THE GOVERNMENT TAKEOVER OF FANNIE MAE AND FREDDIE MAC: UPENDING CAPITAL MARKETS WITH LAX BUSINESS AND CONSTITUTIONAL STANDARDS

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For the record, I have written earlier on this subject in the following places: Richard A. Epstein, *Grand Theft Treasury*, DEFINING IDEAS, (July 16, 2013), http://www.hoover.org/publications/defining-ideas/article/151966; Richard A. Epstein, *The Bipartisan Attack on Fannie and Freddie: How the Treasury and Congress Are Working Overtime to Strip These Corporate Cupboards Bare*, (July 17, 2013), http://www.pointoflaw.com/archives/2013/07/the-biparti san-attack-on-fannie-and-freddie-how-the-treasury-and-congress-are-working-overtime-to-st.php. Richard A. Epstein, *An Unconstitutional Bonanza: The Government Has Seized Billions of Dollars from Fannie and Freddie's Private Shareholders*, DEFINING IDEAS (Nov. 11, 2013), http://www.hoover.org/publications/ defining-ideas/ article/1614 56; Richard A. Epstein, *When Our Government Commits Fraud: The Executive Branch Has Behaved Duplicitously in Its Dealings with Fannie and Freddie's Private Shareholders*, DEFINING IDEAS (Mar. 3, 2014), http://www. hoover.org/publications/defining-ideas/article/169781.

My work on this project has been supported by several hedge funds that have hired me as a legal consultant, analyst, and commentator on issues pertaining to the litigation and legislation over Fannie and Freddie discussed in this article. Matters in this field are moving so rapidly that further revisions of this paper are likely. I have tried to keep current with events as of July 1, 2014.

I.
INTRODUCTION

There is alive today throughout the land an extensive public debate over the future of The Federal National Mortgage Association, commonly known as Fannie Mae, and its somewhat smaller companion, Federal Home Loan Mortgage Corporation, known as Freddie Mac. The widespread consensus on this issue is that these organizations have outlived their usefulness in their present form—a shadowy kind of government-sponsored-enterprise (GSE), half public and half private, as the worst combination of fish and fowl. For the moment, at least, Congress has passed on several opportunities to enact major pieces of legislation that privatize both organizations in order to limit the role of government in real estate markets. The initial generation of efforts includes two notable efforts. The first is the PATH Act (Protect American Taxpayers and Homeowners) proposed by Republican Congressman Jed Hensarling.[1] The second is the Housing Finance Reform and Taxpayer Protection Act of 2013 proposed by Robert Corker,

1. All relevant documents can be found on the website for the Committee on Financial Services, http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=342330.

Republican Senator from Tennessee.[2] More recently, these early efforts have given way to a new Senate version of a Bipartisan Housing Finance Reform Draft, commonly called Johnson/Crapo, which replaces Fannie Mae and Freddie Mac with a new Federal Mortgage Insurance Corporation. That bill also remains in committee.[3] All of the proposed legislative reforms have to grapple with two recurrent issues. The first is the shape of the mortgage market going forward. The second is resolving the various claims of the private shareholders, both preferred and common, of Fannie and Freddie. These multiple bills wipe out any and all claims of private shareholders to receive any of the revenues received by either Fannie or Freddie in the ordinary course of their respective businesses.

In this paper, I shall assume for reasons that should become obvious that, going forward, major structural reform is imperative to prevent a huge run on the public treasury. But I shall address in detail the second half of the problem, which has now given rise to twenty overlapping but separate lawsuits against the Government, most of which deal with the Government's actions in August 2012.[4] At least one of these suits, brought by Washington Federal,[5] also calls into question the earlier Government actions to stabilize the home mortgage

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2. Housing Finance Reform and Taxpayer Protection Act, s. 1217, 113th Cong. (2013). For a recent description of the Bill and its goals, see Press Release, Sen. Bob Corker, Corker: There Is Finally Momentum To Move Beyond Fannie and Freddie (Aug. 6, 2013), *available at* www.corker.senate.gov/public/index.cfm/news?ID=ca7a260a-87e7-4451-a320-2d2eca6e55a7 (describing the introduction of the Senator's Bill and its goal of "replacing government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac with a privately capitalized system"). This is not Senator Corker's first attempt at such legislation. *See* The Mortgage Market Privatization and Standardization Act of 2011, s. 1834, 112th Cong. (2011) (died in committee), *available at* https://www.govtrack.us/congress/bills/ 112/s1834.

3. *See* Summary of Senate Banking Committee Leaders' Bipartisan Housing Finance Reform Draft, *available at* http://www.banking.senate.gov/public/files/SummaryoftheBipartisanHousingFinanceReformDraft_update.pdf. Tim Johnson (D-SD) is the Senate Banking Committee Chairman. Mike Crapo (R-ID) is its Ranking Member.

4. For a full list of the cases, see Appendix, Fairholme Funds, Inc. v. Fed. Hous. Fin. Agency, No. 1:13-cv-00465 (D.C. filed July 10, 2013); Cacciapelle v. United States, No. 13-466c (Fed. Cl. filed July 10, 2013); Perry Capital LLC v. Lew, No. 13-1025 (D.C. filed Jul. 07, 2013).

5. Washington Fed. v. United States, No. 13-385C (Fed. Cl. June 10, 2013).

market between July and September 2008. It challenges the constitutionality of the decision to cast Fannie and Freddie into conservatorship in September 2008, which committed the Government to operating the companies until their affairs were stabilized, so that they could be returned to private ownership.[6] What these suits have in common is that they probe, in overlapping ways, the extent to which the United States shed any alleged obligations owed to the junior preferred and common shareholders of both Fannie and Freddie. At present, the United States has submitted motions to dismiss both Washington Federal and the various suits in both the Federal Court of Claims and in the District Court of the District of Columbia that give clear indication of the range of defenses, both procedural and substantive that it will raise to derail all of these lawsuits.[7] Indeed, these briefs all stress one common theme that not one of plaintiffs is entitled to recover anything in these cases, be it on their individual or derivative claims, in light of the extensive powers that HERA vests in FHFA in its capacity as conservator to the funds.[8]

In light of these extensive claims, it is no surprise that private critics of the Government action frame the fundamental question as whether the Government is bound by the rule of law to follow known and established rules in the pursuit of its objective.[9] For many people, that question has an overly abstract quality that tends to undermine the force of the criticism. But in this case, the gap between the applicable legal principles on the one hand and the Government action on the other reveals the concrete power of rule-of-law principles. In order to develop these principles as they relate to the current private shareholders of Fannie and Freddie, I shall proceed as follows. In Part I, I shall briefly discuss the basic structure and operation of Fannie and Freddie before the financial crisis of

6. *See infra* at Part III.

7. *See* Defendants FHFA, Watt, Fannie Mae, and Freddie Mac's Combined Reply in Support of Their Motion to Dismiss with Alternative Motion for Summary Judgment, and Opposition to Plaintiffs' Cross-Motion for Summary Judgment, In re Fannie Mae/Freddie Mac Senior Preferred Stock Purchase Agreement Class Action Litig., (No. 1:13-cv-01053 (RCL)) (D.D.C. May 2, 2014) [hereinafter "Government Brief"].

8. *See infra* at 15.

9. For discussion, see RICHARD A. EPSTEIN, DESIGN FOR LIBERTY: PRIVATE PROPERTY, PUBLIC ADMINISTRATION AND THE RULE OF LAW (2011).

2008. In Part II, I shall examine the set of financial reforms ushered in with the passage of the Housing and Economic Recovery Act of 2008[10] ("HERA") in July of that year. HERA did two things, which are only imperfectly integrated with each other. First, it authorized the Treasury to offer a temporary assistance program to help Fannie and Freddie though their times of distress.[11] Second, it authorized FHFA to throw both corporations into conservatorship,[12] a power that it exercised at the height of the financial crisis in September 2008. The chief executive officers of both corporations and their boards of directors were stripped of their powers, which were then assumed by the head of FHFA. That government control has continued essentially uninterrupted through June, 2014.

The financial consequences have been dramatic. Since the adoption of the Third Amendment, Fannie and Freddie, whose financial health has been improved by a recovering housing market, will have repaid with interest more than the entire sums borrowed from the United States Treasury in 2008. Thus Fannie and Freddie paid in June 2013 what it denominated as a $60 billion-plus dividend to the Government[13] under the conservatorship agreement. These payments were made pursuant to the Third Amendment to the original 2008 Agreement, which was signed by both Edward Demarco, then Acting Director of FHFA, and then Treasury Secretary Timothy Geithner on August 17, 2012.[14] In 2013 FHFA announced that it will make another combined $39 billion dividend payment to the Government by the end of that year. Indeed by the end of the second quarter of 2014, the dividend payments, plus interest rates owed, have exceeded the total amounts owed on the original SPSPA by $9.6 billion, and for

10. Pub. L. No. 110–289.

11. *Id.* § 1117 (Temporary authority for purchase of obligations of regulated entities by Secretary of Treasury).

12. *See* 12 U.S.C. §§ 4502(9); 4617(a) (2012).

13. *See* CONG. RES. SERV., FANNIE MAE & FREDDIE MAC'S FINANCIAL STATUS: FREQUENTLY ASKED QUESTIONS (Aug. 13, 2013) ("In the second quarter of 2013, Fannie Mae paid slightly less than $60 billion in dividends to Treasury and Freddie Mac paid slightly less than $7 billion in dividends."), *available at* www.fas.org/sgp/crs/misc/R42760.pdf.

14. Third Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement, Aug. 17, 2012, *available at* http://www.treasury.gov/press-center/press-releases/Documents/Freddie.Mac.Amendment.pdf.

Freddie Mac by $13.0 billion.[15] The last draws from Treasury for Fannie were made in the First Quarter of 2012 and for Freddie were made in the Last Quarter of 2011. Some reports of these repayments say that Fannie and Freddie "are close to paying off [the] taxpayer bailout bill,"[16] without fully understanding that under the Third Amendment these payments are treated as dividends whose payment to the Treasury do not reduce the underlying repayment obligation, which under terms of the Third Amendment can never be discharged.

The major question of both corporate and constitutional law is whether the actions taken unilaterally by these key government officials could be attacked on the grounds that they confiscated the wealth of the Fannie and Freddie shareholders and thus required compensation from the Government under the Takings Clause. In addition, the plaintiffs have brought claims both under common law and the Administrative Procedure Act. It is little exaggeration to say that the entire range of private, administrative, and constitutional principles has already been called into question throughout this litigation.

II.
FANNIE MAE AND FREDDIE MAC: THE EARLY STAGES

Fannie Mae was originally established in 1938 as part of Franklin Roosevelt's New Deal effort to revive a moribund real estate mortgage market.[17] By 1968 Fannie had been converted into a publicly traded, privately owned corporation in order to take Fannie off the federal budget.[18] It has retained that ambiguous status as a "government-sponsored enterprise" ("GSE") until the present time. In 1970 Congress authorized Fannie to purchase private mortgages that were not issued by government bodies such as the Federal Housing Authority, the Veterans Administration, or the Farmers Home Administra-

15. See attached tables.

16. *See* Patrice Hill, *Fannie, Freddie Close to Paying Off Taxpayer Bailout Bill: Treasury Reaps Revenue from 2 Mortgage Giants*, WASH. TIMES (Nov. 7, 2013), http://www.washingtontimes.com/news/2013/nov/7/fannie-freddie-close-to-paying-off-taxpayer-bailou/?utm_source=RSS_Feed&utm_medium=RSS.

17. Specifically, Fannie Mae was established through a 1938 amendment to the National Housing Act. FED. HOUS. FIN. AGENCY, HISTORY OF THE GOVERNMENT SPONSORED ENTERPRISES (Oct. 22, 2013), fhfaoig.gov/LearnMore/History.

18. *Id.*

tion (FmHA).[19] In the same year, it created Freddie Mac to compete with Fannie Mae in the secondary market.[20]

As publicly traded corporations, the function of Fannie and Freddie has been to expand the market for home loans by issuing its own mortgages and by allowing the banks that originate these loans to sell them off into the secondary market to GSEs in the form of mortgage-backed securities. Neither Fannie nor Freddie was allowed by law to obtain *explicit* guarantees from the Government after 1968 for repayment of the loan. But it was widely agreed that both organizations enjoyed the benefit of an *implicit* government guarantee that creditors would be bailed out if the underlying mortgages failed.[21] That critical government guarantee reduced the borrowing costs of Fannie and Freddie, saving them hundreds of millions of dollars per year in interest payments with their own commercial lenders, who understood that the firms could turn to the federal government for protection if either faced financial distress. There is little doubt that this implicit guarantee created a government subsidy to both GSEs and their shareholders, highlighting the importance of their dual corporate status. These points were hammered home in October 2013 in a speech by Edward Demarco, then Acting Director of FHFA, "The Five-Year Anniversary of the Conservatorships of Fannie Mae and Freddie Mac: No Time to Celebrate":[22]

> GSE status conveyed important benefits such as the ability to fund operations with much less capital and to borrow at lower interest rates than other private sector companies. Some of this benefit was

19. The Emergency Home Finance Act of 1970, Pub. L. No. 91-351. *See* CONG. RES. SERV., *supra* note 11, at 2 ("In 1970, Congress enacted the Emergency Home Finance Act, which authorized Fannie Mae to buy conventional mortgages. Fannie Mae bought most of the mortgages from mortgage bankers.").

20. FED. HOUS. FIN. AGENCY, *supra* note 17.

21. *See, e.g.*, *Proposals for Improving the Regulation of the Housing Government Sponsored Enterprises: Hearing Before the S. Comm. on Banking, Hous., and Urb. Affairs*, 109th Cong. (2004) (statement of John W. Snow, Secretary, Treasury Department) (discussing the notion of the "so-called implied governmental guarantee" in the GSE context).

22. Edward J. DeMarco, Acting Director, Remarks as Prepared for Delivery, Federal Housing Finance Agency Zillow and the Bipartisan Policy Center: Getting Our House in Order (Oct. 24, 2013), http://www.fhfa.gov/webfiles/25634/Zillow speechFinal102413.pdf.

> passed on to borrowers in terms of lower borrowing rates. Over the years, questions were raised as to how much of the benefit remained with management and shareholders. Also, to the extent a rate subsidy was passed on to borrowers, it surely resulted in higher house prices, thereby transmitting some portion of the subsidy to existing home owners, not home buyers.[23]

That GSE status, however, worked to the disadvantage of both Fannie and Freddie in other ways, which were neither mentioned nor discussed in Mr. Demarco's speech. Starting with the Housing and Community Development Act of 1992,[24] the United States expanded its role in the housing market, announcing that GSEs "have an affirmative obligation to facilitate the financing of affordable housing for low- and moderate-income families in a manner consistent with their overall public purposes, while maintaining a strong financial condition and a reasonable economic return . . . ."[25] The legislation went on to provide that Department of Housing and Urban Development, subject to Congressional approval, would set the appropriate targets for low and moderate income housing to 30% of the total market.[26] This minimum figure was raised to 55% in 2007, just as the housing market topped out. There is no question that these obligations resulted in a weakened financial condition for both Fannie and Freddie, although their precise effect remains unclear today.

Throughout this period, both Fannie and Freddie continued to operate as businesses with common and preferred shareholders, trading on public markets. Each organization was governed by its own CEO that was responsible to its own board of directors. The great challenge at the time was to figure out how these two major commitments—the implicit guarantee and the duty to lend in the subprime market—intersected. The government guarantee was a huge plus for the balance sheets of both companies. Yet the duty to facilitate the financing of low- and moderate-income housing forced both Fannie and Freddie to assume far riskier and more extensive

23. *Id.* at 2.
24. 12 U.S.C. § 4500 (2012).
25. 12 U.S.C. § 4501(7) (2012).
26. 12 U.S.C. § 4562 (2012).

liabilities than ordinary prudence would permit. By virtue of their GSE status, the companies could not exercise any independent business judgment on these two critical operations. They were forced to go into the high-risk end of the mortgage market, but did not receive an explicit compensation for the extra risk that they were forced to assume. Neither its assumption of risk nor its receipt of the implicit government guarantee was in any sense separately priced.

The situation with these two companies looked viable so long as the mortgage market remained strong, which it would only do if housing prices continued to rise. During the early 2000s, a wide range of respected public officials expressed deep concern about the lending practices of both organizations.[27] Although the 1992 and 2007 legislation forced both Fannie and Freddie to furnish "affordable housing" and "maintain[ ] a strong financial condition" in order to earn "a reasonable economic return,"[28] these two obligations were at bottom in sharp tension with each other. The deeper that Fannie and Freddie had to reach into the applicant pool to support affordable housing, the greater the implicit threat posed to the firms' underlying financial soundness by the lending policies. During these years, Daniel Mudd, then President and CEO of Fannie Mae, noted the difficulty that arose when Fannie Mae sought to enforce high standards on the real estate loans that it issued, while serving as a buyer in the secondary market where lenders pushed high-risk loans on the strength of the federal guarantee:

> Unfortunately, Fannie Mae-quality, safe loans in the subprime market did not become the standard, and the lending market moved away from us. Borrowers were offered a range of loans that layered teaser rates, interest-only, negative amortization and payment options and low-documentation requirements on top of floating-rate loans. In early 2005 we began sounding our concerns about this "layered-risk" lending. For example, Tom Lund, the head of our single-

27. *See, e.g.*, Thomas A. Fogarty, *Critics: Fannie, Freddie Grip Mortgage Market*, USA TODAY (May 21, 2002), http://usatoday30.usatoday.com/money/covers/2002-05-21-fannie-mae.htm.

28. Housing and Community Development Act of 1992, Pub. L. No. 102-550, 106 Stat. 3941 (codified at 12 U.S.C. § 4501 (2012)).

> family mortgage business, publicly stated, "One of the things we don't feel good about right now as we look into this marketplace is more homebuyers being put into programs that have more risk. Those products are for more sophisticated buyers. Does it make sense for borrowers to take on risk they may not be aware of? Are we setting them up for failure? As a result, we gave up significant market share to our competitors.[29]

The law of large numbers makes it a virtual impossibility that a lending spree of this proportion can come to a happy ending; outside observers were confident that this housing bubble would burst such that the accumulated weight of the Fannie and Freddie guarantees would put enormous stress on their balance sheets.

It was an open question whether Fannie and Freddie could weather the storm of an adverse financial market. Stated in traditional bankruptcy terms, it was uncertain by 2008 whether or not these two entities were solvent or, more precisely, able to pay off their liabilities as they matured.[30] During the critical months in the late summer of 2008, their stock values gyrated in part because of the turmoil in lending markets, and in part because of evident uncertainty of the strength of the government guarantee. Although the share prices of both corporations tumbled by about 90%, their stock traded at positive values,[31] which reflected the best momentary market estimate of the confluence of the two forces that weighed on both entities—their large portfolio of subprime paper and their implicit government guarantee. Those positive prices are, as becomes critical, hard to interpret. A stock will always trade at a positive price if its assets exceed its liabilities. Yet, a stock will

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29. *The Role of Fannie Mae and Freddie Mac in the Financial Crisis: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. (2008) (statement of Daniel H. Mudd, President and CEO, Fannie Mae).

30. *See* Katie Benner, *The Fannie and Freddie Doomsday Scenario*, CNN MONEY (July 11, 2008), http://money.cnn.com/2008/07/09/news/companies/bennerfanniefreddie.fortune/ (noting that "Fannie and Freddie are among the highly-leveraged companies around" and discussing the concern about insolvency).

31. Colin Barr, *Fannie, Freddie: The Biggest Losers*, CNN MONEY (Sept. 7, 2008), http://money.cnn.com/2008/09/07/news/economy/shareholder_wipeout.fortune/.

also trade at a positive price even if the best snapshot estimate is that its liabilities exceed its assets, so long as the variation in private estimates of its underlying assets was high, as was surely the case on the eve of government intervention. In addition, any stock estimate has to reflect both the likelihood that the Government will honor its implicit guarantee and the declining value of the weak portfolio of loans that it was forced to issue under its Congressional mandates. It is possible to take many different positions as to whether the government could have forced Fannie and Freddie into receivership. The disputes over that issue are the topic of the next section.

III.
THE 2008 REFORMS: HENRY PAULSON STEPS IN

A. *The Political Situation*

In March 2008, Bear Stearns, a respected Wall Street investment bank and securities and brokerage firm, failed despite rescue efforts by the Federal Reserve Bank of New York. Subsequent to its failure, it was sold off at $2 a share to JPMorgan Chase.[32] Bear Stearns's failure triggered awareness that the entire financial market was on rocky times.[33] In response, Congress passed HERA.[34] It was pursuant to the powers created under that Act that both Fannie and Freddie were thrown into conservatorship by the combined actions of Treasury, headed by Secretary Henry M. Paulson, Jr. and Jim Lockhart, the new director of FHFA. Paulson made it clear that, regarding the deterioration of Fannie and Freddie, "FHFA, the Federal Reserve and the Treasury have moved to address this difficult issue"[35] and "conservatorship was the only form in which

32. Andrew Ross Sorkin & Landon Thomas, Jr., *JPMorgan Acts to Buy Ailing Bear Stearns at Huge Discount*, N.Y. TIMES (Mar. 16, 2008), *available at* http://www.nytimes.com/2008/03/16/business/16cnd-bear.html?_r=0.

33. *See, e.g.*, John Waggoner & David J. Lynch, *Red Flags in Bear Stearns' Collapse*, USA TODAY (Mar. 19, 2008), http://usatoday30.usatoday.com/money/industries/banking/2008-03-17-bear-stearns-bailout_N.htm (calling the failure of Bear Stearns "[t]he latest sign that the financial system is close to overheating. . .").

34. Pub. L. 110-289, 122 Stat. 2654.

35. Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers, U.S. DEP'T OF TREASURY (Sept. 7, 2008), http://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx.

[Paulson] would commit taxpayer money to the GSEs."[36] Paulson also announced new management for both organizations, replacing departing CEOs Daniel Mudd and Dick Syron, whose roles were gradually reduced.[37] Regarding their departure, the complaint in *Washington Federal v. United States*,[38] details the arm-twisting tactics that Treasury used to take over the operations of both companies.

As to the necessity of these interventions, there remains a strong division of opinion. In October 2013, Mr. DeMarco backed up Paulson's position to the hilt by insisting that the decision to "provide support" under HERA to the SPSPAs in September 2008 was urgently needed.

There should be no doubt that this set of events and the billions of dollars in subsequent losses meant that Fannie Mae and Freddie Mac had failed. Holders of Enterprise debt and mortgage-backed securities were questioning the value of their investments, and with over $5 trillion of those securities outstanding, the consequences for the financial system and the economy could have been disastrous. Only the financial support provided by Treasury through the SPSPAs allowed Fannie Mae and Freddie Mac to continue as operating entities. There were no private sector investors willing to invest any amount of equity capital into these companies at that time.[39]

Daniel H. Mudd delivered a very different assessment on this issue in December 2009 when he insisted that both Fannie and Freddie "were still maintaining capital in accord with the relevant regulatory standards," and "did not believe that conservatorship was the best solution in the case of Fannie Mae" given that more modest interventions were available.[40]

It is worth noting that Mudd has been sued civilly by the Securities and Exchange Commission for his actions between December 6, 2006 and August 8, 2008 for "misleading investors into believing that the Company [Fannie] had far less ex-

36. *Id.*

37. *Id.*

38. Complaint ¶¶ 61–75, 1:13-cv-00385-MMS (tracing the progression from which Fannie and Freddie are regarded as "adequately capitalized by government on July 10, 2008, to the crisis situation some weeks later").

39. Demarco, *supra* note 22, at 2.

40. *Statement of Daniel Mudd*, *supra* note 29.

posure to these riskier mortgages that in fact existed."[41] But whatever one makes of these remarks, it should be evident, as the further analysis shows that the choice of the form was not, to say the least, inadvertent.

B. *The Legal Framework*

In his public statement in September 2008, Paulson made no explicit reference to the legal framework that provided his authority to act. But in order to understand the transaction, it is necessary to refer to the two key provisions: the power of Treasury to make advances under Section 1117 and the ability to operate the conservatorship under Section 4617.[42]

The apparent authority under Section 1117—"Temporary Authority of Treasury to Purchase Obligations and Securities: Conditions"—is quite constrained because it authorizes the Treasury "to purchase any obligations and other securities issued by the corporation [e.g., Fannie or Freddie] on such terms and conditions as the Secretary may determine and in such amounts as the Secretary may determine."[43] However, the next sentence appears to give Fannie and Freddie the power to block these actions if they want: "Nothing in this subsection requires the corporation to issue obligations or securities to the Secretary without mutual agreement between the Secretary and the corporation."[44] Thus, it looks as though this section contains an authorization to enter into a purchase, but no power to compel either Fannie or Freddie to enter into any transaction with the Government.

More concretely, there is nothing in this section that speaks about the ability of Treasury to throw Fannie or Freddie into insolvency or to force them to enter into any kind of conservatorship without their consent. The section does not make any reference to the conservatorship, but only states that "the corporation [Freddie] shall have the requisite power." The

41. U.S. Sec. & Exch. Comm'n v. Mudd, 11 Civ. 9202 (S.D.N.Y. Dec. 16, 2011).

42. Federal National Mortgage Association Charter Act, 12 U.S.C. § 1719(g) (2012) (Fannie Mae); Federal Home Loan Mortgage Corporation Act, 12 U.S.C. § 1455(l) (2012) (Freddie Mac). These two provisions are parallel in all respects so from here on out I shall only refer to those applicable to Fannie Mae.

43. 12 U.S.C. § 1719 (g)(1)(A).

44. *Id.*

power to throw Fannie and Freddie into either a receivership or a conservatorship lies with FHFA, not with Treasury. Indeed, the next two provisions in Section 1117 do not implicate the conservatorship provisions either. Instead, 304(g)(1)(B)–(C) provides that the Secretary must make a determination that an "emergency" exists that requires the use of that power, after which it explains the conditions in question that are needed to "protect the taxpayers." The list of those conditions deals with key issues of preferences, priorities, amounts,[45] and maturities[46] of the obligations or securities to be purchased, coupled with the creation of a plan that will allow for "the orderly resumption of private market funding or capital market access,"[47] taking into account the "probability" that Fannie and Freddie can discharge their repayment obligations.[48] Keeping each entity as "a private shareholder-owned company" was also on the list of relevant considerations, as were restrictions on the ability of the corporation to pay "dividends and executive compensation" during the period that these obligations remained in effect. It looks as though Section 1117 takes effect wholly without regard to any shift in control in the power of the board to represent the corporation.

Read in isolation, these provisions do not authorize the Treasury's takeover of the operations of these organizations. The protection of the taxpayers through these various provisions is intended to make sure that when the Treasury agrees to advance additional funds to Fannie and Freddie, it receives back from the two corporations sufficient protections so that on balance its transaction will prove advantageous to the taxpayers. On this view, it is not the duty of Treasury to ensure that the transaction works for the benefit of the shareholders of Fannie and Freddie. That task falls on the independent boards of directors of the two firms, who owe fiduciary duties to their own shareholders. The inevitable ambiguity on the scope of the fiduciary duties of these boards does not really matter in this context, because it is certain that the one group to whom the boards do not owe fiduciary duties is the taxpayers themselves. Within the confines of Section 1117, the Trea-

45. 12 U.S.C. § 1719(g)(C)(i) (2012).
46. 12 U.S.C. § 1719(g)(C)(ii) (2012).
47. 12 U.S.C. § 1719(g)(C)(iii) (2012).
48. 12 U.S.C. § 1719(g)(C)(iv) (2012).

sury Department has a single focus for its duties precisely because it knows that its trading partners—here Fannie and Freddie—are in any arm's length transaction well-represented by individuals who have exclusive regard for their own welfare. The point becomes clear by looking first at the procedural and then the substantive confusions under HERA.

C. *The Procedural Morass*

One striking feature about the current litigation is that the United States Government in its motion to dismiss does not recognize any limitations at all on the scope and power of FHFA to deal with these claims in any fashion that it sees fit. Instead the basic claim of the Government is that under 12 U.S.C. § 4617(b)(2)(A), FHFA shall "as conservator or receiver, and by operation of law, immediately succeed to—(i) all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity with respect to the regulated entity and the assets of the regulated entity." According to the Government, this provision silences the shareholders because *all* their rights and powers have been transferred to FHFA. In making this claim, the Government relies on announcements to that effect in a 2012 District of Columbia Circuit Court decision, *Kellmer v. Raines*,[49] which held that only FHFA was in a position to sue Franklin Raines, the former head of Fannie Mae, and former officers and directors of Fannie and Freddie for the breach of their duties to the corporation. That court brushed aside shareholder claims that they could maintain their own suits.

The Court wrote: "Shareholders make many arguments, delving deep into pre-HERA common law and expounding HERA's legislative history. But to resolve this issue, we need only heed Professor Frankfurter's timeless advice: "'(1) Read the statute; (2) read the statute; (3) read the statute!'"[50] At that point, the word "all" was given its full weight so that the individual shareholders lost control of their suit against the former directors. In *Washington Federal*, the Government insists therefore that under *Kellmer* individual shareholders cannot sue the FHFA and Treasury either as owners of shares or "de-

49. 674 F.3d 848 (D.C. Cir. 2012).
50. *Id.* at 850 (citing Henry J. Friendly, *Mr. Justice Frankfurter and the Reading of Statutes*, *in* BENCHMARKS 196, 202 (1967)).

rivatively" (not in their own right but on behalf of the corporation). Thus the Government concludes that persons who claim that billions of their dollars have made it into the Treasury lack "standing" to challenge the FHFA and the Treasury in court.

Two responses are appropriate. First, it is important to understand what is at stake in the Frankfurter remark. Surely it is critical in any and all cases to read a statute so that its terms are not misunderstood or misused. In dealing with this issue, it may well be appropriate to ignore or downgrade the role of legislative history in dealing with the statute, a point on which Justice Antonin Scalia has been especially adamant over the years. But it is a great mistake to assume that either textual fidelity or legislative history should determine the structure of statutory interpretation. The art of textual interpretation, whether with contracts, statutes, or constitutions, is not just a matter of reading accurately the written words. It is also the art of taking those words and placing them in context.[51]

To give a contract example of a tactic of implication that has genuine relevance here, consider the decision of Judge Benjamin Cardozo in *Wood v. Lady Duff Gordon*,[52] where the written agreement gave Otis Wood the exclusive right to sell various products that Lady Duff Gordon designed without imposing any explicit obligation on him about how he was supposed to behave. When Lady Duff Gordon sold items on her own, Wood sued for breach of the exclusive obligation, and was met with the objection that the suit could not be brought because Gordon's promise lacked the mutuality needed to make the arrangement enforceable. Judge Cardozo rejected that argument by noting that the situation was "instinct with obligation," such that Wood had an obligation to act in good faith to sell her wares, for otherwise the business deal would not make economic sense: "We are not to suppose that one party was to be placed at the mercy of the other." As stated in the first contract case to discuss implied terms, without an implied promise, the transaction cannot have such business "effi-

51. I discuss these norms extensively in RICHARD A. EPSTEIN, THE CLASSICAL LIBERAL CONSTITUTION: THE UNCERTAIN QUEST FOR LIMITED GOVERNMENT 44-71 (2014).

52. 118 N.E. 214 (N.Y. 1917).

cacy as both parties must have intended that at all events it should have."[53]

It is important to note that this implication of the good faith obligation is not done by interpreting the words of the contract or indeed by taking any parol evidence on the point. It comes from Cardozo's strong and sound economic intuition that the transaction does not make sense from the ex ante perspective without tacit reliance on these background norms of ordinary transactions. Just that same logic applies to the conservatorship statute that cannot be read as though it contains no implied and necessary exception for those cases in which shareholders claim that FHFA has acted in violation of the duty of loyalty to *them*. It cannot be that FHFA has the exclusive right to sue itself. At this point, the issue starts to assume constitutional proportions in light of the general legal maxim that no person shall be a judge in his own cause, which is just what the Government does when it claims to have total control of all lawsuits involving Fannie and Freddie, even when its own conduct is in the crosshairs. The correct judicial approach is to read the statute as a whole, so as to make sense of all its moving parts, not just some. An instruction to read the statute, and only the statute, is bad, bad advice, if it is meant to foreclose this common practice.

Second, read as the Government would read it, the statute is flatly unconstitutional because it denies individuals and their property the protections afforded against the United States by the Fifth Amendment to the Constitution, which says "[n]o person shall . . . be deprived of life, liberty, or property, without due process of law."[54] At a minimum, in major matters of this sort, this requirement should give them the right to a hearing before a neutral and impartial judge. The canon of constitutional avoidance holds that all statutes should be construed to avoid any serious clash with the Constitution "unless less such construction is plainly contrary to the intent of Congress."[55] The Government's interpretation of the Statute flouts

53. *The Moorcock*, 14 P.D. 64, 68 (1889) (Bowen, L.J.).

54. U.S. CONST. amend. V.

55. Edward J. DeBartolo Corp. v. Fla. Gulf Coast Bldg. & Constr. Trades Council, 485 U.S. 568, 575 (1988); Zadvydas v. Davis, 533 U.S. 678, 689 (2001) (quoting Crowell v. Benson, 285 U.S. 22 (1932)); *see generally* Trevor W. Morrison, *Constitutional Avoidance in the Executive Branch*, 106 COLUM. L. REV. 1189 (2006).

that rule, and, if adopted, should lead to its invalidation to the extent that it bars shareholders from the courtroom door.

Yet that defect in pleading is easily remedied. The explicit purchase agreement took stock from the corporations in exchange for the infusion of cash. The taking comes from the fact that the value given to Fannie and Freddie was less than the value taken. Phrased in this way, there are 100 billion reasons why money that belonged to the two corporations ended up in the pockets of the United States after the last two major sweeps.

My fear is that the current attitude of judicial deference will give these statutory and constitutional arguments less weight than they deserve. But even if FHFA represents "the corporation" in its role as conservator, it cannot possibly arrogate unto itself unlimited discretion to do whatever it pleases with the assets of Fannie and Freddie. Quite the opposite: that conservatorship title imposes on FHFA obligations, common to all conservators, to enter into transactions for the benefit of its shareholders. Indeed, if one could put aside the tumultuous events of early September 2008, the correct institutional response would have been for the board of Directors of both corporations to challenge the takeover on the ground that the conditions statutorily needed to appoint the conservator were not met.[56] But it was quite clear that the Treasury put enormous pressure on both boards to resign so that FHFA could take over its operations. Both boards were summoned for meetings with key Treasury officials just two days before the public announcement, and told to resign their positions or the Treasury would force them out.[57] Members of both boards resigned rather than face public humiliation, or worse. The point was critical because once the removal of the two boards took place, the FHFA action had stripped the shareholders of both corporations of all their defensive powers, which could not have been done under Section 1117 alone.

56. *See* 12 U.S.C. § 1719 (g) (2012).

57. *See* Complaint, *Washington Federal*, ¶¶ 68-73; *see generally* HENRY PAULSON, ON THE BRINK: INSIDE THE RACE TO STOP THE COLLAPSE OF THE GLOBAL FINANCIAL System (2010) (discussing the economic calamities of the economic collapse from the Treasury Secretary's perspective).

D. *Basic Substantive Principles Under FHFA*

Once the procedural issues are removed, it becomes important to expose the many errors in the government position on the substantive issues in this case. Accordingly subsection one examines the text of Section 4617, which the government claims authorizes the implementation of the Third Amendment. Subsection two explores the substantive differences when the government acts either as a conservator or receiver. Subsection three addresses the circumstances in which a fiduciary gains the benefit of the business judgment rule and when it must meet the standards of fairness. Given the manifest conflict of interest in this case, it is the higher standard that applies to the Third Amendment in Part IV.

1. *Section 4617: Authority over Critically Undercapitalized Regulated Entities*

The removal, therefore, of the boards of directors of both Fannie and Freddie was orchestrated by Treasury. But it is critical to note that that removal did not take place, but under Section 4617, which only deals with FHFA authority over critically undercapitalized regulated entities. This gives the Director of FHFA, itself created by HERA, the power to appoint itself as either a "conservator or receiver" when the "regulated entity" is in various forms of financial distress. Although the two terms are bracketed in the statute, it is very clear that they have quite different powers from each other:

> The Agency may, as conservator, 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.[58]

"A conservator's goal is to continue the operations of a regulated entity, rehabilitate it and return it to a safe, sound and solvent condition."[59] In contrast, "[t]he Agency, as re-

58. 12 U.S.C. § 4617(2)(D) (2012).

59. Conservatorship and Receivership, 76 Fed. Reg. 35,724, 35,730 (June 20, 2011).

ceiver, shall place the regulated entity in liquidation . . . ."[60] Choosing that second path therefore spells the end of Fannie and Freddie, which is the antithesis of a conservatorship: the "shall" is a command and not an option.

2. *Conservatorship Versus Receivership*

One important issue in this dispute is whether the Treasury must worry about any of the formalities of the choice between conservatorship and receivership if both of these corporations were insolvent so their liquidation was indeed proper. But the question then remains as to whether in 2008 Secretary of Treasury Paulson would have had the power to initiate that change if he thought it appropriate. There is not one word in Section 1117 that authorizes the Treasury to throw these two corporations into bankruptcy, when at most the section gives "temporary authority of Treasury to purchase obligations and securities"[61] under certain specified conditions. Indeed, as noted before, the Treasury, acting alone, could not install a government conservatorship to oversee the various transactions involved in this case for the benefit of the shareholders. That is a function reserved to FHFA. Its explicit statutory authority "is 'not subject to any other Federal agency' in exercising its authorities under HERA, including the authority to place Fannie and Freddie into conservatorship or receivership."[62] Under this scheme, the only way to force the insolvency would be either to go through the standard bankruptcy proceedings, or to appoint a receiver, which has "additional powers," such that "the Agency shall place the regulated entity in liquidation and proceed to realize upon the assets of the regulated entity in such manner as the Agency deems appropriate . . . ."[63]

Yet even if these points are ignored, there was no evidence brought into the record that could have established that either or both of these corporations were insolvent in September 2008, so as to justify wiping out, without any hearing of any sort, their preferred and common shareholders' interests under standard bankruptcy rules. I do not take any position on

60. 12 C.F.R. § 1237.3(b) (2012).
61. 12 U.S.C. § 1719 (g) (2012)
62. 12 U.S.C. § 4617(a)(7).
63. 12 U.S.C. § 4617(b)(2)(E) (2012).

the factual question of whether that case could have been made out if FHFA had sought to do so. Nor do I take a position on whether the directors of the two companies somewhat "consented" to the takeover, but I do note that the Government's characterization of the transition of control was strongly contested by Washington Federal in its complaint.[64] But it is important to note that any determination that the firm was insolvent necessarily required an explicit judgment that the assets of the firm were less than their liabilities, or that Fannie or Freddie could not pay off their obligations as they come due. Those tests are reflected in the language of Section 4617(a), which holds that a "discretionary appointment" of either a receiver or conservator is appropriate, among other reasons, when "(A) assets are insufficient for the obligations," or (F) that "[t]he regulated entity is likely to be unable to pay its obligations or meet the demands of its creditors in the normal course of business."[65] Neither of these two states of affairs is true by Government assertion.[66] Both must be established by an independent judge in some kind of a judicial hearing, which could not have been done instantly. Nor is it likely that the Government would have prevailed, given that the liquidity of the Fannie and Freddie assets makes them easy to convert to cash and thus to value them in any proceedings. Indeed their liquid position far exceeded their short-term debt.[67] In the absence of any finding of insolvency, there is nothing to stop the Government, or any lender, from declaring each and every homeowner in the United States insolvent by making similar claims.

The question of whether that claim could be made out, FHFA had so determined, was far from clear at the time, given the huge volatility associated with the stock values of Fannie and Freddie and their combustible asset pools. Normally, a determination of insolvency is supposed to take a snapshot of the

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64. Complaint, *Washington Federal*, ¶¶ 82-90.

65. There are in fact other statutory grounds, unrelated to insolvency, for throwing Fannie and Freddie into receivership. But it is clear that none of these have been satisfied. *See* Complaint, *Washington Federal*, at ¶¶ 91-133.

66. *See Statement of Daniel Mudd*, *supra* note 26.

67. Complaint, *Washington Federal*, ¶ 120 (Fannie had $347 billion in liquid assets as of June 30, 2008, and about 247 billion in short term liabilities. Freddie had $745.4 billion in liquid assets against $356.4 billion in short-term debt. These numbers were as of June 30, 2008.)

firm. That snapshot typically is done at a slow rate of speed because there is little momentary fluctuation in the value of the asset pool from one minute, or even one day or week from another. But the situation with both Fannie and Freddie was more difficult to estimate because the short term swings in sentiment could have led to very different answers to the question depending on the time of day that the estimate was made. As a matter of business prudence, it makes good sense to defer any judgment on firm solvency until markets have calmed down a bit. What the conservatorship did was to allow for that postponement. Indeed, there does not seem to be anything under HERA that says that the choice of a conservatorship is a once and for all determination. Quite the contrary: if the condition of Fannie and Freddie continued to decline, the Government could announce that the conservatorship had failed in order to transition the proceedings into a receivership with the intention to liquidate the businesses.[68] At that time, of course, it would still have to make out in court the basic substantive claims of insolvency in order to prevail. Proving a supposed insolvency in 2008 would not, moreover, be sufficient to establish insolvency in 2012. It is no coincidence that the very next provision of the statute deals with "judicial review."[69] And, if

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68. Section 4617 (b)(4)(D):

> Receivership terminates conservatorship:
>
> The appointment of the Agency as receiver of a regulated entity under this section shall immediately terminate any conservatorship established for the regulated entity under this chapter.

12 U.S.C. § 4617(b)(4)(D) (2012).

For a discussion of these transitional arrangements, see *Resolution Trust Corp., v. CedarMinn Bldg. Ltd. P'ship*, 956 F.2d 1446, 1451-52 (8th Cir. 1992) ("Nowhere in the language of the statute is it stated or implied that the appointment of RTC as a conservator negates powers RTC would enjoy if it were *later* appointed a receiver of the same institution.") (emphasis added).

69. Section 4617 (b)(5):

> Judicial review:
>
> (A) In general
>
> If the Agency is appointed conservator or receiver under this section, the regulated entity may, within 30 days of such appointment, bring an action in the United States district court for the judicial district in which the home office of such regulated entity is located, or in the United States District Court for the District of Columbia, for an order requiring the Agency to remove itself as conservator or receiver.

12 U.S.C. § 4617(b)(5) (2012).

after adjudication FHFA was right on the fact of insolvency, its decision to throw the firm into receivership could not be challenged. But if the FHFA decided to throw Fannie and Freddie into receivership without a conclusive determination of insolvency, all fiduciary duties carry over to the new setting, such that if the proceeds generated by the transaction exceeded the amount owing to the senior preferred, the junior preferred and the common, in that order, are entitled to the excess proceeds. For a corporation that has not been adjudicated as insolvent, the residual claims of the junior preferred and the common are protected in both receivership and conservatorship. All these issues are, of course, hypothetical, given that FHFA chose, doubtless with Treasury input, the conservatorship model with its explicit goal of nursing Fannie and Freddie back to health so as to facilitate their orderly return to their private owners.

In addition to the legal situation, the FHFA in all likelihood chose the conservatorship route after concluding that throwing Fannie and Freddie into receivership, with its concomitant duty to liquidate, would roil the markets that Treasury wished to calm. Both corporations were very large and the shares were held by an extensive number of domestic and foreign entities that might receive very little, if anything, out of the insolvency proceeding. The exact nature of the political blowback is always hard to predict. But it is likely that FHFA and Treasury would have faced fierce political criticism from home and abroad, while driving both the mortgage and the stock market lower. Holding off on a final liquidation made perfectly good economic and political sense. But that decision comes at a price. In order for it to reverse field later on, Fannie and Freddie have to meet the requirements for insolvency at that later time, not as of the date of the appointment of the initial conservator. In addition, during the period that the conservatorship is in place, the FHFA had strong fiduciary duties, which means that its actions have to be tested by the standards of 12 U.S.C. § 4617(2)(D). There is not the slightest evidence that the requirement that the regulated entity be put "in a sound and solvent condition" in order "to preserve and conserve the assets and property of the regulated entity" differs in any material way from the ordinary standards of fiduciary duties, derived from corporate law.

In its Reply Brief, the various government entities try to muddy the water by referring to *Starr International v. Federal Reserve Board of New York*,[70] which arose under a different statutory scheme under which the Federal Reserve had far greater powers than are open to the government under either the original SPSPA or its Third Amendment. More specifically, *Starr* involved the decision of the FRBNY to enter into a bailout arrangement: "FRBNY offered AIG a rescue arrangement that included a credit facility from FRBNY of $85 billion at an initial interest rate of 14.5%, but required AIG to give the federal government approximately 80% interest in AIG common stock to be held in a trust."[71] In dealing with this transaction, the FRBNY acted pursuant to the provisions of section 13(3) of the Federal Reserve Act, under which FRBNY is in a position to make loans to nonmember organizations, of which AIG was one, in "unusual and exigent circumstances" when these parties are "unable to secure adequate credit accommodations from other banking institutions."[72] The statutory mandate of the Federal Reserve is broad: "In unusual and exigent circumstances and after consultation with the Board of Governors, a Federal Reserve Bank may extend credit to an individual, partnership, or corporation that is not a depository institution if, in the judgment of the Federal Reserve Bank, credit is not available from other sources and failure to obtain such credit would adversely affect the economy."[73] In light of these provisions, the duties of the FRBNY were quite different from those of FHFA as conservator acting pursuant to HERA, which has no such broad mandate. It therefore was a simple and correct matter for the Second Circuit in *Starr* to affirm the District Court in the conclusion that the broad mandate of the FRBNY was inconsistent with any claim that it owed an undivided duty of loyalty with respect to its "unyielding . . . duty to protect the interests of the corporation and to act in the best interests of its shareholders."[74] There is, however, no analogous provision with under HERA, which means that there is

70. 906 F. Supp.2d 202 (S.D.N.Y. 2012), *aff'd* 742 F.3d 37 (2d Cir. 2014) (dealing only with the preemption issue).

71. 742 F.3d at 38.

72. 12 U.S.C. § 343.

73. 12 C.F.R. § 201,4(d).

74. Cede & Co. v. Technicolor, Inc. 634 A.2d 345, 360 (Del. 1993), cited in *Starr*, 743 F.3d at 42.

no conflict of purposes about reading in standard conceptions of state law into the federal standard.

Indeed, this point is made clear by comparing the Fannie and Freddie situation with the District Court's treatment of the fiduciary duty issue raised in *Starr*. In *Starr*, the District Court squarely rejected the notion that the FRBNY owed AIG any fiduciary duty: "It is centrally important that those decisions were made by AIG's board. And, both on September 17 and September 22, 2008, AIG's board consisted solely of directors who had been elected, well before the financial crisis, through the ordinary mechanisms of corporate democracy."[75] It then added: "in September 2008, AIG was in extremis, and its independent board of directors, to save the company, voluntarily accepted the hard terms offered by the one and only rescuer that stood between it and imminent bankruptcy — FRBNY."[76]

The contrast could not be more explicit. Even under the 2008 transaction, the boards of Fannie and Freddie had been displaced by government order, so that it had to comply only the duties conferred on it by HERA. And in 2012, there were no dire immediate circumstances that put the United States in the position of a potential lender of last resort: indeed no default of any kind by either Fannie or Freddie. The very reasons why there was no fiduciary duty in *Starr* are the precise reasons why the Delaware account of fiduciary duty gains such power in this case: it has a strong, perhaps even a perfect correspondence, with the statutory duties under HERA.

In its Reply brief, the Government sought to escape this clear inference by expanding the power of FHFA under HERA as follows:

> HERA gives the Conservator broad powers—including the power to wind up the Enterprises, transfer Enterprise assets, and take other actions deemed appropriate by the Conservator to stabilize the housing markets. Indeed, HERA explicitly sanctions the Conservator to act as "the Agency determines is in the best interests of the [Enterprises] or the Agency." 12 U.S.C. § 4617(b)(2)(J)(ii).[77]

75. 906 F. Supp.2d at 217-218.
76. *Id.* at 218.
77. Government Brief, *supra* note 7, at 14.

This passage is false and misleading in every relevant sense. First, neither the word "stabilize" nor any of its variations appears in HERA, which, far from being a carbon copy of the FRA, bears no resemblance to it. Second, the snippet from 12 U.S.C. § 4617(b)(2)(J)(ii), is taken out of context. Those words appear in a section entitled the "Incidental Powers" of FHFA," which speak about the actions that may be taken to benefit either the Enterprises or the Agency.[78] It is not a defensible form of statutory construction to wrench the last three words out of context in ways that make it appear that the FHFA can do whatever it wants in any way shape or form. The contrary inference is, moreover, conveyed by the words "as conservator or receiver" with which this section begins. That phrase governs this whole provision, whose purpose is to make sure that the Agency in carrying out its delegated powers does not have to short change itself in connection with any fees that it might charge the entity. It is worth adding that the Government brief at no point cites 12 U.S.C. § 4617(2)(D) in connection with the words "in a sound and solvent financial condition while preserving their assets," but attributes them only to the Plaintiff's brief, as if they were only plaintiff's gloss on the basic statute.[79]

The overall analysis in *Starr* is therefore consistent with the view that the preemption issue is a nonstarter in this context so that the real challenge is to determine the scope of the statutory duties under HERA, for which the general law of fiduciary duty provides an indispensable guide. In making this assessment, it overstates the case to insist that the law of fiduciary duties has sufficient clarity to resolve all potential conflicts

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78. The full provision reads as follows:

> (J) Incidental powers
>
> The Agency may, as conservator or receiver—
>
> (i) exercise all powers and authorities specifically granted to conservators or receivers, respectively, under this section, and such incidental powers as shall be necessary to carry out such powers; and
>
> (ii) take any action authorized by this section, which the Agency determines is in the best interests of the regulated entity or the Agency.

12 U.S.C. § 4617(b)(2)(J) (2012).

79. *See supra* note 49.

of interest. But none of those possible refinements has the slightest relevance to the Government's Third Amendment

3. *Business Judgment Versus Entire Fairness*

What then is the role of FHFA as conservator? The question admits only one answer. FHFA has the same fiduciary duties to the shareholders that the original boards had—but with this critical difference: the original board of directors would be protected by the business judgment rule to the extent that it entered into some deal with the Treasury to bolster its financial position. After all, it was only on one side of the transaction. But the same cannot be said of the FHFA, which, as a government agency, has close ties to the Treasury against whom it is supposed to be adverse. There is in its general receivership powers the capacity to enter into ventures to raise new capital for Fannie and Freddie. But it must seek to do so on terms that strengthen the position of the firm, leaving it to the Treasury to worry about the protection of the taxpayers under Section 1117. At this point, the close connection between the Treasury and FHFA creates a manifest self-dealing situation for which the business judgment rule is wholly inappropriate.[80] Instead, the appropriate standard here is the entire fairness standard which requires some independent and impartial investigation to show that the transaction is fair to the shareholders of Fannie and Freddie in the precise sense that they have received in exchange for the interests that they have surrendered—here the new senior preferred stock—a full and fair equivalent in the form of the government contribution to the enterprise.

The transaction in question was never subject to such fairness review, which adds a serious procedural defect to the inability to apply the right substantive standard. The basic test is so ingrained in the fabric of modern corporate law that it needs little documentation or elaboration, but here is one representative formulation of the general position:

> Entire fairness has two aspects: fair dealing and fair price. The Court must consider how the board of directors discharged all of its fiduciary duties with re-

80. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (discussing the inappropriateness of applying the business judgment rule where there is evident self-dealing).

> gard to each aspect of the non-bifurcated components of entire fairness . . . . In determining the transaction's overall fairness, the Court will conduct a unified assessment that involves balancing the process and the price aspects of the disputed transaction.[81]

It turns out that both these procedural and substantive elements must be taken into account.

IV.
THE THIRD AMENDMENT OF 2012

A. *Background on the Third Amendment*

The question then arises of how these principles apply to both the initial 2008 SPSPA and 2012 Third Amendment. I shall start with the latter because the challenges to the government are far stronger. At this point there was no ongoing crisis of any proportions. To the contrary, the portfolio performance of both Fannie and Freddie had much improved with improving market conditions.[82] Indeed as of August 2012 both entities had "deferred tax assets," or carryover losses, from previous transactions that could be carried forward to offset future taxable income. In light of these positive developments, by the time of the Third Amendment Fannie and Freddie had generated sufficient wealth that it became much more likely that they could pay off the both the principal and interest due on the senior preferred when the Third Amendment was put into place. Nor was there any question that FHFA still acted as a conservator for the junior and common shareholders, which meant that it owed them a duty of loyalty under the situation.

Given these conditions, the Third Amendment has to be evaluated under the procedural and substantive standards set out above. Procedurally, neither FHFA nor Treasury performed any systematic examination of the transaction in question. At this point, there has been no discovery on the deliberations inside the government. Yet such has been ordered by Judge Margaret Sweeney in *Fairholme Funds, Inc. v. United*

81. Ryan v. Tad's Enters., Inc., 709 A.2d 682, 690 (Del. Ch. 1996) (internal citations and quotation remarks removed).

82. *See supra* note 10.

States.[83] In addition, there is now available one suggestive tidbit reported by Gretchen Morgenson of *The New York Times*, dated December 20, 2010 from Jeffrey Goldstein, then undersecretary of domestic finance, to then-Secretary of the Treasury Timothy Geithner. It made unequivocal reference to "the administration's commitment to ensure existing common equity holders will not have access to any positive earnings from the G.S.E.'s in the future." The Treasury has tried to backtrack from that position by insisting that the memo was "only about the importance of repaying the taxpayers for the enormous investment that they made in the G.S.E.s if the G.S.E.s ever generated positive returns, which at the time was uncertain to return."[84] But that last-minute rationalization has to be false, given that this objective could be achieved simply by collecting the 10% interest payments on a periodic basis.

The situation in fact looks even worse than this for the government because it was clear at the time of the Third Amendment that neither Fannie nor Freddie were in default, or in imminent danger of default, under the 2008 agreements, so that the Treasury had no unilateral options that it could impose on either Fannie or Freddie. Any renegotiation of the terms of these agreements had to be with mutual consent. At this point, the fiduciary duty of FHFA required it to seek a deal that would, at the very least, leave it as well off as it was under the 2008 SPSPA. That agreement in Paragraph 2(c) allowed, without default, for Fannie and Freddie to defer payments indefinitely so long as they were prepared to pay 12% interest on the larger balances, payments that could also be deferred and added to principle. At this point it is unclear just what benefit

83. The government has also filed for a protective order with respect to documents produced after August 17, 2012, the date of the Third Amendment. *See* Defendant's Motion for Protective Order, Fairholme Funds, Inc. v. United States, Case 1:13-cv-00465-MMS, Dkt. No. 49 (Fed. Cl. May 30, 2014); Plaintiffs' Response to Defendant's Motion for a Protective Order, Case 1:13-cv-00465-MMS, Dkt. No. 58 (Fed. Cl. June 10, 2014). My evaluation see, Richard A. Epstein, *What Is the Government Hiding About Fannie Mae and Freddie Mac*, REAL CLEAR POLITICS (June 19, 2014), *available at* http://www.realclearmarkets.com/articles/2014/06/19/what_is_the_federal_government_hiding_about_fannie_mae_and_freddie_mac_101130.html.

84. *See* Jillian Kay Melchior, *Did the Fannie and Freddie Bailout Involve Securities Fraud?*, THE CORNER, NAT'L REV. (Feb. 17, 2014), *available at*, http://www.nationalreview.com/corner/371319/did-fannie-and-freddie-bailout-involve-securities-fraud-jillian-kay-melchior.

comes to the private shareholders of Fannie and Freddie from the sweep that takes all future cash flows into both companies and pays them out as dividends to Treasury. The only explanation the Government offers runs as follows:

> The Third Amendment preserved and effectively extended the finite amount of Treasury funds that can be drawn by the Enterprises, which was important to ensuring the safety and soundness of the Enterprises. As such, the execution of the Third Amendment was well within the core powers and functions of the Conservator. See FHFA Mot. Dismiss at 21-32.
>
> In their oppositions, Plaintiffs do not—and cannot—dispute that the practice of drawing funds from Treasury to pay dividends to Treasury was problematic because it decreased Treasury's funding commitment.[85]

Yet this passage ignores that the GSEs's option under Paragraph 2(c), mentioned above, to add deferred interest to principal. Nor does the Government explain where the Treasury is obligated under the Third Amendment to make additional advances to either Fannie or Freddie. Indeed, by the time of the Third Amendment, the draws from the Treasury had both stopped. The key question for FHFA is why it waived without any consideration the benefit of all the provisions of the SPSPA that were inserted for their benefit. It is odd in the extreme to insist that wiping out the private shareholders in the entity is the way to protect them, when the Treasury siphons off all the cash. Further on, the Government claimed that the Third Amendment somehow "calmed" the markets,[86] which have been in an uproar ever since. The simple truth here is that the private shareholders of Fannie and Freddie get nothing in exchange for the cash flow that the government unilaterally took for its self. It is no wonder that David Skeel, writing in *The Wall Street Journal*, referred to the Government's "astonishingly duplicitous behavior,[87] by forcing on Fannie and Freddie a new agreement that offers no new consideration

85. Government Brief, *supra* note 7, at 7-8.

86. *Id.* at 8.

87. David Skeel, *Now Uncle Sam Is Ripping Off Fannie and Freddie: Next Month the Companies Finish Paying Back the Bailout Money—But the Feds Want All Shareholder Profits, Forever*, WALL ST. J. (Feb. 27, 2014), *available at* http://on

to Fannie and Freddie, so that "all positive net income each quarter will be swept to the Treasury," without any reduction in the amount of the principal owing with respect to the senior preferred. The transaction was all *quid* without any *pro quo*. It was a blatant violation of the standard principle of contract law that A (FHFA) and B (Treasury) may not enter into any transaction that deprives C (the shareholders of Fannie and Freddie) of their contractual rights. The lawsuits brought to restore these funds to the corporations are, moreover, easy to implement. All that need be done to determine the amount of money owed to the private shareholders of Fannie and Freddie under the basic 2008 Agreement (which is assumed valid for these purposes) is to treat the remainder of the money paid over as a return of capital, which by rough calculations suggests that the full advances had been paid out by June 31, 2014.

B. *The Government Defenses*

The Government has resisted this position in both its motion to dismiss filed against Washington Federal on November 7, 2013,[88] and its subsequent brief filed on the Third Amendment cases. In both briefs, the Government argued that even if the standing issues were resolved against it, the Government had not taken any property from Fannie and Freddie on two grounds. By the first, it insisted that the complaint was defective because it had only alleged that the Government's action had resulted in a diminution in value of the assets of the two companies, so that the action was only derivative and not direct, and thus passed to the Government under HERA.[89] By the second, it argued that the government had not taken anything at all, but had only frustrated the contracts that Fannie and Freddie had with mortgagors, which under the Supreme Court decision in *Omnia Commercial Inc. v. United States*,[90] counts only as a form of consequential damages that are not

line.wsj.com/news/articles/SB10001424052702304610404579404811651661726.

88. Defendant's Motion to Dismiss, Washington Fed. v. United States, No. 13-385C (Fed. Cl. Nov. 7, 2013).

89. *Id.* at 19.

90. 261 U.S. 502 (1923)

caught by the takings clause. Both of these points are incorrect.

1. *The Derivative Action*

In dealing with this issue, the plaintiff's chosen phraseology of "diminishing value" is linguistically unfortunate because it lumps together the government's stripping of assets from the funds with declines in share value attributable to changes in market prices as a result of the fluctuation of supply and demand. But the case could, and should, be repleaded to make it clear that all the loss in value came, as the case may be, either from the Third Amendment, or, to be discussed later, from the decision of the Government to take an (as yet unexercised) option on 79.9% of the common stock, in addition to take for itself (which it was well within its rights to do) a preferred stock position senior to that of the original preferred and common.

The government defends all its actions on the grounds that all the private claims in this instance revert to the government because "all" derivative claims go to the government. That position makes sense when the claims are brought against some third party, because it is manifestly inconvenient to have two rival sets of claimants pursuing the same claim. But as argued in subsection 2(c) above, this point makes no sense where the derivative claims are against the government and not some third party. Nonetheless, the government insists that just this result applies when the losses in question amount to a simple diminution in value.[91] But the key case on which they rely, *Gentile v. Rossette*,[92] actually stands for the exact opposite proposition. Where there is no conflict of interest, only the board can maintain the claims. But that rule is displaced to allow direct shareholder actions where the conflict is apparent.

Gentile was a self-dealing case in which the controlling shareholder arranged to receive from the corporation (SinglePoint) new shares, which necessarily diluted all voting and liquidation rights of the minority shareholders, in exchange for a release of a debt that the controlling shareholder was owed by the corporation. The plaintiffs, public shareholders of the cor-

91. Government Brief, *supra* note 7, at 21.
92. 906 A.2d 912 (Del. 2006).

poration, claimed that the debt released was worth far less than the shares the defendant obtained. The public shareholders claimed that the deliberate dilution of their stock interest made their claim direct, as well as derivative. "Because the shares representing the 'overpayment' embody both economic value and voting power, the end result of this type of transaction is an improper transfer—or expropriation—of economic value and voting power from the public shareholders to the majority or controlling stockholder."[93]

The parallels between *Gentile* and the Third Amendment are exact given the wipeout of the junior preferred and the common, which makes the Third Amendment both a breach of corporate duty and an expropriation of shareholder interests. To be sure, the Government brief quotes one line from *NAF Holdings LLC v. Li and Fung*: "And the Delaware Supreme Court has repeatedly emphasized that a decrease in a shareholder's stock's value can be asserted only as a derivative claim." But that proposition only holds when there is no conflict of interest of the sort, such that arises "any dilution in value of the corporation's stock is merely the unavoidable result (from an accounting standpoint) of the reduction in the value of the entire corporate entity, of which each share of equity represents an equal fraction." Under *Gentile*, that proposition does not apply in dilution cases, of which the Third Amendment is the best exemplar.

2. *The Frustration Claim*

The second case, *Omnia Commercial v. United States*[94] requires some detailed attention on two grounds. First, it is clearly distinguishable from the instant case because *Omnia* only applies to fully executory contracts, and not to the receipt of funds by any party in discharge of any liquidated obligation, whether by way of loan repayment or corporate dividend. Second, *Omnia* only has surface applicability to this case because it is one of the most ill-considered takings cases ever handed down by the Supreme Court, which should be overruled insofar as it uses the fact of divided interests in any particular asset to deny the two (or more) parties to that transaction receipt of its full fair market value.

93. *Id.* at 100.
94. 261 U.S. 502 (1923).

At issue in *Omnia* was the decision by the United States to requisition steel in possession of the Allegheny Steel Company that had entered an executory contract to sell that steel to Omnia. Owing to the run-up in prices during the First World War, the contract price for the steel was lower than its market value at the time of its requisition. It was widely agreed that if the steel had not be under contract for sale at the time it was taken, the Government would have had to pay its fair market value, whether it was then owned either by Allegheny or by Omnia. Indeed, if the government had decided to condemn Omnia's contract rights to receive the steel, it would have been required to pay Omnia the same amount that it could have received from a private buyer of its rights, which is the contract/market differential. The government, however, chose to take the steel directly from Allegheny, without taking any assignment, and it offered Allegheny only the price that it would have received from Omnia had the contract been performed. That left Allegheny in exactly the same place it would have been in if the contract had been performed, so that it has no complaint about the process. But by this strategy, Omnia lost its profit, and sued for that contract/market differential under the Takings Clause.

The Supreme Court rejected that claim for compensation for two related reasons, both of which were incorrect. By the first, it claimed that the performance under the contract was rendered impossible by the government order, such that Allegheny was discharged from its performance, and so too Omnia.[95] The government seeks to avoid this conclusion by insisting that "if one Substitute 'dividends and potential liqui-

95. The two relevant Restatement provisions are from the Restatement (Second) of Contracts:

> § 261 Discharge by Supervening Impracticability
>
> Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.
>
> § 264 Prevention by Governmental Regulation or Order
>
> If the performance of a duty is made impracticable by having to comply with a domestic or foreign governmental regulation or order, that regulation or order is an event the non-occurrence of which was a basic assumption on which the contract was made.

RESTATEMENT (SECOND) OF CONTRACTS §§ 261, 264 (1981).

dation proceeds' for 'steel,' and *Omnia* fits Plaintiffs' allegations like a glove."[96] Technically speaking, that claim is wrong because the Government has not identified the executory contract that is upset by the Third Amendment. In order for the cases to be identical, the government would have had to commandeer the proceeds before they were received by Fannie and Freddie. But to allow that result is to say that the government may take all vested contract rights in future certain payments, simply by ordering the obligor to pay them over direct to the government, which means that the government could lay claim to *every* dividend payment and loan repayment with a single drop of the pen. The simple point is that whatever the rules for *executory* contracts, in which there has been no performance on either side, the seizure of future fixed payments owing to a private party have to be protected by a per se takings rule, lest the entire system be shaken to its roots. But once it is clear that the government has to pay to acquire this income stream, the entire transaction is otiose: what pay money to take money, when the proper procedure is for the government to borrow what it needs in arm's length transactions with unrelated private lenders. The reason why one takes steel is that it has value in use for the government during a war effort that is greater than its value in use in private hands. That proposition is always incorrect with respect to money, which has exactly the same monetary value regardless of who holds it. There is no contract/market differential in the current Fannie and Freddie disputes of the sort found in *Omnia*. The two cases are entirely and completely distinguishable.

The confusions that are evident in the Government's brief make it imperative to show that *Omnia* is not only distinguishable from the current situation, but also wrong. The analysis starts with a more accurate account of the consequences of impossibility in the law of contract. On this point, the hornbook law states that when a contract is fully executory, *both* sides are discharged by the government's intervention. A useful parallel deals with divided interests when the government condemns land that is subject to a lease. The usual solution is that the lease between the two parties terminates, so that the landlord receives the full compensation for the undivided in-

96. Government Brief, *supra* note 7, at 40.

terest in land, which is equal to its fair market value.[97] That exact same principle applies with divided interests under executory contracts. Once the contract is at an end, it follows that that outright ownership of the steel now reverts to Allegheny, which can then command the market price for the goods once they are removed from under the contract. At this point, the question remains whether it should be allowed to keep the profits from the transaction, which by agreement belonged to Omnia. Since the government has no interest whatsoever in the division of the proceeds, it should be for the parties to decide that question by contract, preferably in advance of condemnation. In dealing with an analogous situation with leasehold interests, the contract/market differential of a nonliquid asset is difficult to determine, so that it is common for parties to discharge the lease in full, so that the landlord gets the gain if the property has appreciated, and bears the loss if it has gone down in value. In this instance, the easy calculation of the contract/market differential points to a payment of the value of the contract to Omnia, so that the distribution is exactly what it would have been if the contract had been fully performed. Indeed, note the moral hazard here: if the value of the steel had gone down, the government would have waited until delivery to take it at its then-lower fair market value.

None of these fine points should obscure the central conclusion, which is that the government always pays the fair market value of the property taken under any and all scenarios. Quite simply, there is no reason whatsoever to apply the doctrine of impossibility *selectively* to one side of the sale contract but not the other. It makes no sense to allow the government to circumvent its obligation to pay full market value for the property taken by refusing to demand an assignment of rights from the buyer. Indeed in *Brooks-Scanlon Corp. v. United States*,[98] the Court adopted just this standard when the government did take an assignment of the contract rights for the construction of a ship, at which point the fair market value of the contract right was held to be the proper measure of compensation. It is quite clear that the government's duty of compensation

97. *See, e.g.*, Victor P. Goldberg, Thomas W. Merrill, & Daniel Unumb, *Bargaining in the Shadow of Eminent Domain; Valuing and Apportioning Condemnation Awards*, 34 U.C.L.A. L. REV. 1083 (1987).
98. 265 U.S. 106 (1924).

should not depend on the way in which it decides to take title to either steel or ships.

The second reason Justice Sutherland offered was more functional. He claimed:

> [The Takings Clause of the Fifth Amendment] has always been understood as referring only to a direct appropriation, and not to consequential injuries resulting from the exercise of lawful power. It has never been supposed to have any bearing upon or to inhibit laws that indirectly work harm and loss to individuals. A new tariff, an embargo, a draft, or a war, may inevitably bring upon individuals great losses; may, indeed, render valuable property almost valueless. They may destroy the worth of contracts.''[99]
>
> . . .
>
> The Government took over during the war railroads, steel mills, shipyards, telephone and telegraph lines, the capacity output of factories and other producing activities. If appellant's contention is sound, the Government thereby took and became liable to pay for an appalling number of existing contracts for future service or delivery, the performance of which its action made impossible. This is inadmissible. Frustration and appropriation are essentially different things.[100]

The key mistake in these passages is to misstate the relationship between frustration and appropriation, which in turn depends on the appropriate level of compensation for contract damages. In this connection, the standard measure of contract damages is the contract/market differential, which simply requires the party in breach to pay over to the other side the money that it obtained from a sale to a third party.[101] There are no difficulties of estimating these damages or in finding the funds to pay them. The profit from the sale to the third party becomes the measure of damages.

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99. *Omnia*, 261 U.S. at 510.

100. *Id.* at 513.

101. Globe Refining Co. v. Landa Cotton Oil Co., 190 U.S. 540 (1903); British Columbia & V.I. Spar, Lumber, & Saw-Mill Co. v. Nettleship, L. R. 3 C. P. 499, 500 (1868).

The situation is very different with respect to the true cases of consequential damages that are referred to in the earlier period, where the question is whether or not when the Government takes the steel from either party it is responsible for consequential damages that result down the road from its inability to do business with third parties with whom it is under contract. It is quite common for contracts to exclude liability for those consequential damages for a combination of three reasons. First, any duty to compensate for consequential damages dulls the incentives for the downstream party to take steps in mitigation of the losses in question. Second, the estimation of these damages is always difficult. Third, neither party wants to bear the costs of extensive litigation in setting these damages, so that the usual solution is to give some smaller level of damages in order to forestall these problems.[102] But the claim in *Omnia* was only for the contract/market differential, and that claim could have been granted without any of the embarrassments mentioned in *Omnia* itself. The frustration to which Justice Sutherland refers is sufficient to end the contract between Omnia and Allegheny. It is not sufficient to allow the Government to acquire the steel at below market prices.

The difficulties of Sutherland's position are evident from two cases, one of which he cites and the other not. The case cited is *Monongahela Navigation Co. v. United States*,[103] which stands for the proposition that once the Government decides to take property that "[t]here can be no doubt in view of the combination of those two words [just and compensation], be no doubt that the compensation must be a full and perfect equivalent for the property taken,"[104] which cashes out at the fair market value of the property, divided between buyer and seller in accordance with the terms of their contract. The best precedent on this point is *Pumpelly v. The Green Bay Company*,[105] where the defendant company, acting pursuant to the eminent domain power, permanently flooded land owned by the plaintiff, only to insist that it did not owe the plaintiff any money because he had been allowed to retain title to the land.

102. *See generally*, Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEGAL STUD. 105 (1989).
103. 148 U.S. 312 (1893).
104. *Id.* at 326.
105. 80 U.S. 166 (1872).

That argument brought forth this tart reply from Justice Miller:

> The argument of the defendant is that there is no taking of the land within the meaning of the constitutional provision, and that the damage is a consequential result of such use of a navigable stream as the government had a right to for the improvement of its navigation.
>
> It would be a very curious and unsatisfactory result, if in construing a provision of constitutional law, always understood to have been adopted for protection and security to the rights of the individual as against the government, and which has received the commendation of jurists, statesmen, and commentators as placing the just principles of the common law on that subject beyond the power of ordinary legislation to change or control them, it shall be held that if the government refrains from the absolute conversion of real property to the uses of the public it can destroy its value entirely, can inflict irreparable and permanent injury to any extent, can, in effect, subject it to total destruction without making any compensation, because, in the narrowest sense of that word, it is not taken for the public use. Such a construction would pervert the constitutional provision into a restriction upon the rights of the citizen, as those rights stood at the common law, instead of the government, and make it an authority for invasion of private right under the pretext of the public good, which had no warrant in the laws or practices of our ancestors.[106]

That is precisely what has happened in this case.The Government has sought to avoid compensation for the market value of the property taking by the simple expedient of not taking an assignment of rights from the party who is in fact entitled to receive the money, but by commandeering the money under the Third Amendment after it has been paid over to Fannie and Freddie by third parties. Just as *Pumpelly* refuses to characterize as "a consequential result" any decision to flood property without taking title, so too the Supreme Court in *Omnia* should have treated the Government's refusal to take an assignment of Omnia's claim as an inexcusable

106. *Id.* at 177-178.

dodge of its constitutional obligation to pay for the fair market value of the steel.

3. *The Irrelevance of FIRREA*

Nor is the situation changed by the extensive body of law that comes out of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).[107] To be sure, the Government brief takes the highly contentious line that all banks know that they cannot challenge government regulations because they have willingly entered into a highly-regulated area. Consequently, they do not have the requisite "investment-backed expectations" that they will be free of government regulation.

Yet, as noted early, the attack on the Third Amendment does not arise in a case where the government has acted pursuant to its general powers to regulate thrift institutions. Those cases are worlds apart from the present for three reasons. First, the source of the shareholders' disaffection here is the *purchase* agreement of the senior preferred stock, and not any form of general government regulation of banks that have otherwise failed. Second, the FIRREA cases do not contain the obvious element of self-dealing which pervades the Third Amendment. And third, the creation of any explicit contractual relationship will always create "investment-backed expectations" under the elusive *Penn Central* test for compensation.[108] The case here does not involve some general government program, such as a landmark designation statute, but rather implicates a particular transaction in which the Government seeks to vary its own agreement unilaterally for its own

107. Pub. L. No. 101–73, 103 Stat. 183.

108. *See Penn Central,* 438 U.S. at 123:

> In engaging in these essentially ad hoc, factual inquiries, the Court's decisions have identified several factors that have particular significance. The economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations are, of course, relevant considerations. So, too, is the character of the governmental action. A "taking" may more readily be found when the interference with property can be characterized as a physical invasion by the government than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good.

advantage. In these cases, the regulation does not seek to adjust burdens among the citizenry at large, but to impose specific burdens on one group.

In connection with Fannie and Freddie, the decisive precedent remains *United States v. Winstar Corp.*,[109] which held that the United States could not by statute renege from a critical contractual promise that it would allow Winstar to include "supervisory goodwill" in its capital accounts in exchange for its willingness to assume various liabilities that could produce claims against the Government. The Court repeatedly noted that Winstar operated in a "regulated industry,"[110] but held that this fact did not allow the Government to disaffirm its contracts with the regulated party, which is what the Third Amendment has done to the common and junior preferred shareholders.

Both the current case and *Winstar* are far cries from such decisions as *Golden Pacific Bancorp v. United States*,[111] where a bank was thrown into insolvency because of irregularities in the way in which it treated certain deposits. That case did stress the *Penn Central* line of cases that banks, as heavily regulated institutions, have no reasonable investment-backed expectations in dealing with standard forms of regulation. But that case too was not cited in *Winstar* for the simple reason that the case dealt with contractual arrangements of the type involved here. In sum, it is not possible for the Government to use a general aura of regulation to justify its one-sided behavior under the Third Amendment.

V.
THE 2008 GOVERNMENT BAILOUT OF FANNIE AND FREDDIE.

The second situation that needs evaluation is much closer, for it involves the initial decision of the Government to bailout Fannie and Freddie in the initial conservatorship agreement of 2008. Without doubt, the Government had the power unilaterally to force the transaction. Its claim that this bold intervention was necessary to stabilize the financial markets, even if disputable on economic grounds, rests on a sound constitutional foundation. No court will second-guess this

109. 518 U.S. 839 (1996).
110. *Id.* at 843.
111. 15 F.3d 1066 (Fed. Cir. 1994).

judgment after *Midkiff v. Hawaiian Housing Authority*[112] and *Kelo v. City of New London*[113] gave a broad reading to the public use limitation in the Takings Clause.[114] But on the compensation issue, the appropriate standard has been that the government must supply a full and perfect equivalent for the interest taken,[115] which can only happen if its market value is equal to or greater than what it was before the government engineered its forced exchange.

The problem then is how to evaluate the question of whether the transaction taken as a whole offered the needed compensation to the shareholders of Fannie and Freddie, who were forced to go along with the transaction against their will. In answering that question, it is quite clear that the situation resembles that in *Starr* in one respect, but differs from it in a second. The overlap between the two situations is that the Treasury does not owe any fiduciary duty to Fannie and Freddie and can drive whatever bargain it wants. But the key difference between the two cases is that in *Starr,* the Government was only on one side of the transaction, while in 2008, the Government stripped the independent directors of Fannie and Freddie of their powers, which it then conferred on FHFA. At this point, the self-dealing element requires an examination of the overall fairness of the transaction. Without question, the Government's action at the time of acute distress has a presumption of fair value that cannot be maintained in connection with the Third Amendment. But that presumption is rebuttable, for much depends on the terms of the deal.

In this setting, the basic sums lent, and the 10% (12% deferred) will be exceedingly hard to attack. The more likely point of vulnerability is the government's demand that it take, in addition to the senior preferred, a 79.9% interest in the common. The Government took the same interest in the AIG transaction, without, however, taking the separate issue of senior preferred. It is therefore important to look at both trans-

112. 467 U.S. 229 (1984).

113. 545 U.S. 469 (2005).

114. 545 U.S. 469 (2005).

115. Monongahela Nav. Co. v. United States, 148 U.S. 312, 326 (1893) ("There can, in view of the combination of those two words, be no doubt that the compensation must be a full and perfect equivalent for the property taken . . . .").

actions in some detail, which I shall do after evaluating the basic standards by which they are evaluated.

A. *Mortgages and the Takings Clause*

The basic constitutional language provides: "Nor shall private property be taken for public use, without just compensation."[116] The initial question in all cases is what kinds of interests count as property that receives this form of constitutional protection. In dealing with that answer, the starting point is that the outright taking of possession of any interest in property counts as a per se taking for which just compensation is required.[117] The difficulties in this area come when the government actions amount to less than a total dispossession of property interests. In principle, none of these differences in the nature of the property interest should matter for the overall analysis of the takings question. The differences in the amount of property taken should reflect itself solely in the amount of compensation owing. The more the government takes, the more the government has to pay.

To step back for a moment, the key feature of all property systems is the ability of owners to divide the whole pie into slices in order to increase its overall value. The key relationship in all such cases is whether the costs of implementing and policing the division is greater than, or less than, the gains from the realignment of property rights. If the former, then the deal will go through. If not, then high transaction costs will frustrate these otherwise beneficial deals. The office of the legal system therefore is to reduce transactions costs in order to increase the velocity and magnitude of positive sum transactions.

At this point, it should be clear that any mortgage liens imposed on property, whether for services rendered or for money lent, should receive the same level of per se protection offered to possessory interests, such as the fee simple, a life estate, a lease, or any future interest by way of remainder or reversion. The key case on this issue is *Armstrong v. United States*,[118] which addressed the question of whether a material-

116. U.S. CONST. amend. V.
117. Loretto v. TelePrompter Manhattan CATV Corp. 458 U.S. 419 (1982).
118. 364 U.S. 40 (1964).

man's lien counts as property. That lien arises in the context of work done on the property of another by a subcontractor who has not been paid by the general contractor for work done. Unless the property owner has received a valid lien waiver, the subcontractor can attach a lien to the subject property to prevent the owner from being unjustly enriched by receiving the value of the work done for nothing. In *Armstrong*, the question was whether the United States could escape the payment of a materialman's lien attached to its boats solely by removing them from the state in order to dissolve the lien. *Armstrong* treated liens as valid property interests. The Government may have had the power to dissolve these liens, but in so doing it could not escape its obligation to pay for services rendered. Instead it only substituted its liability on the lien for its liability as an unsecured debtor. Justice Black thus concluded:

> The Fifth Amendment's guarantee that private property shall not be taken for a public use without just compensation was designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole. A fair interpretation of this constitutional protection entitles these lienholders to just compensation here.[119]

The point here is critical. The construction of naval vessels was for the protection of the United States as a whole. There was no special benefit conferred by that military on the materialmen whose liens were removed by sailing boats out of Maine. Forcing compensation means that they do not have to bear a disproportionate share of public expenses solely by virtue of the Government's default in the case.

Armstrong is generally applicable to all liens. To see why, consider what happens if the mortgage is classified as a second-tier interest bereft of constitutional protection. If the Government should then choose to condemn a piece of property that is worth $100 on which a mortgagee has a lien of $80, the Government need only pay to condemn the equity but could ignore the lien in question. At this point all loans are made in peril of forfeiture upon condemnation. If that threat came to pass, the entire lending market would shut down. Instead, the

119. *Id.* at 49.

uniform answer is that the property is condemned for its fair market value. The government then puts the money into an account that allows first for the repayment of the loan, followed by a return of the remainder of the cash to the holder of the equity interest. Where the property is subject to more than one lien, the loans are discharged in order of their priority such that the borrower gets nothing until the creditors are paid off in full.

The protection that is given to liens is not limited to their outright expropriation. The demotion of the priority of a lien necessarily counts as a *partial* taking in the same fashion as the taking of a future interest or part of a single parcel of land—something that the courts have not grasped in connection with air rights.[120] Thus, suppose that the government decides unilaterally to demote a first mortgage to the second position. It can do so by reversing, through legislation or administrative decree, the priority of private mortgages. Or it can do so by taking for itself a lien prior to that of existing lienholders. In these cases, the shift in priority is a taking of the property in question, because it reduces the probability that the demoted lien will be discharged in the future. The value of the taking by subordination is *presumptively* measured by the reduction in value of the lien.

The question then has to be asked whether just compensation has been supplied to offset the loss in lien priority. In a well-run system, the high priority lien is supplied to the ongoing firm solely as security for its fresh advances to its operation. Thus in bankruptcy it is common that "new" money receives a priority over all old money, which is now at risk because of prior events. Were that not the case, new contributors would never offer funds in the risky attempt to rescue some failing business. If it is the case, then the operative inquiry is whether the cash (or property) infusion into the business has greater value to the existing firm than the lien that is imposed on its

120. *See* Penn Cent. Transp. Co. v. City of New York, 438 U.S. 104 (1978). This case led to infinite mischief because of its refusal to offer systematic protection of air rights under the Constitution when they are fully protected under state law. For discussion, see Richard A. Epstein, *The Takings Clause and Partial Interests in Land: On Sharp Boundaries and Continuous Distributions,* 78 BROOK. L. REV. 789, 590-591, 596, 600 (2013); Richard A. Epstein, *From* Penn Central *to* Lingle*: The Long Backwards Road*, 40 J. MARSHALL L. REV. 593 (2007).

future earnings. Where the transaction is well conceived, that condition should be met. The situation is thus win/win, for the lender gets a risk-adjusted rate of return on its assets, while the borrower gets a larger equity cushion for its position.

By way of simple example, suppose that before the new money is contributed to the firm, its value is $90, and the value of the liens against the property totals $100. At that point there is at least a $10 shortfall in the event of immediate liquidation. If now new money equal to $30 comes into the firm, whose value then moves from $90 to $140, the existing lienholders are in a better position than before because there is now the higher probability of recovering their advances with assets worth $140 and total liens of $130, so that a $10 cushion replaces a $10 shortfall. No separate cash payment to the subordinated lienholder is therefore required whenever the cash contributed increases the value of the now subordinate liens, or for that matter, subordinate equity positions.

B. *The 2008 Transaction*

One tell-tale sign that matters are amiss is that FHFA and the Treasury did not do any form of due diligence before setting the terms of the 2008 bailout. The Government can properly argue that during the tense period of September 2008, the exigencies of the moment justified the rapid and unilateral imposition of the basic agreement. But even if there was a self-evident necessity for the immediate infusion of cash, nothing *after* that initial date prevented FHFA from insisting on a careful review of the terms of the SPSPA in light of the applicable constitutional and fiduciary standards. The procedural reprieve should never be expanded to a total immunity from oversight when FHFA and the Treasury acted as a united front against all the shareholders of Fannie and Freddie.

Any substantive review of the transaction only reinforces the same conclusion. The first point here is that the transaction calls for the elimination of 79.9% of the common stock through the device of an option that allows the Treasury to purchase those shares at the nominal price of $0.00001 per share, which is the implicit value that the Treasury attached to them. It is worth noting that the Third Amendment made it unnecessary for the Government to exercise that option since it takes all the cash anyhow. But if, as should be the case, the

Third Amendment is voided, the proper treatment of this government option needs closer attention.

The initial premise is that the stated price is below any that the common shareholders could hope to realize if the venture were able to recover, and the number of shares subject to the option was not set for the benefit of the common shareholders, but for the exclusive benefit of the Government. If the United States took an option on 80% of the shares or more, it would have to report the Fannie and Freddie debt on its balance sheet, which it was loathe to do. This situation allowed it to acquire the benefits of economic control in the event of an upswing without having to bear any of the short-term consequences of it.

So long as the fiduciary duties are owed to all shareholders, one possible remedy in this case is to invalidate the supposed option. The claim could be made that by taking this step, the Government is left (at least from the ex ante perspective) with an unfair deal that does not meet taxpayer needs under HERA. But in this instance, the clear disregard of both the requirements of Section 1117 and the basic fiduciary duty should exact their toll on the Government's litigating position. A government that does not wish to follow even the most rudimentary of procedures should derive no benefit from its substantive judgments that are unfailingly in favor of itself.

The procedural gaps are of especial concern in Fannie and Freddie (but not AIG) because of the presence of two different classes of shareholder claimants. That dual presence makes it difficult to reconcile fiduciary duties owed to the two separate classes of claimants.[121] This difficulty reflects the commonplace concern that the different risk/reward profiles of common and preferred shareholders make it hard to be fair to both groups at the same time. More concretely, the common shareholders will on average prefer riskier actions than the preferred shareholders. In these distress-like situations, the expected return from a riskier strategy is higher for the common shareholders who hold the residual value. If a safe strategy is followed, the increase in revenue will first cover the junior pre-

121. *See* Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1310-1311 (2008) ("The common stockholder is merely one flavor of investor. Others, such as lenders, bondholders, and preferred stockholders, also stand to gain or lose with right or wrong decisions.").

ferred with little or no added value to the common. A riskier strategy in many cases with increase both the expected value of the common (higher yield, and perhaps higher probability of recovery), even if it is likely to reduce the expected value of the preferred (lower probability of a more stable recovery).

In light of these complexities, a board of directors bound only by a generalized fiduciary duty will have to decide, at a minimum, what weight to give to each class of stock. In part this problem can be controlled by specific covenants that limit the degree of control, but those are in general more likely to be found in bond covenants that contain various equity instruments, which is why many public corporations limit themselves to a single class of stock, whose uniform attributes reduce these shareholder conflicts.

This point then ties in to the interaction between Sections 1117 and 4617 of HERA, given that the former makes no reference to any conservatorship. One distinct possibility is that once FHFA places the entity into conservatorship, the Treasury can no longer seek to do business with FHFA, as conservator, over the terms of any subsequent advance of new money in exchange for senior preferred shares. That position is not implausible because there are good reasons to believe that the entire scheme of Section 1117 presupposes that a corporation has, and is entitled to have, its own independent board that can negotiate with Treasury. That, decidedly, is not the case once FHFA has displaced the boards of directors of Fannie and Freddie in the management of the business, leaving those shareholders without any independent representation. The manifest—and realized—risk of self-dealing between FHFA and Treasury means that it is no longer possible to give either government party the benefit of the business judgment rule that was appropriate when the original boards of both companies were still in place.[122] Instead, the manifest conflict of interest means that the burden of proof in this context is for FHFA, consistent with federal law, to establish the entire fairness of the transaction. The simple way to avoid that conflict is to choose the correct interest rate for the senior preferred, without taking a large share of the common stock, which could have been easily arranged. Under this analysis, the correct

122. For further discussion, see *infra* at subsection E.

remedy is to invalidate the warrant to purchase at nominal price in light of the improper way in which it was obtained.

The shoddy way in which FHFA and the Treasury treated the common shareholders also shapes the perception of the second half of the transaction, the creation of ten senior preferred with the 10% dividend, payable quarterly on any outstanding amount that the Treasury advanced to Fannie and Freddie. That amount in turn rose to 12% in the event of any default in prompt payment. Recall the Treasury paid $1 billion to Fannie and Freddie at the outset of the process in the form of a commitment fee, after which it advanced some $187 billion (out of over $200 billion eventually authorized) to Fannie and Freddie in exchange for an issue of its new senior preferred stock. The question over the 2008 transaction is whether it supplied fair value to the shareholders. It is in principle hard to answer this question, but there is certainly no reason to believe that, so long as the snapshot insolvency issue could be avoided, the shares had zero value. Indeed, one sensible test is to ask whether the value of the shares rose or fell on the consummation of the transaction. In this instance the losses in share value were serious.

The common stock of Fannie Mae and Freddie Mac subsequently traded at less than $1.00 per share — down from over $7.04 per share and $5.10 per share, respectively, immediately prior to the imposition of the conservatorship. Preferred shares of each of the Companies subsequently traded at roughly 2-15% of redemption value immediately following the imposition of the conservatorship.[123]

In both instances, the actual loss from the Government's action could have been greater, for the pre-bailout valuation doubtless reflected, not only inherent share value, but also the possibility that Treasury was going to infuse funds into both Fannie and Freddie on terms favorable to them. It is therefore unclear whether the higher price at which the shares traded prior to the 2008 SPSPA simply reflected an initial pre-bailout collective judgment that the government bailout would have come on terms more favorable than those which were actually given, which necessarily complicates the analysis. The matter will obviously require detailed factual evidence. But in my view, the burden is surely on the private shareholders to show

123. Complaint, *Washington Federal*, ¶ 79.

that they were short-changed by the issuance of the senior preferred, given the difficulty of finding any reason for thinking that there was a want of fair value in a transaction based on the massive uncertainties at that time.

The question then arises as to what remedy should be supplied in the case, assuming that the Government was in breach. If the transaction is thought of as a breach of the entire fairness rule, the correct response seems to be to undo the option to purchase the common at nominal prices and to reduce the Government's yield on the preferred until that (hypothetical) point where the value of the junior preferred and common are equal to what they were before the Government forced the exchange.

At this point the Government gains a number of advantages. First, if there is any surplus generated by its forced transaction, the Government gets to keep all of it for the taxpayers. The valuation in question should be made on the best estimation of the condition of Fannie and Freddie at the time of the infusions, without reflecting the increase in value as the mortgage market started to recover. But at the same time, any doubts on the proper estimation should not be resolved in favor of the Government because of its conscious decision to ignore all statutory procedures, thus creating much of the current difficulty in the first place.

Second, making adjustments to the permissible yield gets rid of the difficulties in trying to undo the transaction long after the money has been infused into Fannie and Freddie. In the end, therefore, the objective is to try to return the position of both corporations to what it would have been if the initial 2008 transaction had met the entire fairness standard that governs both transactions.

Third, in light of the neglect to the interests of the common shareholders in the 2008 transaction, the option that the Government took for itself to acquire 79.9% of the common stock at a nominal price should be voided. Given that the fiduciary duty of FHFA as conservator ran to both classes of stock, the correct methodology is to increase the yield on the senior preferred to the point where it offsets the potential gain that the Treasury at the time thought it could gain through exercising its options to buy the common shares for a nominal price. At that point the Treasury's overall rate of return is held constant, without imposing any actions that act to the special prejudice of the common stockholders to whom it owed a fiduciary duty. There is no difference in the underlying analysis if the same arguments are cast in terms of the need for just compensation in a forced taking of a security interest. At this point, the argument first looks at the value of the senior preferred stock that the Government receives under the 2008 SPSPA. The sum owing for its loss is then offset *in part* by the value of the subordinate stock that it returns to the shareholders, in this instance the junior preferred or the common stock. It is that difference that represents the value of the takings claim.

As a matter of first principle, then, the case to undo the harm is on firm legal grounds. But the underlying reality in cases of this sort is that the Government often receives the benefit of the doubt in any circumstances where it acts in order to forestall major public harm. Put otherwise, the temptation in all these cases is to conjure up the constant refrain that the complexity of these issues is beyond the judicial ken, so that courts should not second-guess actions taken under time of necessity. In my view, that argument is incorrect. The Government may have had to act under conditions of necessity on September 7, 2008, but the financial arrangements between it and the Fannie and Freddie shareholders did not have to be fully resolved at the time of that intervention. These financial adjustments could have been postponed until the basic situation had settled down, at which point a more accurate accounting could have been made, with an appropriate correction of the yield on the new senior preferred to reflect the accurate financial position in the case.

VI.
The Legislative Response

In light of the difficulties in challenging the terms of the initial 2008 bailout, most of the legislative attention has been focused on the Third Amendment. In this regard, it is striking that both parties in Congress take the view that neither the claims of the common nor those of the preferred shareholders have any merit.[124] One common feature to the Hensarling,[125] Corker,[126] and Johnson/Crapo bills is that they all seek to preserve the Third Amendment in toto as part of the system of comprehensive legislative reform, which at this point is stalled for all sorts of other reasons.

By way of example, Sections 103 and 104 of Rep. Hensarling's PATH bill will, according to his legislative summary, provide for "Termination of Conservatorship" such that "[f]ive years following the date of enactment mandates the appointment of the Federal Housing Finance Agency director to act as receiver for each Enterprise (i.e., Fannie Mae and Freddie Mac) and carry out receivership authority."[127] Section 104 then provides for declining maximum amounts that GSEs shall be entitled to own over the five-year transitional period before these entities are liquidated.

Note that this legislative proposal is intended to convert the current arrangements over Fannie and Freddie from conservatorships into receiverships in order to accomplish their orderly liquidation. As noted, the rhetorical misdirection of these bills lies in treating the protection of the "taxpayer interest" in HERA as the touchstone for all future analysis, without noting that FHFA's takeover of the management of Fannie and Freddie leaves the private shareholders of Fannie and Freddie without any independent representation at all. As noted earlier, taxpayer protection cannot be treated as the Holy Grail of political entitlement when FHFA acts in cahoots with Treasury. Instead it is an open admission that FHFA is in breach of its fiduciary duties.

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124. Nick Timiroas, David Benoit & Emily Glazer, *Ackman Makes Big Bet on Fannie, Freddie: Investment Buys 10 Percent Stakes as Wall Street Jousts with Washington over Fate of Mortgage-Finance Giants*, WALL ST. J. (Nov. 15, 2013), http://online.wsj.com/news/articles/SB10001424052702303789604579199692404211088?KEYWORDS=FAnnie ("[T]he Obama administration and top Republicans and Democrats haven't shown any support for a recapitalization or sale of the companies, instead insisting that the firms should be wound down in coming years in a way that minimizes any impact on the availability of mortgages.").

125. *See supra* note 1.

126. *See supra* note 2.

127. *See supra* note 1. For a full breakdown of the PATH Act, see COMM. ON FIN. SERVS., PROTECTING AMERICAN TAXPAYERS AND HOMEOWNERS (PATH) ACT: SECTION-BY-SECTION SUMMARY (last visited Dec. 26, 2013), http://financialservices.house.gov/uploadedfiles/bills-113hr-pih-pathdd-ss.pdf.

This massive disregard for basic principles is painfully evident in the justification that Rep. Hensarling offers for his legislation by its creative reinterpretation of the Third Amendment. His comment on the issue in PATH Act Questions & Answers reads as follows:

Some are arguing that Fannie and Freddie have begun paying a financial benefit to taxpayers. While it's true that both companies had positive net income for the last three quarters of 2012 and have made $65.2 billion in dividend payments, these statistics don't give a complete picture of their financial situation. It is important to note that under the GSEs' contract with the federal government, these dividend payments cannot be used to offset prior Treasury draw, so that regardless of how much is paid out in dividends, the GSEs still owe taxpayers $187 billion in bailout funds borrowed. And since their contracts with the federal government state that all positive net income each quarter will be swept into the Treasury as a dividend payment, in their current state the GSEs will never be able to repay that debt to the taxpayers.[128]

Hensarling's "complete picture" of the financial deal is wrong in all its particulars. Nowhere does Rep. Hensarling note the August 2012 Third Amended Agreement was signed only by two government operatives, then acting director Edward J. DeMarco of FHFA and Timothy Geithner, then Treasury Secretary. "Their contracts" with the federal government are not "their" contracts, but are sham arrangements that the United States has entered into with itself. Neither government agency represented the Fannie and Freddie shareholders whose assets were stripped bare by government actions. Of course, the companies cannot pay back the debt because the government has seized all the assets that would allow that result to happen.

Nonetheless, Johnson/Crapo keeps the old position alive, which it provides in Section 604, Wind Down:

> Wind Down Provisions of the Senior Preferred Stock Purchase Agreement relating to dividend pay-

128. Richard A. Epstein, *The Bipartisan Attack of Fannie and Freddie: How the Treasury and Congress Are Working Overtime to Strip These Corporate Cupboards Bare*, POINTOFLAW.COM (July 17, 2013), http://www.pointoflaw.com/archives/2013/07/the-bipartisan-attack-on-fannie-and-freddie-how-the-treasury-and-congress-are-working-overtime-to-st.php.

> ment dates, periods, rates, and amounts shall not be amended, restated, or otherwise changed to reduce the rate or amount of dividends in effect pursuant to such Agreement as of the Third Amendment to such Agreement dated August 17, 2012, except that any amendment to such Agreement to facilitate the sale of assets of the enterprises to facilitate compliance with the resolution plan requirement.[129]

In effect this provision purports to lock in all of the provisions of the Third Amendment insofar as they relate to the full dividend sweep, allowing for modification so that Amendment may be made only to facilitate the liquidation of both Fannie and Freddie. The legal effect of this provision should be precisely nil because it amounts to an effort by Congress to lock in its own position by unilateral action. In some sense the outcome should not be surprising in this bipartisan bill, given the strong anti-bailout and anti-Wall Street sentiment that dominates the thinking of both parties. The provision therefore is more relevant as a measure of dominant political sentiment, not the underlying legal situation. Whether Johnson/Crapo eventually passes or not, this provision should, and in all likelihood will, be accorded no weight in the ongoing litigation.

VII.
FINAL WORDS: LINKING PAST AND FUTURE

In closing, it is important to place the current dispute over the 2008 and 2012 transactions in a broader context. Right now Congress is making fitful efforts to restore the confidence in the real estate mortgage markets. In testimony before Rep. Hensarling's House Committee on Financial Services on April 24, 2013, Mr. James E. Millstein, CEO of Millstein & Co. spoke on the then-present state of the mortgage market in words that are still applicable over a year later.[130] His testi-

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129. Section-by-Section of Senate Banking Committee Leaders' Bipartisan Housing Finance Reform Draft, *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=b8ab780d-0486-41be-9579-eac40dd09ce8.

130. *Building a Sustainable Housing Finance System—Examining Regulatory Impediments to Private Investment Capital: Hearing Before the H. Comm. on Fin. Servs.*, 112th Cong. (2013) (Statement by James E. Millstein, Chief Executive Officer, Millstein & Co.).

mony starts with the proposition that major government interventions have "effectively nationalized the residential mortgage market," and that this form of "continued government dominance of the mortgage market is unacceptable."[131] Clearly the effort is needed to induce private capital to come back into the market. Yet how can that be done in light of the high-handed way in which traditional financial interests are treated? The situation started with the Chrysler and General Motors bankruptcies, where a set of dubious government maneuvers upset established modes of doing business.[132] But however egregious those transactions were, they are dwarfed by the imbroglio over Fannie and Freddie, both in the size of the transactions and the audacity of the government position.

The same argument applies in this case. It should be painfully clear that the entire path of government action from start to finish paid scant attention to the normal procedural safeguards against intrigue and bias that are part and parcel of the rule of law. It is equally clear that the government moves, in the administrative, judicial, and legislative arenas, will only result in a loss of the precious and intangible assets to which the federal government pays lip service, namely the preservation of public confidence that the securities markets operate under open and transparent conditions. Yet what one sees is the dogged government prosecution of firms like JP Morgan for the conduct of the firms that Treasury asked it to take over. But at the same time, there is scant public attention to the highly questionable conduct of Treasury and FHFA in connection with Fannie and Freddie shareholders. This striking double standard will not escape widespread public attention. What private parties will want to move forward by investing large sums capital if they know that in one form of another they are subject to a confiscation risk by government? In the summer of 2008, no one who was involved in HERA thought that down the road the Treasury could have found ways to evade all the safeguards built into the Act by signing the Third Amendment

131. *Id.*

132. For my views, see Richard A. Epstein, *Political Bankruptcies: How Chrysler and GM Have Changed the Rules of the Game,* 59 THE FREEMAN (Dec. 2009), http://www.thefreemanonline.org/featured/political-bankruptcies-how-chrysler-and-gm-have-changed-the-rules-of-the-game/; *see also, Barry Adler, A Reassessment of Bankruptcy Reorganization After Chrysler and General Motors,* 18 AM. BANKR. INST. L. REV. 205 (2010).

with FHFA. But that is precisely the point. It is the "unknown unknowns," the sudden twists, the audacious moves, that really hurt market confidence in government actions. It may well be that the next transaction will contain thousands of assurances going forward. But so long as the Government's frame of mind is that there are always creative ways to get around legal restrictions, these unknown unknowns yield to this known and indisputable truth. Ultimately, the only unknowns are the size and scope of government misbehavior. If these lawsuits do result in government victory, the capital markets will start to shrink, and the privatization of the real estate lending markets, which everyone wants, will never take place. The old maxim still applies. If you fleece me once, shame on you. If you fleece me twice, shame on me.

POSTSCRIPT

In my article on Fannie and Freddie, I take the case narrative through July 1, 2014. Since that time many discrete events have happened, but the only matter that requires separate comment is the recent memorandum opinion of Judge Royce Lamberth in *Perry Capital v. Lew*,[1] filed on September 30, 2014, which I have sharply attacked in several posts on Forbes.com[2] in my role as consultant advisor for several institutional investors. This postscript was revised for the last time on November 3, 2014.

On this occasion, I will not recap all the points in the paper, but to add some commentary about the novel arguments that Judge Lamberth advanced in *Perry Capital.* I shall not therefore restate the arguments that I raised in this article, to which I believe that opinion in *Perry Capital* does not adequately respond. I include in this group his contention that the text of HERA blocks any and all private law suits,[3] and his further contention that a takings claim is precluded because the private shareholders of Fannie and Freddie do not have any cognizable interest in their shares.[4] Nonetheless there are five separate points that are worthy of some mention. More specifically, *Perry Capital* plays fast and loose with key provisions of the senior preferred shareholder certificate. In addi-

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1. Case 1:13-cv-01025-RCL (D.D.C. September 30, 2014). .
2. Richard A. Epstein, *Will Fannie and Freddie Shareholders Be Able to Set Aside the Third Amendment? Judge Royce Lamberth's Indefensible Decision Is Only One Battle in a Long War*, FORBES (Sept. 30, 2014), http://www.forbes.com/sites/richardepstein/2014/09/30/will-fannie-and-freddie-shareholders-be-able-to-set-aside-the-third-amendment-the-recent-sweeney-decision-will-not-alter-the-basic-dynamics/; Richard A. Epstein, *The* WSJ's *Improbable Defense of Judge Lamberth's Indefensible Decision in* Perry Capital, FORBES (Oct. 2, 2014) http://www.forbes.com/sites/richardepstein/2014/10/02/godzilla-versus-the-thing-the-wall-street-journals-improbable-defense-of-judge-lamberths-indefensible-decision-in-perry-capital/, attacking the *Journal's* editorial *Godzilla Defeats the Thing*, WALL ST. J. (Oct. 2, 2014) http://online.wsj.com/articles/godzilla-defeats-the-thing-1412204855; Richard A. Epstein, *Withdraw and Correct the Error of Thy Ways: The* Perry Capital *Opinion*, FORBES (Oct. 10, 2014), http://www.forbes.com/sites/richardepstein/2014/10/10/withdraw-and-correct-the-error-of-thy-ways-the-perry-capital-opinion/. Richard A. Epstein, *Judge Sweeney Should Let Discovery Continue on Fannie and Freddie*, FORBES (Nov. 1, 2014), http://www.forbes.com/sites/richardepstein/2014/11/01/judge-sweeney-should-let-discovery-continue-on-fannie-and-freddie/.
3. *Perry Capital*, at 47-51; Epstein, *supra* at 393-396.
4. *Perry Capital*, at 43-51; Epstein, *supra* at 417-419.

tion, it misstates the statutory framework of the 2008 Housing and Economic Recovery Act on three key points. First, Judge Lamberth inaccurately characterizes the rights and duties of FHFA as conservator or receiver. Second, it incorrectly describes the scope of Treasury's authority under HERA. Third, it refuses to admit any evidence on the possible collusion between FHFA and Treasury in fashioning the Third Agreement. Finally, the government has argued in its motion before Judge Margaret Sweeney that the takings claims presented to her are not ripe for adjudication.

First, the dividend rate. In order to make out the claim that the Third Amendment was misconstrued, *Perry Capital* gives a novel yet indefensible interpretation to the key dividend provision contained in the senior preferred stock certificates, which reads as follows:

> "'Dividend Rate' means 10.0%; provided, however, that if at any time the [GSE] shall have for any reason *failed to pay dividends in cash in a timely manner as required by this Certificate*, then immediately following such *failure* and for all Dividend Periods thereafter until the Dividend Period following the date on which the Company shall have paid in cash full cumulative dividends (including any unpaid dividends added to the Liquidation Preference pursuant to Section 8), the 'Dividend Rate' shall mean 12.0%."[5]

Perry Capital added the italics in order to characterize the 12 percent deferred dividend option as a "penalty,"[6] a move that makes no sense at all. A penalty makes a party worse off, which happens when it must pay a late fee in cash, in addition to the standard monthly payment in cash. Here the "penalty" is an option that leaves Fannie and Freddie *better off* than before. It is for that reason that the provision ends with the

5. FED. HOUS. FIN. AGENCY, Senior Preferred Stock Purchase Agreement § 2(c), http://www.fhfa.gov/Conservatorship/Documents/Senior-Preferred-Stock-Agree/2008-9-7_SPSPA_FreddieMac_Certificate_508.pdf [hereinafter "*Senior Preferred Agreement*"].

6. *Perry Capital* at 6-7, n.7. Judge Lamberth seeks to make something out of the use of the word "failed" in clause 2(c). But there is nothing in the point. Clause 2(b) states: (b) Top the extent not paid pursuant to Section 2(a) above, dividends on the Senior Preferred Stock shall accrue and shall be added to the Liquidation Preference pursuant to Section 8 . . ." (emphasis added). *Senior Preferred Agreement, supra* note 5, § 2(b).

phrase "the 'Dividend Rate' shall *mean* 12.0%," which makes this a definitional rather than a penal matter. Since Fannie and Freddie are not in default regarding the SPSPA, FHFA acting as a conservator has no reason whatsoever to accept by contract Treasury's offer of a dividend sweep that leaves its beneficiaries with nothing at all. FHFA as their conservator can just stand on the contractual option until Treasury offers a better deal, such as a reduction in the basic dividend rate in exchange for the release of that second option. Instead FHFA released all private shareholder rights to all income at all times, an alternative that made Fannie and Freddie unambiguously worse off in each and every state of the world going forward.

Perry Capital fares no better on the three critical points of statutory interpretation. First, *FHFA's rights and duties*. *Perry Capital* quotes 12 U.S.C. § 4617(a)(2), which provides that "[FHFA] may, at the discretion of the Director, be appointed conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity."[7] The implication is that both conservators and receivers have all the powers listed in this section, at which point there is no reason to distinguish between them. But that argument fails in light of the provisions, nowhere quoted in *Perry Capital,* that set out the separate duties of the FHFA as either conservator *or* receiver:

> 12 U.S.C. § 4617(b)(2)(D). Powers as conservator:
>
> The Agency may, as conservator, 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.

Note that this last provision does not refer to any ability of the conservator to "wind up" the operations. That power is, however, found in 12 U.S.C. 4617(b)(2)(E),[8] which bears the

7. *Perry Capital*, at 46.
8. 12 U.S.C. § 4617(b)(2))(E). Additional powers as receiver:

title "Additional powers as receiver", which includes the ability for the Agency to put "the regulated entity into liquidation." *Perry Capital* then seeks to avoid confronting the issues by writing: "The Court has no occasion to decide whether the conservator is empowered to wind down the GSEs."[9] But the only reason the opinion can take this leap is because of the suggestion in footnote 20 that a "fluid progression" allows FHFA secretly to morph itself from a conservator to a receiver, without going through any formal process to work that change.[10] The need for that formal change is found in yet another provision that is not cited in *Perry Capital.* 12 U.S.C. § 4617 (b)(4)(D) stresses that discontinuity:

> Receivership terminates conservatorship:
>
> The appointment of the Agency as receiver of a regulated entity under this section shall immediately terminate any conservatorship established for the regulated entity under this chapter.

This explicit opposition between conservator and receiver precludes the conclusion that "FHFA can lawfully take steps to maintain operational soundness and solvency, conserving the assets of the GSEs, until it decides that the time is right for liquidation. *See* 12 U.S.C. § 4617(b)(2)(D) ("[p]owers as conservator")."[11] The cited section, quoted in full above, negates that suggestion. The FHFA needs to initiate a formal appointment to make the shift from one role to the other, which it

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> In any case in which the Agency is acting as receiver, the Agency shall place the regulated entity in liquidation and proceed to realize upon the assets of the regulated entity in such manner as the Agency deems appropriate, including through the sale of assets, the transfer of assets to a limited-life regulated entity established under subsection (i), or the exercise of any other rights or privileges granted to the Agency under this paragraph.

Id.

9. *Perry Capital*, at 24.

10. *Id.* at 25, n.20. "There surely can be a fluid progression from conservatorship to receivership without violating HERA, and that progression could very well involve a conservator that acknowledges an ultimate goal of liquidation. FHFA can lawfully take steps to maintain operational soundness and solvency, conserving the assets of the GSEs, until it decides that the time is right for liquidation. See 12 U.S.C. § 4617(b)(2)(D) ("[p]owers as conservator").

11. *Perry Capital*, at 25, n.20.

never attempted when it signed on to the Third Amendment. Ultimately, the explicit transition between these two roles matters.

Second, *Treasury's authority*. Indeed, the stringent limits on FHFA referred to above fit into the parallel limitations that HERA imposes on Treasury. Footnote 3 in *Perry Capital* contains this reading of key provisions in HERA:

> The purpose of HERA's provision authorizing Treasury to invest in the GSEs was, in part, to "prevent disruptions in the availability of mortgage finance"—disruptions presumably due to the challenges confronting the GSEs in 2008. *See* 12 U.S.C. § 1455(*l*)(1)(B); 12 U.S.C. § 1719(g)(1)(B) ("Emergency determination required[.] In connection with any use of this [purchasing] authority, the [Treasury] Secretary must determine that 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.").[12]

The passage is accurate insofar as it goes, but it does not go far enough, because it ignores the sections just before and just after it. Thus *Perry Capital* does not deal with 12 U.S.C. § 1719(g)(1)(A), which makes it clear that any bailout requires the "mutual agreement between the Secretary and the corporation," such that the Secretary cannot unilaterally impose a deal. Similarly, it ignores 12 U.S.C. § 1719(g)(1)(C), which lists among the relevant considerations "[t]he corporation's plan for the orderly resumption of private market funding or capital market access," and "[t]he need to maintain the corporation's status as a private shareholder-owned company." The Third Amendment, which precludes any return to the private market, is flatly inconsistent with these provisions. Nor does *Perry Capital* note that HERA contains not a single reference to a receiver or receivership in its section dealing with Treasury's powers. Any modification of the initial 2008 deal that purports to turn the conservatorship into a receivership is beyond the powers of Treasury. Thus, the same fate should await the de facto liquidation under the Third Amendment.

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12. *Id.* at 5, n.3.

Third, *Treasury oversight of FHFA*. *Perry Capital* quotes Section 4617(a)(7) which notes that "When acting as conservator or receiver, the Agency shall not be subject to the direction or supervision of any other agency of the United States or any State in the exercise of the rights, powers, and privileges of the Agency." That provision appears to preclude FHFA from taking directions from Treasury as the plaintiffs alleged. *Perry Capital* dismisses this section as "irrelevant" because of the defect in the plaintiff's pleadings.

However, "records" showing that Treasury "invented the net-worth sweep concept with no input from FHFA" do not come close to a reasonable inference that "FHFA considered itself bound to do whatever Treasury ordered. . . . The plaintiffs cannot transform subjective, conclusory allegations into objective facts."[13]

Perry Capital recognizes that the firm has the standing to challenge the way in which the Third Amendment was crafted. Indeed the opinion appears to concede indirectly that the Treasury came up with this idea on its own, but nonetheless dismisses the plaintiff's contention as "conclusory allegations." But the opinion offers no explanation as to why this matter has to be decided on the pleading, without allowing for any discovery to establish the nature of the FHFA/Treasury connection. That decision to short-circuit discovery seems wrong. *Perry Capital* contains no reference to the memo of December 20, 2010, written by Jeffrey Goldstein, then Treasury's under secretary for domestic finance, as reported by Gretchen Morgenson of *The New York Times.* That memo contained the bald assertion that "'the administration's commitment to ensure existing common equity holders will not have access to any positive earnings from the G.S.E.'s in the future."[14] Nor has anyone in either FHFA or Treasury proffered any independent work by FHFA preparatory to the Third Amendment that disproves the issue that Treasury exercised oversight capacity of FHFA. Judge Lamberth should have surely allowed for discovery on this key issue, which he refused to do.

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13. *Id.* at 23.

14. Gretchen Morgenson, *The Untouchable Profits of Fannie Mae and Freddie Mac*, N.Y. TIMES (Feb. 15, 2014), http://www.nytimes.com/2014/02/16/business/the-untouchable-profits-of-fannie-mae-and-freddie-mac.html?_r=0.

Finally, The government also takes the position that the entire matter is not ripe for litigation before the Court of Federal Claims (CFC), because FHFA is not yet in liquidation. Hence the private shareholders cannot exercise their liquidation preference so long as Fannie and Freddie remain in conservatorship. This argument is incorrect for a variety of reasons.

First, its basic contention would allow the government to strip out all the money from Fannie and Freddie so long as it chooses never to liquidate them, and thus escape any judicial challenge ever.

Second, all of the facts that are needed to resolve the question of whether FHFA and Treasury exceeded their powers under the law are available right now. Nothing that may be done in the future can either add to or detract from the strength of the takings claim that is now before the CFC. The postponement therefore does nothing whatsoever to sharpen the issue.

Third, there is no likelihood that Treasury will ever release Fannie and Freddie from the Third Amendment, even if FHFA abandoned its conservatorship and put the control of the operation back into the hands of a Board of Directors responsive to the interests of the private shareholders whom FHFA was supposed to represent in the first place.

Fourth, it is incorrect legally to insist that the takings claim only ripens once the liquidation takes place. The breach of fiduciary duty claims brought before Judge Lamberth are distinguishable from the takings claims in the CFC. The former seek to treat any cash paid over and beyond the interest owing as a return of capital. Their precise amount cannot be determined today, but depends on the patterns of redemption under the Third Amendment.

In contrast, the takings claim before Judge Sweeney treats the government's taking as consummated as of the date of the Third Amendment. It then asserts that just compensation is owed for the immediate loss that came from that government action, plus interest for the over four years that compensation has not been paid. Those losses are fixed in stone the day that the taking takes place. In this case, the correct measure of damages would be the fair market value of the shares when traded in a liquid market less a residual value equal to zero under the Third Amendment is allowed. Now that the transaction is closed the government, which has taken all the assets of the private shareholders, gets the benefit of any future rise in prices, just as it suffers the loss in value should the stock go down. Thus the claim is ripe as of the date of the Third Amendment.

I regard these deficiencies as incurable. Judge Lamberth senses the uneasiness of his position when he writes:

> It is understandable for the Third Amendment, which sweeps nearly all GSE profits to Treasury, to raise eyebrows, or even engender a feeling of discomfort. But any sense of unease over the defendants' conduct is not enough to overcome the plain meaning of HERA's text.[15]

Perry Capital, with its multiple mistakes of omission and commission, flunks Judge Lamberth's plain meaning test, and the Court of Appeals should summarily reverse and remand. In the interim, the claims before Judge Margaret Sweeney are ripe and she should continue with her discovery on all disputed questions of fact until the full record is available.

15. *Perry Capital*, at 52.