tor”⁸⁰ when it agreed to the Third Amendment, which prohibits the Companies from building capital. The FHFA’s conduct exceeded its statutory authority.⁸¹ The particular allegations are that the APA limits FHFA’s authority; the FHFA’s action as conservator are limited by statute;⁸² and the FHFA, as conservator, “lacked the authority to initiate a wind down”⁸³ of the two companies. A further allegation is that even if the FHFA was acting as receiver, it failed to follow specific applicable procedures that would apply in that context.⁸⁴

The FHFA is liable for breach of contract.⁸⁵ That is, preferred shareholders had contractual rights to specified, non-cumulative dividends and liquidation preference and, as conservator, the FHFA breached its obligation by nullifying these contractual rights.

The FHFA breached the implied covenant of good faith and fair dealing.⁸⁶

80. *Perry Capital*, No. 1:13-cv-01025, at *8 (D.D.C. July 7, 2013); *Fairholme Funds*, No. 13-cv-1053, at *31 (D.D.C. July 10, 2013).

81. *Perry Capital*, No. 1:13-cv-01025, at *8 (D.D.C. July 7, 2013); *Fairholme Funds*, No. 13-cv-1053 (D.D.C. July 10, 2013).

82. Powers as conservator include returning the entity into “sound and solvent condition” and to “preserve and conserve the assets and property” of the entity. 12 U.S.C. § 4617 (b)(2)(D) (2012).

83. *Perry Capital*, No. 1:13-cv-1025, at *9.

84. The relevant section reads:

Authority of receiver to determine claims.

(A) In general. The Agency may, as receiver, determine claims in accordance with the requirements of this subsection and any regulations prescribed under paragraph (4).

(B) Notice requirements. The receiver, in any case involving the liquidation or winding up of the affairs of a closed regulated entity, shall—

(i) promptly publish a notice to the creditors of the regulated entity to present their claims, together with proof, to the receiver by a date specified in the notice which shall be not less than 90 days after the date of publication of such notice; and

(ii) republish such notice approximately 1 month and 2 months, respectively, after the date of publication under clause (i).

12 USCS § 4617(b)(3) (2012).

85. *Fairholme Funds*, No. 1:13-cv-01053, at *3, 8; *Dennis v. Fed. Hous. Fin. Agency*, No. 1:13-cv-01208, at *32-33 (D.D.C. Aug. 5, 2013) (Bloomberg); *Cacciapelle v. Fed. Nat’l Mortg. Ass’n*, No. 1:13-cv-01149, at *1-7 (D.D.C. Jul. 29, 2013) (Bloomberg).

86. *Id.*

The FHFA breached its fiduciary duty as conservator.⁸⁷ That is, because the FHFA assumed a fiduciary duty and a duty of loyalty to shareholders, entering into the Net Worth Sweep is a manifest conflict of interest, one that constituted self-dealing, was intrinsically unfair, was a gross abuse of discretion, and did not further any valid business purpose or reasonable business objective of Fannie and Freddie.

Finally, the FHFA failed to finance the Housing Trust Fund.⁸⁸ Pursuant to HERA, the FHFA Director could temporarily suspend payments to the Housing Trust Fund under certain circumstances.⁸⁹ FHFA suspended payments in fall 2008 and refused to review their suspension.⁹⁰ In 2012, the Companies returned to profitability, amounting to more than \$17 billion between the two.⁹¹ Additionally, the Third Amendment had no impact on the amount due to the fund “since the mandatory payments to the HTF would be made prior to the calculation of the dividend paid to the U.S. Treasury.”⁹²

87. *Fairholme Funds*, No. 1:13-cv-01053, at *3, 8; *Dennis*, No. 1:13-cv-01208, at *32-33.

88. Complaint for Declaratory and Injunctive Relief at 15, *Samuels v. Fed. Hous. Fin. Agency*, No. 1:13-cv-22399-MGC (S.D. Fla. July, 9, 2013) (Bloomberg).

89. In relevant provision reads:

(b) Suspension of Contributions.—The Director shall temporarily suspend allocations under subsection (a) by an enterprise upon a finding by the Director that such allocations—

(1) are contributing, or would contribute, to the financial instability of the enterprise;

(2) are causing, or would cause, the enterprise to be classified as undercapitalized; or

(3) are preventing, or would prevent, the enterprise from successfully completing a capital restoration plan under section 1369C.

Housing and Economic Recovery Act of 2008, *supra* note 13 at § 1337.

90. Complaint for Declaratory and Injunctive Relief ¶ 54, *Samuels v. Fed. Hous. Fin. Agency*, No. 1:13-cv-22399-MGC (S.D. Fla. July, 9, 2013).

91. *Id.* ¶ 55.

92. *Id.* After several requests, including an appeal on “Defendants’ refusal to respond, FHFA provided two letters dated November 13, 2008 instructing Fannie Mae and Freddie Mac to suspend allocations pursuant to Section 1337 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended.” *Id.* ¶ 59. The letters state that the suspension was “based on findings that (a) the amount of the contribution would further contribute to the financial instability of the Enterprises; and (b) while FHFA has suspended capital classifications, it was anticipated that

The United States. Shareholders are owed just compensation under the Takings Clause of the Fifth Amendment of the United States Constitution⁹³ for the taking of the value of their stock.⁹⁴

V.

PRELIMINARY THOUGHTS ON THE LITIGATION

Given that all of the litigation is in such early stages, without any substantive rulings from the courts, I can only make the most preliminary of judgments as to how the cases themselves will be decided. Let me start with a gut check on the equities at issue in the case. As Theodore Olson has argued in the complaint he drafted on behalf of Perry Capital and in a *Wall Street Journal* op-ed, there is more than a whiff of strong-arming by the federal government.⁹⁵ The holders of the Junior Preferred Stock — particularly the holders that predate conservatorship — look like they are receiving a raw deal from the federal government. As noted above, federal law encouraged some banks to hold GSE preferred stock over other investments. Such a regulatory regime seemed to imply that the fed-

the Enterprises would be required to draw funds from the US Treasury to maintain a positive net worth.” *Id.*

93. Class Action Complaint, *Am. European Ins. Co. v. United States*, No. 1:13-cv-00496-MMS (Fed. Cl. July 19, 2013).

Complaint, *Fairholme Funds*, No. 13-465C (Fed. Cl. July 9, 2013).

Complaint, *Wash. Fed.*, No. 1:13-cv-00385 (Fed. Cl. June 10, 2013).

94. “Before being placed into conservatorship, both Fannie and Freddie had issued several series of Preferred Stock. Holders of Preferred Stock are contractually entitled to non-cumulative dividends when declared by the Companies and are so contractually entitled to a liquidation preference should the Companies liquidate.” Complaint ¶ 33, *Fairholme Funds*, No. 13-465C.

“In sum, ‘every dollar of earnings each firm generates’ is now being expropriated by the government on a quarterly basis. This guarantees that there can NEVER be a distribution to the holders of Preferred Stock no matter how much income the Companies earn and no matter how much their assets are worth in any liquidation. That is, the preferred shareholders’ stake in the Companies has been taken, in quarterly installments, since the moment the Net Worth Sweep took effect, and this taking of the preferred shareholders’ property will continue until the last dime has been extracted from the Companies if and when they are wound up.” *Id.* ¶ 70.

95. See Theodore B. Olson, *Treasury’s Fannie Mae Heist*, WALL ST. J. (July 23, 2013, 7:22 PM), <http://online.wsj.com/news/articles/SB10001424127887323309404578617451897504308>.

eral government was guaranteeing performance of the GSEs to some extent. This gut check does not have the same impact, of course, for investors who purchased preferred stock after 2008, when the government's message was much less sanguine. Some of the complaints go a step further and state that the companies were not "likely to incur losses that would deplete all or substantially all of" their capital.⁹⁶ Having lived through this history myself and having read the "first draft" of history carefully in the pages of the *New York Times*, the *Wall Street Journal* and many trade periodicals, I am somewhat taken aback by this revisionist history.

For those of us who believe that the federal government saved Fannie and Freddie, two heavily regulated companies, from certain financial ruin in 2008, there is a different narrative. Indeed, one might label the plaintiffs' narratives as variants of the "have your cake and eat it too" storyline: not only should you have rescued us, but now you should give us back a big chunk of the stabilized companies at a fire sale price. One can well imagine how the government will describe the same events in its inevitable motions to dismiss:

Fannie and Freddie were at the brink of ruin. We swept in, provided unlimited capital and rescued the companies, the housing market, the country and the world from the Second Great Depression. To have the plaintiffs engage in Monday morning quarterbacking and focus on the details from the crisis response that harmed them, to have them ignore the competing concerns that were at stake for each of these critical decisions, adds insult to these injurious lawsuits. Judge, do not succumb to this hindsight bias!⁹⁷

These competing narratives raise a bigger, more interesting question than just the fate of Fannie and Freddie: What role should these types of lawsuits play after a major crisis has

96. See e.g., Complaint ¶ 125, *Wash. Fed.*, No. 1:13-cv-00385.

97. Since the writing of this article, the government's briefs have, unsurprisingly, echoed the tenor of this speculative text. See, e.g., Treasury Defendants' Reply in Support of Their Dispositive Motions and Opposition to Plaintiffs' Summary Judgment Motions, *In re Fannie Mae/Freddie Mac Senior Preferred Stock Purchase Agreement Class Action Litigs.* No. 1:13-cv-01053, at *1-5 (D.D.C. May 2, 2014).

passed? Some would say that they are an outrage—second-guessing what our leaders did to avert financial ruin. Others might say that this is an efficient way to respond to crises: allow the government to do what it needs to do during the crisis, but use litigation to make an accounting to all of the stakeholders once the situation has stabilized. I do not have a fully thought out view on this, but I am struck by the dangers of each approach. The first allows for various kinds of scapegoating (as Hank Greenberg argues in the AIG bailout litigation) while the second allows for the kind of revisionism that favors the wealthy and powerful (as with these Fifth Amendment takings suits by powerful investors who bought Fannie and Freddie preferred shares on the cheap as a long shot bet on what the two companies will look like going forward).⁹⁸ It is tough to choose between the two.

98. MAURICE R. GREENBERG & LAWRENCE A. CUNNINGHAM, *THE AIG STORY* (2013).