The Government Takeover of Fannie Mae and Freddie Mac: Upending Capital Markets with Lax Business and Constitutional Standards

By

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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 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. Congress has had a chance to pass two major pieces of legislation that propose fundamental efforts to increase the privatization of both organizations in order to limit the role of government in real estate markets. The first is the PATH Act (Protect American Taxpayers and Homeowners) proposed by Republican Congressman Jed Hensarling.[1] The second is the Housing Finance

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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-bipartisan-attack-on-fannie-and-freddie-how-the-treasury-and-congress-are-working-overtime-to-st.php. 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 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 November 15, 2013. Comments are welcome.

[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.

Reform and Taxpayer Protection Act of 2013 proposed by Robert Corker, Republican Senator from Tennessee.[2] Both pieces of legislation deal with two 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. Both bills treat these equity rights as effectively extinguished.

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 the second half of the problem, which has now given rise to seventeen separate lawsuits against the Government, most of which deal with the Government's actions in August, 2012.[3] One suit[4] also calls into question the earlier Government actions to stabilize the home mortgage market between July and September 2008, challenging the constitutionality of the decision to cast Fannie and Freddie into conservatorship in September 2008, which committed the Government to operating the companies until they became stabilized.[5] 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 a motion to dismiss in the *Washington Federal* case that gives some clear indication as to the tack that it will take in seeking to derail all of these lawsuits regardless of the particular legal theory on which they arise. Indeed, the brief goes so far to say that not a single one of the plaintiffs is entitled to

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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] 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).

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

[5] *See infra* at Part III.

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.[6]

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.[7] To 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 2008. Thereafter I shall examine the set of financial reforms ushered in with the passage of the Housing and Economic Recovery Act of 2008[8] ("HERA") in July of that year. That law 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.[9] Second, it authorized FHFA to throw both corporations into a conservatorship,[10] a power that it exercised at the height of the financial crisis in September of 2008. The chief executive officers of both corporations and their Boards of Directors were stripped of their powers, which were then assumed by FHFA as their successors in office. That government control has continued essentially uninterrupted until the current year when Fannie and Freddie, whose financial health has been improved by a recovering housing market, paid in June 2013 what it denominated as a $60 billion-plus dividend to the

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[6] *See infra* at 15.

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

[8] Pub. L. No. 110–289.

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

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

Government[11] under the conservatorship agreement. That payment was made pursuant to the Third Amendment to the original 2008 Agreement, which was signed by both Edward Demarco, Acting Director of FHFA, and then-Treasury Secretary Timothy Geithner on August 17, 2012.[12]

Matters are still very much in flux. Since that time FHFA has announced that it will make another combined $39 billion dividend payment to the Government by the end of this year. The reports of these repayments often say that Fannie and Freddie "are close to paying off taxpayer bailout bill,"[13] without fully understanding that under the Third Amendment these payments are treated as dividends whose payment to Treasury does 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, there are various complaints both at common law and under the Administrative Procedure Act. It is little exaggeration to say that the entire range of private, administrative, and constitutional principles will be called into question in this litigation.

I. FANNIE MAE AND FREDDIE MAC: THE EARLY STAGES

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[11] *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.

[12] 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.

[13] *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.

Fannie Mae was originally established in 1938 as part of Franklin Roosevelt's New Deal effort to revive a moribund real estate mortgage market.[14] By 1968, Fannie had been converted into a publicly traded, privately owned corporation, in order to take Fannie off the federal budget.[15] It has retained that ambiguous status as a "government-sponsored enterprise" ("GSE") until the present time. In 1970, Congress authorized Fannie to engage in the purchase of private mortgages that were not issued by government bodies such as the Federal Housing Authority, the Veterans Administration, or the Farmers Home Administration (FmHA).[16] In the same year, it created Freddie Mac to compete with Fannie Mae in the secondary market.[17]

As publicly traded corporations, the function of Fannie and Freddie has been to expand the market for home loans both 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 were 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.[18] That critical government guarantee reduced the borrowing costs of these organizations, 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 Fannie or Freddie faced financial distress. There is

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[14] 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.

[15] *Id.*

[16] 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.").

[17] FED. HOUS. FIN. AGENCY, *supra* note 15.

[15] *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).

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 recently 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":[19]

> 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 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.[20]

That GSE status, however, worked to the disadvantage of both Fannie and Freddie in other ways, which were not mentioned or discussed in Mr. Demarco's speech. Starting with the Housing and Community Development Act of 1992,[21] 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 . . . ."[22] 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 percent of the total market,[23] a figure that was raised to 55 percent in 2007, just as the housing market topped out.

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[19] 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/ZillowspeechFinal102413.pdf.

[20] *Id.* at 2.

[21] 12 U.S.C. § 4500 (2012).

22 12 U.S.C. § 4501(7) (2012).

23 12 U.S.C. § 4562 (2012).

There is no question that these obligations resulted in a weakened financial condition for the companies, although their precise effect was unclear.

Throughout this time, both Fannie and Freddie continued to operate as businesses with both common and preferred shareholders, which were traded on public markets. Each organization was governed by its own CEO 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 greater 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 payment for the extra risk that they were forced to assume. Neither its assumption of risk nor its receipt of the implicit guarantee were 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.[24] Although the 1992 and 2007 legislation told both Fannie and Freddie that they had to both furnish "affordable housing" and "maintain[] a strong financial condition" in order to earn "a reasonable economic return,"[25] these two obligations were at bottom deeply in 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 the lending policies posed to the firms' underlying financial soundness. During these years, Daniel Mudd, then President and CEO of Fannie Mae,

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Yes. It was just a small textual change. The number of minority loans was boosted.

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[24] *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.

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

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-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.[26]

The law of large numbers makes it a virtually 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 (to pick a neutral phrase) 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 in fact solvent or, more precisely, able to pay off their liabilities as they matured.[27]

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[26] *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).

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

During the critical months in the late summer of 2008, these 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 percent, their stock traded at positive values,[28] 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 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 liabilities. Yet at the same token, a stock will 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

II. THE 2008 REFORMS: PAULSON STEPS IN

A. The Political Situation

In March 2008, Bear Stearns, a respected Wall Street Investment Bank, Securities and Brokerage Firm failed after 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.[29] That event triggered the awareness that the entire financial market was on rocky times.[30] In response, Congress in 2008 passed The Housing and Economic

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

[29] 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.

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[30] *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 . . .");

Recovery Act of 2008.[31] It was pursuant to the powers created under that Act that both Fannie and Freddie were thrown into a 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"[32] and "conservatorship was the only form in which [Paulson] would commit taxpayer money to the GSEs."[33] Paulson also announced that new management was put in place for both organizations, replacing departing CEOs, Daniel Mudd and Dick Syron, who were reduced to advisory roles during the transition.[34] For the details of how these men were both pushed aside by the Department of Treasury, it is only necessary to read the complaint in *Washington Federal v. United States*,[35] which 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. Mr. DeMarco in his recent remarks backed up Paulson's position to the hilt.

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> As the housing downturn worsened in 2008, it became evident that the Enterprises could no longer raise capital and by late summer were having difficulty issuing debt. This led to the enactment of the Housing and Economic Recovery Act of 2008, or HERA, on July 30, 2008. HERA created FHFA, addressed some of the shortcomings with Enterprise oversight, and provided explicit authority for the Treasury Department to provide financial support to the Enterprises.
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> Over the next month, as housing and financial market conditions

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[31] Pub. L. 110-289, *available at* http://www.gpo.gov/fdsys/pkg/PLAW-110publ289/pdf/PLAW-110publ289.pdf. FIX

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[32] 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 TREAS. (Sept. 7, 2008), http://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx.

[33] *Id.*

[34] *Id.*

[35] 1:13-cv-00385-MMS. ¶¶ 61–75 (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").

> deteriorated further, more questions were raised about the continued viability of the Enterprises. On September 6, 2008, FHFA placed the Enterprises into conservatorships and the Treasury Department agreed to provide financial support through the Senior Preferred Stock Purchase Agreements, or PSPAs. The PSPAs included a return to taxpayers on this investment.
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> 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 PSPAs 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.[36]

Daniel H. Mudd delivered a very different assessment on this issue in December 2009.

> At the time the government declared conservatorship over the company, we were still maintaining capital in accord with the relevant regulatory standards, and we were still—along with Freddie Mac—the principal source of lending to the mortgage market. Based on ongoing examinations and frequent, if not daily meetings, our regulator had declared us in full compliance with our capital requirements throughout the period.
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> While I deeply respect the myriad challenges facing the Treasury Department and the regulator, I did not believe that conservatorship was the best solution in the case of Fannie Mae. I made that argument at the time and proposed that more modest government support could be used to encourage private investment capital—basically something more like the program many banks are now eligible for. That approach would have maintained the

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[36] Demarco, *supra* note 19, at 2.

GSE model; admittedly it would not have been a magic bullet, but this market seems to defy magic bullets whether they are fired by the government or the private sector.[37]

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 exposure to these riskier mortgages that in fact existed."[38] 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.

1. Section 1117: Temporary Authority of Treasury to Purchase Obligations and Securities: Conditions[39]

The apparent authority under that section 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."[40] But 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

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[37] *Statement of Daniel Mudd*, *supra* note 26.

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

[39] 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.

[40] 12 U.S.C. § 1719 (g)(1)(A).

Secretary and the corporation."[41] 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.

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More concretely, there is nothing in this Section that speaks about the ability of the 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." Indeed, the next two provisions in this section do not implicate the conservatorship provisions either. Instead 304(g)(1)(B)–(C) provide 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,[42] and maturities[43] 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,"[44] taking into account the "probability" that Fannie and Freddie can discharge their repayment obligations.[45] 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 were 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.

To just look at these key provisions in isolation, it seems clear that, standing alone, they 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 does agree to advance additional

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[41] *Id.*

[42] 12 U.S.C. § 1719 (g)(C)(i) (2012).

[43] 12 U.S.C. § 1719(g)(C)(ii) (2012).

[44] 12 U.S.C. § 1719(g)(C)(iii) (2012).

[45] 12 U.S.C. § 1719(g)(C)(iv) (2012).

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 there is no need for the Treasury to take care to see that the transaction works for the benefit of the shareholders of Fannie and Freddie because that is something that, within the confines of this Section, their Boards are quite able to on their own behalf, given that their fiduciary duties run exclusively in favor of the shareholders as a group. The inevitable ambiguity on the scope of those duties 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 Treasury Department has a single focus for its duties precisely because it knows that its trading partner is well represented by individuals who have exclusive regard for their own welfare.

2. Section 4617: Authority over Critically Undercapitalized Regulated Entities

Therefore, the decision to remove the Board of Directors of both Fannie and Freddie from the management of their operations is not something that took place under Section 1117, which makes no reference whatsoever to a conservatorship arrangement. Instead, the authority for this provision comes under Section 4617, which deals with authority over critically undercapitalized regulated entities. This gives the Director of FHFA, itself created by HERA (Housing and Economics Rights Advocates), 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--
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> (i) necessary to put the regulated entity in a sound and solvent condition; and
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> (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity.[46]

[46] 12 U.S.C. § 4617(2)(D) (2012).

"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."[47] In contrast, "[t]he Agency, as receiver, shall place the regulated entity in liquidation . . . ."[48] 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.

C. Conservatorship v. Receivership

One common issue, much debated in this question, was whether the Treasury had to worry about any of the formalities of the choice between conservatorship and receivership in light of the assertion that both of these corporations were insolvent so their liquidation was indeed proper. But the question then remains as to whether Paulson would have had the power to initiate that change if he so thought. 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"[49] 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."[50] 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 . . . ."[51]

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

[48] 12 C.F.R. § 1237.3(b) (2012).

[49] 12 U.S.C. § 1719 (g) (2012)

[50] 12 U.S.C. § 4617(a)(7).

[51] 12 U.S.C. § 4617(b)(2)(E) (2012).

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 at the time, so as to justify wiping out their preferred and common shareholders interests under standard bankruptcy rules. I do not take any position on whether 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 some what "consented" to the takeover, but I do note that this characterization of the transition of control was strongly contested by Washington Federal in its complaint.[52] 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."[53] Neither of these two states of affairs can be simply asserted as true by the Government.[54] 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 in these proceedings. Indeed their liquid position far exceeded their short term debt.[55] In the absence of any finding of insolvency, there is nothing to stop the Government, or any lender,

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52 Complaint, *Washington Federal*, at ¶¶ 82-90.

53 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.

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

55 Complaint, *Washington Federal*, at ¶ 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.)

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 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 that judgment 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 and that there was a need to force the operation into insolvency.[56] At that time, of course, it would still have to make out the basic substantive claims in order to prevail. Proving a supposed insolvency at an earlier time would not be sufficient. It is no coincidence that the very next provision of the statute deals with "judicial review."[57] And, if after

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[56] 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).

[57] Section 4617 (b)(5) Judicial review

> (A) In general
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> 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.

adjudication it 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 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 through both the receivership of conservatorship operation. All these issues are, of course, hypothetical, given that the conservatorship was chosen with the 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 Treasury in all likelihood chose the conservatorship route precisely because it concluded 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 a wide number of domestic and foreign entities who might get very little out of the insolvency proceeding. The exact nature of the political blowback is always hard to predict. But it is likely that the 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, it has to meet the requirements for insolvency at that 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 Government had strong fiduciary duties, which means that its actions have to be tested by the normal standards of corporate law, which then dovetail quickly with the requirements of both administrative and constitutional law.

In making this assessment, it overstates the case to insist that the law of fiduciaries duties has sufficient clarity to resolve all potential conflicts of interest.

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12 U.S.C. § 4617(b)(5) (2012).

To be sure, in any situation where there are different classes of claimants, it is an open question of how to reconcile fiduciary duties to different classes of claimants.[58] It is therefore a commonplace concern that since the risk/reward profiles differ between common and preferred shareholders, the former will on average tend to prefer riskier actions than the preferred shareholders. In these distress-like situations the expected value of 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 preferred with little or not 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.

The key point then concerns the interaction between Sections 1117 and 4617, 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 its own independent board that can negotiate with Treasury. That, decidedly, is not the case once FHFA displaces the Boards of Directors by taking over the management of the business,

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[58] *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.").

leaving the shareholders of Fannie and Freddie without independent representation. There is nothing in FHFA's enumerated powers that lets it become a conservator with explicit powers to enter into these share purchase agreements. 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, where typically the burden of proof is on the board to establish the entire fairness of the transaction. In effect, the argument is that Congress can choose either one route or the other, but cannot, given the conflicts of interest, pursue both courses of action simultaneously.

D. 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. Indeed, 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 Circuit Court decision, *Kellmer v. Raines*,[59] 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.

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

[59] 674 F.3d 848 (D.C. Cir. 2012).

the statute; (3) read the statute!'"[60] At that point, the word all was given its full weight and the individual shareholders lost control of their suit. In *Washington Federal*, the Government insists therefore that now individual shareholders cannot sue the FHFA and Treasury either as owners of shares or "derivatively" (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 contexts.[61]

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*,[62] where the written agreement gave Otis Wood the exclusive right to sell various products that Lady Duff Gordon designed without imposing any explicit obligation upon him on how he was supposed to behave. When Lady Duff Gordon sold items on her owned, Wood sued for breach of the exclusive obligation, and was met with the objection that the suit could not be brought because it 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

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[60] *Id.* at 850, (citing Henry J. Friendly, *Mr. Justice Frankfurter and the Reading of Statutes*, *in* BENCHMARKS 196, 202 (1967)).

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

[62] 118 N.E. 214 (N.Y. 1917).

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 "efficacy as both parties must have intended that at all events it should have."[63]

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 the strong economic intuition of the judge that the transaction does not make sense from the ex ante perspective unless other obligations are assumed into the agreement in light of a widespread implicit social consensus as to the 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*. 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."[64] 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

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

[64] U.S. CONST. amend. V.

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."[65] The Government's interpretation of the Statute flouts 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 one 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.[66] But it was quite clear that the Treasury put enormous pressure on both Boards to resign so that FHFA could take over its operations. Indeed, both Boards were summoned for meetings with key Treasury officials just two days before the public announcement,

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[65] 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).

[66] *See* 12 U.S.C. § 1719 (g) (2012).

and told to resign their positions or the Treasury would force them out.[67] 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.

E. Evaluating the 2008 Deal: 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.[68] 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

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[67] *See* Complaint, *Washington Federal*, at ¶¶ 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).

[68] *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).

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 regard 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.[69]

The process that FHFA and the Treasury used in this case was zero. The argument could be that the in the tense period of September 2008, the exigencies of the moment justified the rapid imposition of the basic agreement. But even if that point were true about the necessity for the infusion of cash, nothing *after* that initial date prevented a careful review of the terms of the agreement under the applicable substantive 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 percent of the common stock through the device of an option that allows the Treasury to purchase those shares at the nominal price $0.00001 per share, which is the implicit value that the Treasury attached to them. That 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 percent 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

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

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, the easy remedy in this case is to invalidate the supposed option. The claim could be made that in so doing the Government is left (at least from the ex ante perspective) with an unfair deal that does not meet taxpayer means. 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. The government that does not wish to follow even the most rudimentary of procedures should derive no benefit from its operation.

The shoddy way in which FHFA and the Treasury treated the common shareholders shapes the perception of the second half of the transaction, under which the Fannie and Freddie received large cash infusions in exchange for the creation of a new class of senior preferred stock that carried with it a 10 percent dividend, payable quarterly on the amount that the Treasury added to Fannie and Freddie. That amount in turn rose to 12 percent in the event of any default. Thus 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 at this point is whether this transaction was one that 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, that the shares had zero value. Indeed, the appropriate test under these circumstances is whether the value of the shares rose or fell on the consummation of the transaction. In this instance the losses in 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.[70]

In both instances, the actual loss from the Government action could have been greater, for the valuation in question doubtless reflected the possibility of some political or judicial correction to the results of the original transaction.

The same analysis applies if one views the creation of the September 2008 receivership through the lens of the Takings Clause. The basic constitutional language provides: "Nor shall private property be taken for public use, without just compensation."[71] 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.[72] 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.

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 transactions. 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 mortgage liens imposed on property, whether for services rendered or for money lent, should receive the same level of

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[70] Comp laint, *Washington Federal*, at ¶ 79.

[71] U.S. CONST. amend. V.

[72] Loretto v. TelePrompter Manhattan CATV Corp. 458 U.S. 419 (1982).

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*,[73] which addressed the question of whether the United States could escape the payment of materialmen's liens attached to its ships solely by moving them out of state in ways that dissolved these liens. *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 as a general creditor subject to the identical liability. 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.[74]

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 ships 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.

That decision is capable of generalization 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

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[73] 364 U.S. 40 (1964).

[74] *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 an integrated parcel of land—something that the courts have not grasped in connection with air rights.[75] 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 private mortgages. Or it can do so by ordering itself a lien that is prior to that of the individual owner. In these cases, the shift in priority is a taking of the property in question, because it reduces the probability that the loan 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 contributions would never come in an attempt to rescue the old. 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 future earnings. Where the transaction is well conceived, that condition should

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[75] *See* Penn Central Transp. Co. v. City of New York, 438 U.S. 1014 (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).

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, such that a $10 cushion replaces a $10 shortfall. No separate cash payment is therefore required whenever the cash contributed increases the value of the now subordinate liens, or for that matter subordinate equity positions.

These principles should be applied to examine the soundness of the 2008 agreement. The government here had the power unilaterally to force the transaction. Its claim that this bold intervention was necessary to stabilize the financial markets is, perhaps, disputable on economic terms, but not on constitutional terms. The collateral benefits count as a taking for public use (or at least benefit or purpose, wider conceptions than the constitutional text), and no court will second-guess this judgment after *Midkiff v. Hawaiian Housing Authority*[76] and *Kelo v. City of New London*.[77] But on the compensation issue, the appropriate standard has been that the government must supply a full and perfect equivalent for the interest taken,[78] which can only happen if their market value is equal to or greater than what it was before the government engineered its forced exchange.

On the basis of the evidence assembled in this case, that is decidedly not so. The very reason therefore why this transaction fails the corporate principles of fair accounting explains why that transaction fails under the takings clause. Both of

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[76] 467 U.S. 229 (1984).

[77] 545 U.S. 469 (2005).

[78] 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 . . . .").

these provisions allow for the transaction to go through, but only on terms that are fair to the party that is forced to go along with the deal. The only question therefore is the value of the interest taken, which in the first instance should be equal to the decline in the value of the outstanding shares of common and preferred stock—large numbers indeed given the total capitalization of the firm.

F. Shareholder Remedies for the 2008 Takeover

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 it was its conscious decision to ignore all statutory procedures that created much of this 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 been done in accordance with 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 percent 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 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 preferred stock that the government takes. 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 addition, it will be claimed that this once-and-for-all harm was completed at the time of the takeover, should not be regarded as a continuing harm, so that the statute of limitations (whatever it may be) has run on the event. In my view, these arguments are 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. The statute of limitation issue is closer, but there is at least a respectable argument that the maintenance of the original illegal structure is a continuous management wrong.

III. The 2012 Third Amendment

For these purposes, we can assume against the weight of the evidence that any action against the Government on the basis of its actions in September 2008 are beyond legal attack. The same cannot be said of the next major event that took place, which was the Third Amendment to the original agreement that was entered into by FHFA as conservator of Fannie and Freddie and the Treasury. At this point there was no ongoing crisis of any proportions. To the contrary, it was quite clear that the portfolio performance of both Fannie and Freddie had much improved, such that both companies would turn a profit, and could pay the 10 percent dividend on the senior preferred and return the $187 billion that the Government advanced.[79] Indeed at that time it was clear that both entities had "deferred tax assets," or losses from previous transactions that could be carried forward to offset future taxable income. In light of these positive developments it was clear by the time of the Third Amendment that Fannie and Freddie had generated sufficient wealth to 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 agreement is a flat out confiscation of the shareholder stake in both Fannie and Freddie. HERA made it impossible for Treasury to advance new money to Fannie and Freddie after December 31, 2009. At that point, the Government could not enter into a one-sided transaction with itself whereby it received an outsized return on its new investment. To avoid that difficulty, the Government simply amended the existing agreement so that it now provided, for no new consideration to Fannie and Freddie, 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

[79] *See supra* note 10.

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 by any measure so clear and straight-forward that both defendants ought to confess the error of their positions and make the needed adjustments to undo the mischief created. The simplest way to do this is to determine first the amount of money owing on the basic 2008 Agreement (which is assumed valid for these purposes), only to credit the remainder of the money paid over as a return of capital, which by rough calculations suggests that some $50 billion of ersatz dividends should be treated as a return of capital, reducing the overall level of indebtedness from $187 billion to about $137 billion, and counting.

The Government resists this position in the much-anticipated brief[80] for a motion to dismiss that it filed against Washington Federal on November 7, 2013. The Government argued that even if the standing issues were resolved against it, the Government had not taken any property from Fannie and Freddie because the complaint had only alleged that the Government's action had resulted in a diminution in value of the assets of the two companies.[81] That phraseology is unfortunate because it lumps together the downward valuations with shifts in share value attributable to changes in market prices as a result of the fluctuation of market demand. But the case could and should be repleaded to make it clear that all the loss in value came from the decision of the Government to take an (as yet unexercised) option on 79.9 percent of the common stock, and its decision to give itself a preferred stock position senior to that of the original preferred and common. If any board of directors of a private corporation had done this action on its behalf, the stock in question would be cancelled lest it work a theft on the other shareholders. In this instance, the private shareholders cannot force the Government to abandon its position any more than they could keep the ship in *Armstrong* in Maine waters. But it can demand compensation for the property that has been so taken. At this point it becomes genuinely odd for the Government to

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

[81] *Id.* at 19.

dismiss this case on the ground that the plaintiffs did not allege that "the Government has the citizen's money in its pocket."[82] But of course that is exactly what the Government has done in two steps instead of one. First it expands the rights of the senior preferred and then it transfers the cash to the Treasury. If that strategy is allowable here, it could be used everywhere. The Government by fiat could place a lien on the property of its choice, and then foreclose on the lien down the road. If the first step is legitimate, the second is as well, which only goes to show that neither step can be tolerated. Beyond these arguments, the Government makes three separate claims that should be quickly dismissed.

First, in a flight of fancy, it insists that the Third Amendment was really a bargain that worked for the benefit of both sides. In its view, the Third Amendment was needed "because of a concern that the Enterprises [Fannie and Freddie], although solvent with Treasury's assistance, would fail to generate enough revenue to fund the 10 percent dividend obligation." That kind of argument is wholly inappropriate for a motion to dismiss that must take as true the facts alleged in the complaint, which stressed repeatedly the improved condition of Fannie and Freddie prior to August 2012. But even if the Government's factual predicate were true, the conclusion is simply absurd. If the Treasury was worried about the ability of Fannie and Freddie to generate enough revenue to pay off their obligations, the *last* thing they ought to do is strip both entities of all the wealth needed to pay down their admitted death. The means chosen work against the stated end. Indeed, the only way to magnify the miniscule risk of default as of August 2012 was to strip Fannie and Freddie of liquidity by the unilateral "dividend" payment made to the Government. As a conservator, FHFA is supposed to defend shareholders, not fork over their money to the Treasury.

Next, the Government offers two more threadbare arguments for its position. It first claims that the time is not "ripe" for a complete accounting because the books have not closed on the transaction. In this instance, the supposed accounting is a trivial matter because all that need be done to rectify the situation is to first

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[82] *Id.* at 37.

calculate the amount of interest payments owed on the preferred, after which the remainder of the money paid over could, and should, be treated as the repayment of the principal on the debt. Those calculations are beside the point here. What is needed is a declaration of rights, which if decided in favor of the shareholders of Fannie and Freddie should lead to an injunction of any payment beyond those owing on the junior preferred. The great risk here is that the Treasury will continue to collect "dividends," even after the senior preferred has been entirely redeemed.

Finally, the Government claims that the shareholders of Fannie and Freddie have assumed the risk that all the money in the coffers of Fannie and Freddie would be turned over to the Government given that such entities are subject to extensive regulation from multiple federal and state authorities. As a general matter, the point is not credible. Banks and corporations are always subject to extensive regulation, but those forms of regulation could never justify the tactics of the Third Amendment in any other context, lest the federal government be allowed to use the tactics evolved here to wipe out any and all corporations that it unilaterally deems to be in some form of distress.

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).[83] To be sure, the Government 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.

But this lawsuit is not 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 two 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, those cases do not contain the obvious element of self-dealing which pervades the Third

[83] Pub.L. No. 101–73, 103 Stat. 183 .

Amendment. And third, the creation of any explicit contractual relationship will always create the "investment-backed expectations" under the elusive *Penn Central* test for compensation.[84] 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 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, much as was done in *Armstrong*. In this regard, the relevant precedent remains *United States v. Winstar Corp.*,[85] in which it was held that the United States could not by statute renege from a critical contractual promise that it would allow Winstar to include "supervisory good will" 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,"[86] 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. The *Penn Central* test did not figure anywhere in that analysis, just as it does not figure into this one.

Both the current case and *Winstar* are far cries from such decisions as *Golden Pac. Bancorp v. United States*,[87] where a bank was thrown into insolvency because of irregularities in the way in which they treated certain deposits. That case did stress the *Penn Central* line that banks, as heavily regulated institutions, have no reasonable investment backed expectations in dealing with standard forms of

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[84] *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 government than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good.

[85] 518 U.S. 839 (1996).

[86] *Id.* at 843.

[87] 15 F.3d 1066 (Fed. Cir. 1994)

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.

A. The Legislative Reaction

The issues surrounding this case have also been extensively mooted in the legislative arena, where the current position is that the Congress does not think the claims of the common and preferred shareholders have any merit.[88] And worse, both the Hensarling[89] and Corker bills,[90] insist that future reforms of the lending system need not take into account the position of the current shareholders of Fannie and Freddie. Thus, Rep. Hensarling's PATH legislation contains Sections 103 and 104, which, according to his legislative summary, provides 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."[91] 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. The rhetorical misdirection of both statutes is that it treats the protection of the "taxpayer interest" in HERA as the

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[88] Nick Timiroas, David Benoit & Emily Glazer, *Ackman Makes Big Bet on Fannie, Freddie: Investment Busy 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.").

[89] *See supra* note 1.

[90] *See supra* note 2.

[91] *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.

touchstone for all future analysis, without noting the radical change in context in the case. It is perfectly correct for HERA to insist that FHFA protect taxpayers when it has to negotiate with the independent boards of Fannie and Freddie, with their strong fiduciary duties. But it is wholly incorrect to treat the taxpayer protection as the Holy Grail of political entitlement when FHFA is on both sides of the transaction. Given the change in context, the exaltation of the taxpayer interest has to be understood as an open admission that FHFA is a conscious and deliberate disregard of its own fiduciary duties. If FHFA were a private entity subject to regulation under the various corporate and securities acts, its conduct would expose it to civil liability and perhaps criminal liability as well, given the requisite conscious mental state to disregard its fiduciary duties. But these are government entities that love to insist on their release from the fetters that bind private corporations.

That 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.[92]

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Comment: We were unable to find the Questions & Answers document; we cited your article here because that appears to be the only online source for this statement.

[92] 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),

His "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 (and now permanent) director Edward J. DeMarco of FHFA and Timothy Geithner, then Treasury Secretary. "Their contracts" with the federal government are not "their" contracts. The independent Boards of both corporations had been removed in the 2008 transaction so that these "contracts" are just 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.

IV. Final Words: The Future

The precedential effect of these decisions is most disturbing. 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 state of the mortgage market.[93] His testimony 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."[94] 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.[95] But

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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.

[93] *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.).

[94] *Id.*

[95] 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-

however egregious those transactions were, they are dwarfed by the situation with respect to Fannie and Freddie, both in the size of the transactions and the audacity of the government position. A closer parallel in this regard is the now ongoing civil and/or criminal investigation of JP Morgan with respect to its exposure on multiple financial fronts, where its liability appears to extend to Bear Stearns, which it took over at the express consent of the government. The obvious question on this transaction was asked by Richard Parsons, formerly of Bank of America, who noted that the DOJ crusade against JP Morgan necessarily sends a "bad message to big banks," which will make them reluctant to enter into any transaction with FDIC, or indeed any other branch of government, that has the possibility of massive civil and criminal prosecutions at the end of the tunnel should something go wrong.

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 moves that were made will 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 moves. Yet what one sees is the dogged government prosecution of firms like JP Morgan in large measure on the dubious ground that it should bear civil, and perhaps criminal responsibility, 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. But that is precisely the point. It is the "unknown unknowns" that really hurt. It may well be that the next

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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).

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. 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.