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Are the Feds Forcing Fannie and Freddie Into Early Retirement?

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INTRODUCTION

Ronald Regan once said, "[t]he nine most terrifying words in the English language are, 'I'm from the government and I'm here to help.'"[2] Unfortunately, this is a lesson that many learned in a very harsh way when the federal government squeezed out private stockholders of Fannie Mae and Freddie Mac by amending the terms of superior, Treasury-owned government stock in those entities.

This Article presents the facts surrounding the bevy of lawsuits[3] filed in mid-2013, and analyzes the claims asserted therein, against the federal government for its attempt to siphon off all of Fannie Mae's and Freddie Mac's profits with the purported purpose of shuttering the

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2. *Ronald Regan Quotes*, THE QUOTATIONS PAGE, http://www.quotationspage.com/quotes/Ronald_Reagan/21 (last visited Aug. 17, 2013).
3. *See infra* note 132.

entities. In doing so, this Article begins by providing a brief history of Fannie Mae and Freddie Mac in Part I. Then, Part II explains the benefits and costs of obtaining a loan through these entities, as opposed to using an institution that the government did not charter. Next, Part III explains the growing and popping of the housing bubble and the government's reaction: the creation of various entities and implementation of agency actions that are the subject of the lawsuits at issue. Part IV analyzes the claims that the investors assert against these governmental entities involved in this controversy. Finally, Part V briefly discusses how the government answered the complaints in court.

I. A VERY BRIEF HISTORY OF FANNIE MAE AND FREDDIE MAC

Before delving into the analysis of the claims asserted against the U.S. government, it is necessary to provide a brief background on these two government behemoths, Fannie Mae and Freddie Mac, and how they were impacted by the 2008 housing crisis. While this history provided herein is by no means a complete primer on the events surrounding the housing bubble and its subsequent pop, it sufficiently provides the reader with a working understanding in order to illustrate how the housing giants and private investors wound up in their current situation.

A. FANNIE MAE

Fannie Mae's roots can be traced back to October 29, 1929, known as "Black Tuesday,"[4] the unofficial beginning of the Great Depression in the United States.[5] During this time, "[t]here was a big decline in house prices . . . and a large increase in mortgage foreclosure rates."[6] In the

4. *See October 29, 1929: "Black Tuesday,"* CNN.COM (Mar. 10, 2003), http://www.cnn.com/2003/US/03/10/sprj.80.1929.crash/. "After an initial downturn on October 24, [1929], . . . the market plummeted in two days of panic—on October 28, . . . and October 29, 'Black Tuesday,' the day it completely collapsed." *Id.*

5. *See id.*

6. David Wheelock, *The Great Depression Q&A*, FED. RESERVE BANK OF ST. LOUIS, http://www.stlouisfed.org/great-depression/qa.html (last visited Aug. 18, 2013) (drawing a distinction between the housing market during the Great Depression and during the 2008 housing crisis).

federal government's attempt to stymie the Great Depression's detrimental effects on homes and homeowners, the National Housing Act of 1934 ("NHA")[7] was passed.[8] Particularly, Title III of the NHA[9] authorized the creation of the Federal National Mortgage Association,[10] which has become known as Fannie Mae.[11] Congress officially charted Fannie Mae in 1938,[12] which was initially established to "issue[] bonds to raise funds for the purchase of FHA-insured mortgages and, beginning in 1948, Veteran's Administration (VA)-guaranteed mortgages."[13] It was, however, reorganized into a for-profit corporation in 1968.[14] Operating in this form, private entities are permitted to purchase stock in the government-chartered corporations.[15]

As currently codified, the purpose of the NHA and Fannie Mae is to facilitate a "secondary market . . . for residential mortgages"[16] by:

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7. National Housing Act of 1934, Pub. L. 73-479, 48 Stat. 1246 (1934) (codified at 12 U.S.C. § 1716-17 (2012)).

8. *See* Julia Patterson Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners*, 72 MO. L. REV. 1077, 1080–83 (2007) (discussing the formation and evolution of Fannie Mae and Freddie Mac); *HUD Historical Background*, U.S. DEP'T OF HOUSING & URBAN DEV., http://www.hud.gov/ offices/adm/about/admguide/history.cfm (last visited Aug. 17, 2013) [hereinafter *HUD Historical Background*].

9. Kenneth G. Lore, *Fannie Mae and Freddie Mac Multifamily Financing*, *in* COMMERCIAL REAL ESTATE FINANCING 2013, at 3 (2013).

10. *See HUD Historical Background*, *supra* note 8.

11. *See id.*

12. *See* Fairholme Funds D.D.C Complaint ¶ 33, Fairholme Funds, Inc. v. United States, No. 1:13-cv-01053-RLW (D.D.C. July 10, 2013) [hereinafter Fairholme Funds D.D.C Complaint].

13. Forrester, *supra* note 8, at 1081 (citing 43 Fed. Reg. 36,201 (Sept. 14, 1978)).

14. *See id.* at 1080–81.

15. *See id.*; *see also* Class Action Complaint ¶ 29, Cacciapalle v. United States, No. 13-cv-00466 (Fed. Cl. July 10, 2013) [hereinafter Cacciapalle Class Action Complaint] (stating that "[f]rom 1968 until the [the federal government amended the Preferred Government Stock in 2012,] Fannie Mae has been publically traded on the New York Stock Exchange and therefore owned by private shareholders and has obtained funding from private capital on a self-sustaining basis"). Fannie Mae stock trades under the stock symbol "FNMA." *See Fannie Mae*, MARKETWATCH.COM, http://www.marketwatch.com/investing /stock/fnma (last visited Aug. 21, 2013). This hybrid nature of Fannie Mae and Freddie Mac is at the heart of these complaints. *See* discussion *infra* Part IV.

16. 12 U.S.C. § 1716 (2012).

> (1) provid[ing] stability in the secondary market for residential mortgages;
>
> (2) respond[ing] appropriately to the private capital market;
>
> (3) provid[ing] ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;
>
> (4) promot[ing] access to mortgage credit throughout the nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and
>
> (5) manag[ing] and liquidat[ing] federally owned mortgage portfolios in an orderly manner, with a minimum of adverse effect upon the residential mortgage market and minimum loss to the Federal Government.[17]

Briefly stated, a secondary housing market is created by the following process. First, individual lenders[18] make residential home loans to borrowers[19] that are secured[20] by the homes.[21] These mortgages

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17. *Id.*

18. The lender in a secured transaction is considered a "secured party," which is an entity "in whose favor a security interest is created." U.C.C. § 9-102(72) (2010).

19. The borrower is termed the "debtor," which is defined as "a person having an interest, other than a security interest or other lien, in the collateral." U.C.C. § 9-102(28).

20. A "secured transaction" is defined as a "business arrangement by which a buyer or borrower gives collateral to the seller or lender to guarantee payment of an obligation." BLACK'S LAW DICTIONARY 1475 (9th ed. 2009).

21. *See* CTR. FOR AM. PROGRESS, A RESPONSIBLE MARKET FOR HOUSING FINANCE 1 (2011), *available at* http://www.americanprogress.org/issues/2011/01/pdf/responsiblemarketforhousingfinance.pdf.

> The secondary market for mortgages encourages the flow of mortgage capital directly by replenishing the lending funds of

are then purchased and pooled together by the secondary lender.[22] Through a process of securitization, these pools of loans are subsequently "packaged into mortgage-backed securities . . . [and] sold to investors."[23] When being securitized, these mortgaged-backed securities are "converted . . . into more liquid, flexible instruments,"[24] such as bonds, and are then issued to investors globally.[25] "The investors in these mortgage-backed securities will be paid from the principal and interest payments flowing into the pool from the mortgages."[26]

Fannie Mae purchases both single-family and multi-family residences for the secondary market.[27] Through the third quarter of 2013, Fannie Mae has paid $105.3 billion to taxpayers and made 3.1 million home purchase loans.[28]

> mortgage originators almost immediately rather than over thirty years of repayments. A secondary market for mortgages also indirectly encourages increased real estate capital by (a) matching up the cost of lending capital to loan returns and (b) spreading risks borne by a mortgage lender.

Andrea J. Boyack, *Laudable Goals and Unintended Consequences: The Role and Control of Fannie Mae and Freddie Mac*, 60 AM. U. L. REV. 1489, 1495–96 (2011).

22. *See* Boyack, *supra* note 21, at 1501–02.

23. *Id.* A "commercial mortgage-backed security" may be defined as "[s]ecurities collateralized by a pool of mortgages on commercial real estate in which all principal and interest from the mortgages flow to certificate holders in a defined sequence or manner." BAXTER DUNAWAY, LAW OF DISTRESSED REAL ESTATE § 56:1 (2013). Securitization may generally be defined as the "conver[sion] ([of] assets) into negotiable securities for resale in the financial market, allowing the issuing financial institution to remove assets from its books, and thereby improve its capital ratio and liquidity, and to make new loans with the security proceeds if it so chooses." BLACK'S LAW DICTIONARY 1475 (9th ed. 2009). Essentially, this occurs when the Companies pool the mortgages and issue mortgage-back securities.

24. FANNIE MAE, BASICS OF FANNIE MAE SINGLE-FAMILY MBS 1 (2013), *available at* http://fanniemae.com/resources/file/mbs/pdf/basics-sf-mbs.pdf.

25. *See* Jeff Holt, *A Summary of the Primary Causes of the Housing Bubble & the Resulting Credit Crisis: A Non-Technical Paper*, 8 J. BUS. INQUIRY 120, 126 (2009).

26. *Id.*

27. *See generally* FANNIE MAE, https://www.fanniemae.com/ (last visited Aug. 17, 2013).

28. *See 2013 Progress Report*, FANNIE MAE, http://www.fanniemae.com/progress/index.html (last visited Aug. 17, 2013).

B. Freddie Mac

Freddie Mac followed a somewhat similar path as Fannie Mae, albeit several decades later.[29] Congress passed the Federal Home Loan Mortgage Corporation Act in 1970[30] in order:

> (1) to provide stability in the secondary market for residential mortgages;
>
> (2) to respond appropriately to the private capital market;
>
> (3) to provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and
>
> (4) to promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.[31]

The resulting entity was Freddie Mac.[32] Specifically, and as currently codified, Freddie Mac "is authorized to purchase, and make commitments to purchase, residential mortgages. [Freddie Mac] may

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29. *See supra* Part I.A; *see also infra* note 31 and accompanying text. As with Fannie Mae, Freddie Mac is also a privately controlled government-sponsored entity. *See* Forrester, *supra* note 8, at 1080–81.

30. Federal Home Loan Mortgage Corporation Act, Public Law No. 91-351, 84 Stat. 450 (1970) (codified as amended at 12 U.S.C. §§ 1451–59) (2012)); *see also* Complaint ¶ 31, Wash. Fed. v. United States, No. 13-385C (Fed. Cl. June 10, 2013) [hereinafter Washington Federal Complaint].

31. Public Law No. 91-351, 84 Stat. 450 (codified as amended at 12 U.S.C. § 1451–59) (2012)). "Freddie Mac was created in 1970 to provide a secondary market for conventional mortgages originated by savings and loan associations." Lore, *supra* note 9, at 3.

32. *Cf.* FREDDIE MAC, FEDERAL HOME LOAN MORTGAGE ACT 1 (2010), *available at* http://www.freddiemac.com/governance/pdf/charter.pdf (showing Public Law No. 91-351, 84 Stat. 450 as the charter document establishing Freddie Mac).

hold and deal with, and sell or otherwise dispose of, pursuant to commitments or otherwise, any such mortgage or interest therein."[33] Also, according to Freddie Mac's 10-K[34] issued on December 31, 2012, its "public mission [is] to provide liquidity, stability, and affordability to the U.S. housing market."[35]

As with Fannie Mae, Freddie Mac purchases loans with single-family or multi-family residences put-up as collateral.[36] Since January 1, 2009, Freddie Mac has financed 1.8 million single-family purchases and 1.4 million units of multi-family rental housing.[37]

II. THE BENEFITS AND DRAWBACKS OF OBTAINING A LOAN THROUGH FANNIE MAE OR FREDDIE MAC

In addition to providing the general history of Fannie Mae and Freddie Mac (collectively, the "Companies"), it is beneficial, for background purposes, to briefly discuss some of the benefits and drawbacks that a mortgagor would encounter when originating a mortgage loan through the Companies. This Part provides more insight into how the Companies operate and why a borrower might want to get involved with their somewhat burdensome loan process.

A. STANDARDIZED FORMS

When obtaining a loan through Fannie Mae or Freddie Mac, the terms of the loan documents are fairly rigid and non-negotiable.[38] This

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33. 12 U.S.C. § 1454 (2012).

34. A 10-K is an annual report, required by the Securities and Exchange Commission, which provides "a comprehensive overview of the company's business and financial condition." *Form 10-K*, SEC, *available at* http://www.sec.gov/answers/form10k.htm (last visited Jan. 22, 2014).

35. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 30 (quoting the Freddie Mac December 31, 2012, 10-K).

36. *See generally* FREDDIE MAC, http://www.freddiemac.com/ (last visited Aug. 17, 2013).

37. *See Corporate Facts*, FREDDIE MAC, http://www.freddiemac.com/news/corp_facts.html (last visited Aug. 17, 2013).

38. *Cf.*, *e.g.*, Forrester, *supra* note 8, at 1083–87; FREDDIE MAC, MULTIFAMILY LOAN AND SECURITY AGREEMENT (CME) (2013), *available at* http://www.freddiemac.com/multifamily/docs/Loan_Agreement_CME.doc. In

is, however, largely beneficial to most borrowers because the forms are the product of intense negotiations with consumer advocacy groups that sought the best possible terms for home buyers.[39]

Although "[m]ost loans purchased and securitized by the [Companies] are fixed-rate loans,"[40] borrowers of either program may obtain a loan with either a fixed[41] or variable interest rate.[42] The use of a fixed rate note allows the borrower to avoid fluctuations in the interest rate over the course of the loan and is generally a safer alternative for the cash-strapped borrower.[43] Moreover, the attorney fees associated with a loan through the Companies *should* be lower because the documents have, in most respects, previously been negotiated and are now rather non-negotiable. Therefore, fewer hours should be billed on a loan obtained through the Companies.

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particular, Exhibit B of the Freddie Mac Loan Agreement requires that every change to the document be shown here and will only be permitted after Freddie Mac's written consent. *Cf.* FREDDIE MAC, MULTIFAMILY LOAN AND SECURITY AGREEMENT (CME) (2013), *available at* http://www.freddiemac.com/multifamily/docs/ Loan_Agreement_CME.doc. Freddie Mac also utilizes a set of Uniform Covenants that are used in all multi-family mortgages, regardless of where the collateral is located. *See* FREDDIE MAC, UNIFORM COVENANTS (CME AND PORTFOLIO) (2013), *available at* http://www.freddiemac.com/multifamily/docs/Uniform_Covenants_CME_Portfolio .doc.

39. *See* Forrester, *supra* note 8, at 1083–87.

40. *Id.* at 1088.

41. *See* FANNIE MAE, SCHEDULE 2 TO MULTIFAMILY LOAN & SECURITY AGREEMENT, *available at* https://www.fanniemae.com/content/legal_form/6102fr.doc; FREDDIE MAC, MULTIFAMILY NOTE (CME) MULTISTATE – FIXED RATE DEFEASANCE, *available at* http://www.freddiemac.com/multifamily/docs/ Note_Fixed_Rate_Defeasance_CME.doc.

42. *See* FANNIE MAE, SCHEDULE 2 TO MULTIFAMILY LOAN & SECURITY AGREEMENT, *supra* note 41; FREDDIE MAC, MULTIFAMILY NOTE (CME) MULTISTATE – FIXED RATE DEFEASANCE, *supra* note 41.

43. *See* Forrester, *supra* note 8, at 1088–89. The interest rate on a fixed-rate loan will remain constant throughout the whole term of the loan whereas the interest rate on a variable-rate loan may fluctuate based on market conditions. *See What is the Difference Between a Fixed-Rate and Adjustable-Rate Mortgage (ARM) Loan?*, CONSUMER FIN. PROTECTION BUREAU, *available at* http://www.consumerfinance.gov/ askcfpb/100/what-is-the-difference-between-a-fixed-rate-and-adjustable-rate-mortgage-arm-loan.html (last visited Jan. 22, 2014).

The standardized forms also allow the Companies to pool loans together for securitization.[44] This pooling is possible because the loans are fairly homogenous.[45] For securitization to properly function, "[l]enders submit *similar* mortgaged loans" to the Companies.[46] The reason for this characteristic is, in many ways, more out of convenience than necessity. If the Companies were to securitize loans with varying loan terms, carve-outs, etc., the Companies would need to detail the terms of each individual loan to the investors.[47] By only securitizing loans that are of the same type, in most substantive respects, the Companies can provide one description that is applicable to the entire pool of loans. Obviously, this is easier for both the Companies and the secondary-market investors.

Despite the advantages, standardized forms and take-it-or-leave-it terms can also be significant sticking points for many borrowers. For example, the standard multi-family Fannie Mae Loan and Security Agreement lists sixteen numbered events of default that, generally, cannot be negotiated.[48] Unless the borrower is a major investor with the

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44. *See supra* text accompanying notes 38-43.

45. *See* Forrester, *supra* note 8, at 1083; *cf.* FANNIE MAE, BASICS OF FANNIE MAE SINGLE-FAMILY MBS, *supra* note 24.

46. FANNIE MAE, BASICS OF FANNIE MAE SINGLE-FAMILY MBS, *supra* note 24 (emphasis added).

47. *Cf.* FDIC, *Securitizations*, *in* MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 1980-1994, at 405 (1998), *available at* http://www.fdic.gov/bank/historical/managing/history1-16.pdf (stating that securitization is possible when using assets with "similar features").

48. *See* FANNIE MAE, MULTIFAMILY LOAN & SECURITY AGREEMENT § 14.01 (2013), *available at* https://www.fanniemae.com/content/legal_form/6001nr.doc. Consider also the terms of the Fannie Mae Subordination, Assignment and Security Agreement that requires a senior-care facility operator, who may be completely unrelated to the borrower, to "pledge[] . . . [or] grant[] a security interest in and assign[] to Lender . . . all of [the operator's] right, title and interest . . . in and to all Licenses and any other agreements or permits of any nature whatsoever." FANNIE MAE, SUBORDINATION, ASSIGNMENT AND SECURITY AGREEMENT § 5 (2013), *available at* https://www.fanniemae.com/content/legal_form/6446srs.doc. An entity that is only responsible for operating a facility, rather than owning it, has very little incentive to make such a pledge. Because this is a required form in this type of loan, an operator's refusal to execute the form may be sufficient to completely derail the borrower's loan.

clout to convince the Companies to make special exceptions, borrowers are largely stuck with the pre-negotiated terms in the loan documents.[49]

B. BURDENSOME LOAN PROCESS

Likely, the largest drawback to obtaining a loan through the Companies is the somewhat overly burdensome loan process. While arguments can be made as to why borrowers might actually *prefer* the non-negotiable, standardized loan forms, similar arguments are difficult to find with this aspect of Fannie Mae and Freddie Mac loans.

First, borrowers and lenders must complete a myriad of forms before the Companies will purchase the loan.[50] Some of these forms require a great deal of information of loan-specific details to be completed prior to delivering the loan to the Companies.[51] Moreover, the Companies are very particular about how the forms are to be completed, executed, and delivered. For example, a multi-family loan package to Freddie Mac must be delivered within a five-day window before the delivery deadline;[52] otherwise, the lender will need Freddie Mac's permission to make a delivery at any time outside of this five-day period, even if the loan is being delivered *earlier* than this delivery window.[53] This seems counterintuitive, as most lending houses would presumably prefer to get the loan documents as soon as they are completed and available.

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49. This should not be misunderstood to mean that the loan documents cannot be amended to take into account deal-specific circumstances that do not affect the *substance* of the loan terms. For a more thorough discussion on the Companies' forms, *see* Forrester, *supra* note 8.

50. *See generally Loan Documents*, FANNIE MAE, http://www.fanniemae.com/multifamily/loan-documents (last visited Aug. 18, 2013); *Multifamily Loan Documents* FREDDIE MAC, http://www.freddiemac.com/multifamily/guide/documents.html (last visited Aug. 18, 2013). The forms listed on these pages are just the loan forms themselves. They do not include the forms that must be completed by a lender's underwriting department.

51. *See*, *e.g.*, FANNIE MAE, SCHEDULE 2 TO MULTIFAMILY LOAN & SECURITY AGREEMENT, *supra* note 41.

52. *See § 32.1(c): Delivery and Review Period*, ALLREGS ONLINE (Aug. 30, 2013), http://www.allregs.com (on file with author).

53. Presumably, however, this is due to the large number of loans that the Companies are processing at any given time. *Cf. supra* text accompanying notes 28, 37.

C. INTEREST RATES

Even those borrowers who would prefer to negotiate the details of their loan and avoid cumbersome loan procedures will still sometimes obtain their loan through one of the Companies because the interest rates are generally more favorable.[54] "Fannie Mae and Freddie Mac [are] privately owned (for profit) businesses but, because their bonds [are] backed by the federal government, they [are] able to borrow funds at 50 to 75 points cheaper than private lenders."[55] For example, the average loan commitment rate on thirty-year fixed rate loans obtained through Freddie Mac in July 2013 was 4.37%.[56] On the other hand, the national average for this type of loan during the same timeframe was 4.56%.[57] Although this might seem like a somewhat small difference, the Companies purchase loans obtained on large, multimillion dollar apartment complexes in addition to single-family residences.[58] Because of these savings over the life of the loan, some borrowers are willing to give up the negotiability that is traditionally found in the loan process.[59]

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54. *Compare 30-Year Fixed-Rate Mortgages Since 1971*, FREDDIE MAC, http://www.freddiemac.com/pmms/pmms30.htm (last visited Aug. 17, 2013) (showing the monthly average loan commitment rate on 30-year fixed-rate mortgages since 1971), *with Mortgage Interest Rates*, BARCHART.COM, http://www.barchart.com/economy/mortgageallrates.php (last visited Aug. 17, 2013) (showing the average mortgage rate for the last four years).

55. JAMES GWARTNEY, ET AL., SPECIAL TOPIC: CRASH OF 2008, at 6 (2009), *available at* http://commonsenseeconomics.com/wp-content/uploads/CSE_CrashOf2008.pdf.

56. *See 30-Year Fixed-Rate Mortgages Since 1971*, FREDDIE MAC, http://www.freddiemac.com/pmms/pmms30.htm (last visited Aug. 17, 2013).

57. *See Mortgage Interest Rates*, BARCHART.COM, http://www.barchart.com/economy/mortgageallrates.php (last visited Aug. 17, 2013).

58. *See generally Fannie Mae Multifamily Business Homepage*, FANNIE MAE, http://www.fanniemae.com/multifamily/index (last visited Aug. 18, 2013); *Overview*, FREDDIE MAC, http://www.freddiemac.com/multifamily/overview.html (last visited Aug. 18, 2013).

59. *Cf. How Fannie Mae and Freddie Mac Save You Money*, HOUSELOGIC (Jan. 11, 2010), http://www.houselogic.com/home-advice/fannie-mae-freddie-mac/how-fannie-mae-and-freddie-mac-save-you-money/# (stating that "[h]ome owners who use Fannie Mae and Freddie Mac mortgages save thousands of dollars in interest payments each year").

III. THE PRECURSOR: THE HOUSING CRISIS OF 2007-2008

A. THE BUBBLE TAKES SHAPE

Throughout the 1990s, the housing market was relatively stable, but by 2002, home prices rose drastically.[60] In 2006, however, the market began to turn around and was in a free-fall throughout 2007 and 2008.[61] Much scholarly research was conducted to determine the cause of the "housing bubble," but four leading researchers narrowed it down to four simple factors: "(1) relaxed mortgage lending standards, (2) low short-term interest rate policy of the Fed, (3) increased leveraging by investment banks, and (4) increased debt-to-income ratio for households."[62]

1. The Relaxation of Lending Standards

The first factor, a relaxation of lending standards, paved the way for the housing crisis as early as 1995.[63] Although much of the criticism that surrounded the relaxation of the lending standards is placed on the banking industry, this policy change was "the result of federal policy

60. GWARTNEY, ET AL., *supra* note 55, at 4. "Between January 2002 and mid-year 2006, housing prices increased by a whopping 87 percent." *Id.* In the second quarter of 2006, home prices has risen 132 percent over what they were in 1997. *See* Holt, *supra* note 25, at 121. To be sure, empirical data shows that "real house prices had been essentially unchanged for 100 years prior to 1995." Dean Baker, *The Housing Bubble and the Financial Crisis*, 46 REAL-WORD ECONOMIC REV., 73, 73 (2008). Trending similarly as home prices were mortgage defaults. *See* GWARTNEY, ET AL., *supra* note 55, at 4 (stating that the mortgage default rate only fluctuated about 2 percent from 1979 through 2008).

61. *See* GWARTNEY, ET AL., *supra* note 55, at 4.

62. Holt, *supra* note 25, at 121.

63. *See* GWARTNEY, ET AL., *supra* note 55, at 7. According to former Texas Senator Phil Gramm, "[t]he origin of the subprime mortgage blowout that sparked the financial crisis of 2008 and 2009 goes back to the Clinton administration. Dan Weil, *Phil Gramm: Roots of Subprime Mortgage Crisis Extend to Clinton Administration*, MONEYNEWS (Aug. 15, 2013, 8:05 AM), http://www.moneynews.com/PrintTemplate?modeid=520531. More specifically, the Clinton administration issued new regulations to the Community Reinvestment Act that established a quota system whereby lenders were required to "meet numeric goals based on the minority population in" the lender's service area. GWARTNEY, ET AL., *supra* note 55, at 9.

designed to promote more home ownership among households with incomes below the median."[64] Despite this laudable goal, "the federal government imposed a complex set of regulations and mandates that forced various lending institutions to extend more loans to low- and moderate-income households."[65] Put simply, "Congress . . . forced everybody to go and give mortgages to people who were on the cusp [of being able to afford such a mortgage]."[66]

Starting in 1996, the Department of Housing and Urban Development ("HUD") established a new requirement whereby below-median borrowers had to make up at least of 40% of the loans purchased by the Companies.[67] This percentage grew to 56% by 2008.[68] This requirement "caused Fannie and Freddie to relax the standards that mortgages had to meet to be classified as 'conforming' and thus eligible for purchase by Fannie and Freddie."[69] These loans became known as "subprime mortgages."[70] Essentially, "[Congress] . . . pushed Fannie and Freddie to make a bunch of loans that were imprudent."[71]

The Companies were not the only ones pressured to make risky loans. Congress applied this pressure, at least in part, in a passive manner by making it widely known that the Companies were mandated to purchase these uncertain loans from the lenders. Therefore, the

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64. GWARTNEY, ET AL., *supra* note 55, at 6.

65. *Id.* at 7.

66. Steve Denning, *Lest We Forget: Why We Had a Financial Crisis*, FORBES (Nov. 22, 2011, 11:28 AM), http://www.forbes.com/sites/stevedenning/2011/11/22/5086/print/ (quoting then-current New York City Mayor Michael Bloomberg).

67. *See* GWARTNEY, ET AL., *supra* note 55, at 8.

68. *See id.* In a moment of hindsight, the former director of the FHFA has since stated, "The affordable-housing goals set by HUD were, in retrospect, too high and caused both of [the Companies] to do things they shouldn't have done, such as Fannie's getting involved in the subprime market . . . ." Alan J. Heavens, *Stable Market for Housing Still Elusive Despite Programs, Officials Say, Lack of Readiness*, *Joblessness Are Hurting Efforts*, PHILLY.COM (June 21, 2009), http://articles.philly.com/2009-06-21/business/25286384_1_mortgage-servicers-mortgage-broker-hud-approved-counseling-agencies.

69. Holt, *supra* note 25, at 124. Beginning in 1999, the Companies were also required to accept "smaller down payments and extend larger loans relative to income. Denning, *supra* note 66.

70. *See* Baker, *supra* note 60, at 76. "Subprime mortgages [a]re loans issued to people with poor credit histories." *Id.*

71. Denning, *supra* note 66.

originators of the subprime mortgages had little incentive to probe the borrowers' credit history or ability to repay the loans.[72] In other words, the lenders were assured that most of the risk would be borne by the Companies, not the originators.[73]

Additionally, because the subprime mortgages were mixed together with the prime mortgages when the loans were pooled and securitized, "'[n]o one had enough financial skin in the performance of any single loan to care whether it was good or not.'"[74] If one of the mortgages in the pool went into default, it would not be significant enough to affect the overall quality of the pool as a whole.[75] This rationale, however, did not stop with a single subprime mortgage pooled with a bevy of prime ones. Rather, by 2005, the subprime mortgage market accounted for twenty-five percent of the loans made.[76]

2. The Federal Reserve's Uncommonly Low Interest Rate

During the 1970s and 1980s, the Federal Reserve (the "Fed") primarily focused on "price stability."[77] As a result, the inflation rate was relatively low and "monetary policy-makers avoided abrupt year-to-year changes in the general level of prices."[78] The policy-makers' focus

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72. *See* GWARTNEY, ET AL., *supra* note 55, at 8.

73. *See id.* Interestingly, on October 25, 2013, JPMorgan Chase & Co. announced a $5.1 billion settlement for claims that it misled the Companies "about the quality of mortgage securities and home loans it sold to them during the housing boom." Aruna Viswanatha & David Henry, *JPMorgan in $5.1 Billion Deal with Housing Agency*, REUTERS (Oct. 25, 2013), http://in.reuters.com/article/2013/10/26/us-jpmorgan-settlement-idUSBRE99O12820131026.

74. Holt, *supra* note 25, at 124 (quoting MARK ZANDI, FINANCIAL SHOCK: A 360° LOOK AT THE SUBPRIME MORTGAGE IMPLOSION, AND HOW TO AVOID THE NEXT FINANCIAL CRISIS (2009)).

75. *See id.* at 125.

76. *See* Baker, *supra* note 60, at 76. To fully understand why this was a problem, it is necessary to consider the depths of the subprime-mortgage market and what these mortgages entailed. Of the loans purchased by Fannie Mae from 2005 to 2007, "97 percent were interest-only mortgages, 68 percent had original loan-to-value ratios greater than 90 percent, and 67 percent were extended to borrowers with FICO scores lower than 620." GWARTNEY, ET AL., *supra* note 55, at 9.

77. *See* GWARTNEY, ET AL., *supra* note 55, at 10.

78. *Id.* (stating that in the "mid-1980s, the inflation rate had been reduced to 3 percent").

began to shift to market manipulation in the early- to mid-2000s when the Fed began to "control . . . real variables such as employment and real GDP."[79]

As a result of this new focus, the Fed lowered the short-term interest rates and began pumping cash into the economy, particularly into the banking system, thereby allowing lenders to offer unprecedentedly low interest rates.[80] During 2001, the interest rate was reduced eleven times, dropping to a low of 1.75%.[81] Unfortunately, borrowers became extremely shortsighted and never contemplated the notion that the borrower-friendly market may turn around, so they took advantage of the extremely low interest rates by entering into adjustable rate mortgages ("ARMs").[82] Once the interest rates started ticking back up, many of these borrowers were unable to afford their monthly mortgage payments.[83]

3. Investment Banks Began to Heavily Leverage Their Portfolios

In 2008, the Securities and Exchange Commission (the "SEC") "made it possible for investment banks to increase the leverage of their investment capital"[84] by passing the International Convergence of Capital Measurements and Capital Standards, which became known as Basel I.[85] The tenets of Basel I are divided into four "pillars."[86] For

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79. *Id.*

80. *See id.* at 10–11.

81. *See* Holt, *supra* note 25, at 123. These historically low interest rates allowed investors to start leveraging their investments. *See id.* For example, "investors could increase their returns by borrowing at low short-term interest rates and investing in higher yielding long-term investments, such as mortgaged-backed securities." *Id.*

82. *See* GWARTNEY, ET AL., *supra* note 55, at 11. "Adjustable rate mortgages jumped from 17 percent of the total [number of mortgages being made] during 1998-2001 to 33 percent during 2004-2005." *Id.*

83. *See* Holt, *supra* note 25, at 123.

84. GWARTNEY, ET AL., *supra* note 55, at 12. "A leverage ratio is simply the ratio of a firm's debt to its assets." *Id.*

85. *See id.* Basel I was established by the Basel Committee, which is "a group of eleven nations, that, after the messy 1974 liquidation of the Cologne-based Bank Herstatt, decided to form a cooperative council to harmonize banking standards and regulations within and between all member states." Bryan J. Balin, Basel I, Basel II, and Emerging Markets: A Nontechnical Analysis 1 (May 10, 2008) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1477712.

purposes of the housing bubble analysis, however, it is only necessary to consider three of the four pillars.

The third pillar of the Basel I regulations "sets a universal standard whereby 8% of a bank's risk-weighted assets must be covered by Tier 1 and Tier 2 capital reserves."[87] The first pillar defines Tier 1 and Tier 2 Capital.[88] Tier 1 Capital "consists of only two types of funds—disclosed cash reserves and other capital paid for by the sale of bank equity."[89] Tier 2 Capital includes various types of reserves, holdings, and potential gains.[90]

The rub, however, is that Basel I's second pillar "provide[d] more favorable treatment of residential loans."[91] Banks began pooling mortgages together and financing them with securities, and due to the low default rate *leading up to* the housing crash, these securities were considered relatively safe investments.[92] But because many of these home loans were taken out by borrowers who would be unable to make monthly payments once the ARM interest rates started creeping up, these pools were anything but safe.[93] "The money borrowed to purchase these securities was short-term debt, which meant that it had to be paid back very quickly. When the value of the mortgage-backed securities collapsed, the highly levered investment banks faced massive short-term debt obligations with few reserves on which to draw."[94]

4. Homeowners Bit Off More than They Could Chew

Starting in 1950, and for the next thirty years, "household debt as a share of disposable (after-tax) income ranged from 40 percent to 60 percent."[95] In 2007, however, household debt peaked at 135%.[96] Because mortgage interest payments are tax deductible and many

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86. *See* Balin, *supra* note 85, at 3.
87. *Id.*
88. *See id.*
89. *Id.*
90. *See id.*
91. GWARTNEY, ET AL., *supra* note 55, at 12.
92. *See id.* at 12–13.
93. *See id.* at 13.
94. *Id.*
95. *Id.* at 14.
96. *See id.*

outstanding loans at the time were structured as ARMs, many homeowners held much of their debt in their homes and did not increase the homes' equity.[97] Therefore, when the interest rates started going up, these homeowners simply walked away from their would-be investments.[98] Because most lenders do not want to keep foreclosed residences on their books, they began selling those residences at discounted rates, thereby depressing the housing market as a whole.[99]

B. THE FEDERAL GOVERNMENT REACTS TO THE BUBBLE'S POP BY PASSING HERA

The above factors eventually caused the housing bubble to pop, and the Companies "suffered significant book losses and a substantial decline in value."[100] Because the Companies were unsure as to the extent of the losses, they began recording losses on their balance sheets before the losses were actually incurred.[101] Naturally, Congress grew concerned over the extensive losses and decided to take action.[102]

Congress responded by enacting the Housing and Economic Recovery Act of 2008 ("HERA"),[103] which established the Federal Housing Finance Agency (the "FHFA") to oversee the Companies.[104] HERA also empowered the FHFA to place the Companies into conservatorship and to "take such action as may be—(i) necessary to put

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97. *See id.*

98. *See id.* "[T]he foreclosure rate for subprime borrowers [was] approximately 10 times higher for fixed rate mortgages and 7 times higher for adjustable rate mortgages." *Id.* at 15.

99. *See The Impact of Foreclosures on the Housing Market*, FED. RESERVE BANK OF CLEVELAND, *available at* http://www.clevelandfed.org/research/commentary/2010/2010-15.cfm (last visited Jan. 22, 2014).

100. Fairholme Funds D.D.C Complaint, *supra* note 12, ¶ 38.

101. *See id.* This method of adjusting one's balance sheets is acceptable under Generally Accepted Accounting Principles. *See id.* Pursuant to this method of accounting, Fannie Mae showed losses of $72 billion in 2009 and Freddie Mac booked losses of $50 billion in 2008. *Id.*

102. *See infra* notes 103-109 and accompanying text.

103. *See* Complaint ¶ 42, Fairholme Funds, Inc. v. United States, No. 1:13-cv-00465-MMS (Fed. Cl. July 9, 2013) [hereinafter Fairholme Funds Fed. Cl. Complaint]; Housing & Econ. Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654; *see also* 12 U.S.C. §§ 1455, 1719, 4617 (2012).

104. *See* Fairholme Funds D.D.C Complaint, *supra* note 12, ¶ 38.

the regulated entity in a sound and solvent condition, and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity."[105] On September 6, 2008, the FHFA did just that: it placed the Companies into conservatorship.[106] In doing so, the FHFA had "to continue the operations of [the] regulated entit[ies], rehabilitate [them] and return [them] to a safe, sound and solvent condition."[107]

In addition to conservatorship, HERA permits the United States Treasury (the "Treasury") to purchase specially issued government stock

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105. 12 U.S.C. § 4617(b)(2)(D). HERA set forth several acceptable grounds under which the Companies may be placed into conservatorship or receivership. 12 U.S.C. § 4617(a)(3)(A)-(L). Some of the plaintiffs are claiming that merely placing the Companies into conservatorship was inappropriate because none of the statute's grounds were satisfied. *See* Washington Federal Complaint, *supra* note 30, ¶¶ 91–152 (providing an in-depth analysis of how the Companies failed to meet any of HERA's threshold requirements before they could be placed into conservatorship or receivership).

106. *See* Fairholme Funds D.D.C Complaint, *supra* note 12, ¶ 40. James B. Lockhart, the FHFA Director at the time of placing the Companies into conservatorship, described conservatorship as "a statutory process designed to stabilize a troubled institution *with the objective of returning the entities to normal business operations*." Press Release, Federal Housing Finance Agency, Statement of FHFA Director James B. Lockhart (Sept. 7, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Documents/ fhfa_statement_090708hp1128.pdf (emphasis added). Conservatorship should be contrasted with the act of placing the Companies into *receivership* under the statute because this requires that the FHFA liquidate the Companies. *Compare* 5 U.S.C. § 4617(b)(2)(B), (D) *with* 5 U.S.C. § 4617(b)(2)(E).

Some of the plaintiffs contend that the government's motives for placing the Companies into conservatorship were not entirely pure, arguing that the federal government used the Companies to unload the "toxic debt" plaguing other financial institutions. *See* Washington Federal Complaint, *supra* note 30, ¶¶ 74–78. The Companies "were forced to assume more risky assets and increase their overall exposure to additional, future losses by guaranteeing even more MBS, all in order to support other financial institutions and facilitate the Government's public policy objectives." *Id.* ¶ 14. Bolstering this argument, Henry Paulson, Secretary of the Treasury, explained in 2011, "[W]e really need to use Fannie Mae and Freddie Mac to do anything that's reasonable to provide financial support to the mortgage market." Brian Bolduc, *Paulson's Down Payment*, NAT'L REV. ONLINE (Nov. 18, 2011), http://nationalreview.com/articles/283465/paulson-s-down-payment-brian-bolduc.

107. Conservatorship & Receivership, 76 Fed. Reg. 35,724, 35,730 (June 20, 2011) (codified at 12 C.F.R. § 1237 (2013)).

in the Companies.[108] Under this authority, the Treasury entered into preferred stock purchase agreements ("PSPA") with the Companies whereby the "Treasury purchased 1 million shares of Government Preferred Stock from each of the Companies in exchange for allowing them to draw up to $100 billion each from [the] Treasury."[109] Importantly, this Government Preferred Stock ("GPS") is senior to all other outstanding stock in the Companies.[110]

As consideration for purchasing the GPS, the Treasury was to receive "$1 billion of senior preferred stock in each" of the Companies as well as warrants that would permit the Treasury to purchase up to 79.9% of the common stock of each of the Companies.[111] Moreover, the GPS accumulated a 10% dividend annually.[112]

Soon after the PSPA was executed, the Companies began drawing on their lines of credit with the Treasury,[113] and over the next three years, the Companies borrowed a combined total of approximately $189.4 billion from the Treasury.[114] Some contend, however, that a large portion of this borrowed money was unnecessarily loaned because large amounts of the Treasury's funds were used to cover the book

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108. *See* 12 U.S.C. §§ 1455(*l*)(1)(A), 1719(g)(1)(A) (2012).

109. Complaint and Prayer for Declaratory & Injunctive Relief ¶ 36, Perry Capital LLC v. Lew, No. 1:13-cv-01025 (D.D.C. July 7, 2013) [hereinafter Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief]; *see also* AMENDED & RESTATED SENIOR PREFERRED STOCK PURCHASE AGREEMENT, U.S. DEP'T OF THE TREASURY & FED. NAT'L MORTG. ASS'N, ¶ 6 (Sept. 26, 2008), *available at* http://www.fhfa.gov/webfiles/23898/seniorpreferredstockpurchaseagreementfnm1.pdf; AMENDED & RESTATED SENIOR PREFERRED STOCK PURCHASE AGREEMENT, U.S. DEP'T OF THE TREASURY & FED. HOME LOAN MORTG. CORP., ¶ 3 (Sept. 26, 2008), *available at* http://www.fhfa.gov/webfiles/23900/seniorpreferredstockpurchaseagree mentfrea.pdf.

110. *See* Henry Paulson, Secretary, Dep't of Treasury, Announcement Regarding Fannie Mae & Freddie Mac (Sept. 7, 2008), *available at* http://money.cnn.com/2008/09/07/news/economy/paulsonstatement/; *see also* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 43.

111. *Fact Sheet: Treasury Senior Preferred Stock Purchase Agreement*, U.S. TREASURY OFFICE OF PUB. AFFAIRS, 30 (Sept. 7, 2008), http://www.fhfa.gov/ webfiles/23896/pspa_factsheet_090708%20.pdf [hereinafter *Treasury Fact Sheet*].

112. *See id.* While the GPS was outstanding, the Companies were not permitted to issue any dividends except to the Treasury. *Id.*

113. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 52.

114. *See id.* ¶ 60.

losses,[115] which proved to be excessive,[116] and to pay the Treasury its 10% dividend.[117]

In any event, the Treasury funding, combined with a rebounding housing market,[118] allowed the Companies to stay afloat, and after three years of conservatorship, the Companies began to generate profits.[119] Fannie Mae, in the second quarter of 2012, reported a $2.8 billion profit, which accounted for its dividend obligations to the Treasury.[120] Similarly, Freddie Mac reported a $2.9 billion profit during the same timeframe.[121]

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115. *See supra* text accompanying note 101.

116. *See, e.g.*, Cacciapalle Class Action Complaint, *supra* note 15, ¶ 51.

> [B]etween the beginning of 2007 and the second quarter of 2012, the Companies had placed more than $234 billion in reserve to absorb anticipated loan losses. But over the same time period, the Companies had realized loan losses of just over $125 billion. In other words, the Companies had overstated their projected loan losses by $109 billion which was artificially weighing down their net worth.

Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶ 44.

117. Cacciapalle Class Action Complaint, *supra* note 15, ¶ 51. According to one of the complaints filed against the federal government, "since 2010, but for the dividends the Companies were required to pay the Treasury under the Stock Agreements, the Companies would not have needed the Treasury to provide additional capital by purchasing additional stock at all." Washington Federal Complaint, *supra* note 30, ¶ 157.

118. *See* Jarkko Turunen, *The U.S. Housing Market's Road to Recovery*, ECONOMONITOR (Aug. 2, 2013), http://www.economonitor.com/blog/2013/08/the-u-s-housing-markets-road-to-recovery/.

119. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶¶ 62, 66.

120. *See* FED. NAT'L MORTG. ASS'N, FORM 10-Q, at 3 (2012), *available at* http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/q22012.pdf; *see also* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 64.

121. *See* FED. NAT'L MORTG. ASS'N, FORM 10-Q, *supra* note 120; *see also* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 66.

C. THE FHFA AND TREASURY IMPLEMENT THE "NET WORTH SWEEP" AND ATTEMPT TO SHUTTER THE COMPANIES

Even though the Companies appeared to be returning to profitability, which led private investors to believe that they would soon begin to receive dividends on their stock in the Companies again, the FHFA and Treasury plotted a different course for the Companies. On August 17, 2012, the Treasury announced an amendment to the PSPA whereby the 10% dividend that the Treasury had been receiving on its GPS[122] would be replaced with all of the Companies' profits.[123] This amendment has been termed the "Net Worth Sweep."[124] Pursuant to the Net Worth Sweep, the Companies, starting on January 1, 2013, have been making quarterly dividend payments to the Treasury in the amount of their profits, "minus a capital reserve that starts at $3 billion and decreases to $0 by January 1, 2018."[125] To be sure, in a press release that coincided with the Net Worth Sweep, the Treasury flatly stated that the Net Worth Sweep "will replace the 10 percent dividend payments made to Treasury on its preferred stock investments in Fannie Mae and Freddie Mac with a quarterly sweep of every dollar of profit that each firm earns going forward."[126]

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122. *See supra* text accompanying note 112.

123. *See* U.S. DEP'T OF THE TREASURY & FED. NAT'L MORTG. ASS'N, THIRD AMENDMENT TO AMENDED & RESTATED SENIOR PREFERRED STOCK PURCHASE AGREEMENT ¶ 3 (2012), *available at* http://www.treasury.gov/press-center/press-releases/Documents/Fannie.Mae.Amendement.pdf [hereinafter Fannie Mae Net Worth Sweep]; U.S. DEP'T OF THE TREASURY & FED. HOME LOAN MORTG. CORP., THIRD AMENDMENT TO AMENDED & RESTATED SENIOR PREFERRED STOCK PURCHASE AGREEMENT ¶ 3 (2012), *available at* http://www.treasury.gov/press-center/press-releases/Documents/Freddie.Mac.Amendment.pdf [hereinafter Freddie Mac Net Worth Sweep].

124. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 71.

125. *Id.*

126. Press Release, U.S. Dep't of the Treasury, Treasury Dep't Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac (Aug. 17, 2012), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx [hereinafter Treasury 2012 Press Release]. According to the Treasury, the Companies profits will be seized and used to benefit taxpayers for their investment in the Companies. *See id.*

Moreover, increased profit for the Treasury was not the singular aim of the Net Worth Sweep.[127] The Net Worth Sweep was also designed to force the Companies out of the housing market because, according to the press release,[128] another objective of the Net Worth Sweep is that the Companies "will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form."[129] In addition to seizing the Companies' profits and to further facilitate this winding down process, the Companies are also required to "accelerate [the] reduction of [their] investment portfolios."[130] This announcement understandably caused the stock prices of the Companies to plummet over 50% the day following this announcement.[131]

IV. The Private Investors React to the Net Worth Sweep: An Analysis of the Claims Against the Federal Government

Approximately one year following the Treasury's announcement of the Net Worth Sweep, the private investors filed suits against the FHFA, the Treasury, the United States, and various individuals in the federal government.[132] Each filed complaint alleges one or more similar claims against the federal government, including: unconstitutional taking under the Fifth Amendment;[133] FHFA action without proper authority;[134]

127. *See id.*

128. *See id.*

129. *Id.*

130. *Id.* "Those portfolios will now be wound down at an annual rate of 15 percent – an increase from the 10 percent annual reduction required in the previous agreements." *Id.*

131. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 77.

132. *See* Cacciapalle Class Action Complaint, *supra* note 15; Fairholme Funds Fed. Cl. Complaint, *supra* note 103; Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109; Fairholme Funds D.D.C Complaint, *supra* note 12. The plaintiffs in these lawsuits are those that purchased one of several classes of junior preferred stock in the Companies. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 19; Fairholme Funds Fed. Cl. Complaint, *supra* note 103, ¶ 17; Washington Federal Complaint, *supra* note 30; Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶ 25; Fairholme Funds D.D.C Complaint, *supra* note 12, ¶ 18.

133. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 78–94; Fairholme Funds Fed. Cl. Complaint, *supra* note 103, ¶¶ 76-88.

improper FHFA conduct under the Administrative Procedure Act;[135] action by the Treasury without proper authority;[136] improper conduct by the Treasury under the Administrative Procedure Act;[137] breach of contract against the FHFA;[138] breach of implied covenant of good faith and fair dealing against FHFA;[139] and breach of fiduciary duty against FHFA in its role as conservator of the Companies.[140] This Part explains each of these claims and their likelihood of success.

A. UNCONSTITUTIONAL TAKING UNDER THE FIFTH AMENDMENT

Three of the lawsuits filed in 2013 contend that the federal government unconstitutionally appropriated the investors' property by enacting the Net Worth Sweep.[141] The Fifth Amendment of the United States Constitution provides that "[n]o person shall . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."[142] Accordingly, the plaintiffs in these three suits argue that, because the federal government amended the PSPA in a way that would prevent the private stockholders from receiving a dividend on the privately owned

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134. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶¶ 79–87; Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 84–93.

135. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶¶ 88–94; Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 94–99.

136. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶¶ 58–68; Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 100–10.

137. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶¶ 69–78; Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 111–20.

138. *See* Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 121–28.

139. *See id*. ¶¶ 129–35.

140. *See id*. ¶¶ 136–145.

141. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶¶ 78–94; Fairholme Funds Fed. Cl. Complaint, *supra* note 103, ¶¶ 76–88; Washington Federal Complaint, *supra* note 30, ¶¶ 187–88.

142. U.S. CONST. amend. V.

stock, the stockholders were unconstitutionally deprived of their property.[143]

The largest potential hurdle with this count that these plaintiffs will need to clear is whether the federal government took *property*. Unlike in straightforward eminent domain actions, the federal government did not seize a tangible piece of property in these cases. Rather, the Net Worth Sweep interrupted the *right to receive* future payments. Therefore, these plaintiffs must establish that this right constitutes "property" under the Fifth Amendment.

"The Constitution neither creates nor defines the scope of property interest compensable under the Fifth Amendment."[144] Therefore, it is necessary to look to the laws that purportedly establish the property rights of the thing being seized by the government[145] as well as the "'existing rules and understandings' and 'background principles' derived from independent sources, such as *state*, federal, or common law."[146] Because the federal courts should look to state law to determine whether property rights were created, one must examine the claims over Freddie Mac stock separate from those involving Fannie Mae stock.[147]

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143. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶¶ 78–94; Fairholme Funds Fed. Cl. Complaint, *supra* note 103, ¶¶ 76–88; Washington Federal Complaint, *supra* note 30, ¶¶ 187–88.

144. Members of Peanut Quota Holders Ass'n, Inc. v. United States, 421 F.3d 1323, 1330 (Fed. Cir. 2005) (quoting Conti v. United States, 291, F.3d 1090, 1340 (Fed. Cir. 2001) (citing Bd. of Regents of Colls. v. Roth, 408 U.S. 564, 577 (1972))).

145. *See id.* (citing *Roth*, 408 U.S. at 577–78).

146. *Id.* (citing Lucas v. S.C. Coastal Council, 505 U.S. 1003, 1030 (1992)) (emphasis added). "The Court . . . frequently has taken a very positivist approach [to defining property], looking to the state law defining the property interest, in deciding whether there is property under the Constitution." ERWIN CHEMERINSKY, CONSTITUTIONAL LAW 658 (3d ed. 2006).

There is a possibility that the reviewing court would eschew the application of state law by holding that, because the Companies are government-sponsored entities, federal law should apply. The problem with this line of thought is that the quasi-public natures of the Companies are rare, and there does not appear to be much federal case law or statutes that will shine light on the issue of whether stock rights are considered "property" under the Constitution's Fifth Amendment. Therefore, unless the court is willing to unnecessarily create new case law, it will most likely look to the states that govern the relationship between the Companies and their respective shareholders.

147. An examining court should consider "whether the citizen had the rights to exclude, use, transfer, or dispose of the property." *Members of Peanut Quota Holders*

1. Stock Dividends Pursuant to Fannie Mae Preferred Stock

Before Fannie Mae was placed into conservatorship, several different series of preferred stock were issued for purchase by private investors.[148] Each series, however, contained a similar Certificate of Designation that created the stockholders' dividend rights under the preferred stock.[149] These certificates held:

> Holders of record of [the particular series of] Preferred Stock (each individually a "Holder," or collectively the "Holders") will be entitled to receive, ratably, when, as and *if declared by the Board of Directors, in its sole discretion* out of funds legally available therefore, *non-cumulative* cash dividends at [the specified percentage rate] per annum of the [specified] stated value . . . per share of [the particular series of] Preferred Stock.[150]

Delaware law, which should govern in the transactions between Fannie Mae and its stockholders,[151] is renowned for providing much flexibility to those businesses operating under Delaware law.[152] The Delaware General Corporation Law allows businesses and their shareholders to regulate their own affairs and allocate risks as they see fit.[153] Delaware law, however, has long provided that *under certain circumstances*, the right to receive dividends is considered "property" that is, therefore, protected under the Fifth Amendment.[154]

Ass'n, Inc., 421 F.3d at 1330 (citing United States v. Gen. Motors, 323 U.S. 373, 378 (1945)).

148. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 34.

149. *See id.* ¶ 36.

150. *Id.* (omissions in original) (emphasis added).

151. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶ 75.

152. *See* LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE 1–2 (2007), *available at* http://corp.delaware.gov/pdfs/whycorporations_english.pdf.

153. *See id.* at 2.

154. *See* Keller v. Wilson & Co., 190 A. 115, 125 (Del. 1936) (holding that "a just public policy, which seeks the equal and impartial protection of the interests of all, demands that the right [of a holder of *cumulative* preferred stock to unpaid dividends] be regarded as a vested right of property secured against destruction by the Federal and State Constitutions") (emphasis added).

The Delaware cases that deem cash dividends as "property" have a similar element that appears to be missing from the cases at hand. In the previous cases, the stocks in question were deemed *cumulative*.[155] When stock is "cumulative" in nature, it "means that if dividends are not paid in any year, the obligation accumulates."[156] Therefore, the holder of cumulative stock has a vested and established right to receive a dividend, even if a dividend was not declared[157] to occur at a particular time. If no dividend is declared, the corporation's obligation to pay that dividend continues until the dividend is, in fact, declared and paid.[158]

Unfortunately for the Fannie Mae preferred stockholders, their stock is explicitly *noncumulative* and declared only in the Board of Director's "sole discretion."[159] Therefore, these stockholders' right to receive dividend payments has not vested. Their right to receive payment is merely speculative until declared, and this right to payment does not compound if Fannie Mae chooses to not declare a dividend. It appears that no Delaware court has ruled on whether noncumulative, undeclared dividends constitute property.[160]

Accordingly, there appears to be a strong indication that a Delaware court would most likely find that the right of the Fannie Mae preferred stockholders to noncumulative, undeclared dividends does not constitute "property" under the Fifth Amendment that would entitle

155. *See*, *e.g.*, Shanik v. White Sewing Mach. Corp., 19 A.2d 831, 834–35 (Del. 1941) (citing and analyzing several Delaware cases wherein the courts found accumulated dividends to be property).

156. *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 306 (10th ed. 2007).

157. A "declared dividend" is a dividend that has been approved by a corporation's board of directors but has yet to be paid to the stockholders. *See* 18 C.J.S. *Corporations* § 366. Once declared, the dividend becomes a debt payable to the shareholders. *See id.*

158. *See* KLEIN & COFFEE, *supra* note 156, at 306. For example, XYZ Corp. pays a cumulative dividend of $500 to each of its preferred stockholders at the end of each year. If this dividend is not paid one year, the obligation rolls into the following year. Now, at the end of the next year, the obligation to each of the preferred shareholders stands at $1,000.

159. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 36.

160. *Cf.* Garrett v. Edge Moor Iron Co., 194 A. 15, 17 (Del. Ch. 1937) (explicitly avoiding an analysis of whether noncumulative dividends are considered property).

those stockholders to compensation due to the federal government's interference with that right.[161]

2. Stock Dividends Pursuant to Freddie Mac Preferred Stock

As with Fannie Mae, Freddie Mac issued several series of preferred stock with similar Certificates of Designation before being placed into conservatorship.[162] These certificates, which are, in pertinent part, substantively similar to Fannie Mae's, state: "[h]olders of outstanding shares of Non-Cumulative Preferred Stock shall be entitled to receive, ratably, when, as and if declared by the Board of Directors, in its sole discretion, out of funds legally available therefore, *noncumulative* cash dividends at the [specified] annual rate per share of Non-Cumulative Preferred Stock."[163] Unlike with Fannie Mae, however, the analysis of whether the Freddie Mac preferred stockholders have a viable claim under the Fifth Amendment focuses on Virginia law.[164]

Virginia, unlike Delaware, appears to consider dividends, which are payable even on cumulative stock, to *not* be a vested property right.[165] Rather than focusing on the cumulative or noncumulative nature of dividends, Virginia law looks at the "right to demand payment of cumulated undeclared dividends."[166] Therefore, a plaintiff making a property-based claim in Virginia would most likely need to show that he or she had the right to demand a dividend or to the funds out of which the dividends would be paid.[167] A Virginia court would consider the property right to be vested only if such a claim could be made.[168]

Because Delaware is home to many corporations,[169] it has had more opportunities than most other states, including Virginia, to weigh in on

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161. *See supra* notes 148–160 and accompanying text.
162. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 35.
163. *Id.* ¶ 37 (emphasis added).
164. *Cf.* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶ 75.
165. *See* O'Brien v. Socony Mobil Oil Co., 152 S.E. 2d 278, 286–87 (Va. 1967).
166. *Id.* at 286.
167. *See id.*
168. *See id.* at 287.
169. *See* Jan Ting, *Why Do So Many Corporations Choose to Incorporate in Delaware?*, NEWSWORKS (Apr. 27, 2011), http://www.newsworks.org/index.php/

the complexities of the modern business and securities landscape. Accordingly, should the Virginia courts wish to change their stance on the issue of whether certain dividends may qualify as property, it would not be surprising if they were to take a similar position to Delaware's.[170] In any event, however, it is unlikely that the holders of Freddie Mac stock would be able to successfully make a Fifth Amendment taking claim using Virginia law's definition of property because they are unable to prove that they had a right to demand a dividend or to the funds out of which a dividend might have been paid.[171]

3. Liquidation Rights Pursuant to the Companies' Preferred Stock

In addition to claiming that the federal government took their right to receive stock dividends, the plaintiffs also assert a claim that their liquidation rights were impermissibly taken under the Fifth Amendment.[172] Unlike the above claim, which turns on whether property was taken, the sticking point regarding the liquidation rights is whether any property was actually "taken" by the federal government.

Again, an actionable claim under the Fifth Amendment's Taking Clause[173] requires a physical or regulatory taking.[174] Obviously, there cannot be a physical taking of an economic right. Therefore, it is necessary to determine whether the federal government issued a regulation that caused there to be "no reasonable economically viable use of [the] property."[175] The rub, however, is determining when a regulation is burdensome enough to constitute a taking and when it merely results in property devaluation.[176] The Supreme Court admitted the difficulty in drawing this line:

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local//brandywine-to-broad/18206-why-do-so-many-corporations-choose-to-incorporate-in-delaware.

170. *See generally id.*

171. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 35.

172. *See id.* ¶¶ 78-94; Fairholme Funds Fed. Cl. Complaint, *supra* note 103, ¶¶ 76–88.

173. U.S. CONST. amend. V.

174. *See* CHEMERINSKY, *supra* note 146, at 640.

175. *Id.*

176. *See id.* at 646.

> [W]e have eschewed the development of any set formula for identifying a "taking" forbidden by the Fifth Amendment, and have relied instead on *ad hoc*, factual inquiries into the circumstances of each particular case. To aid in this determination, however, we have identified three factors which have "particular significance": (1) "the economic impact of the regulation on the claimant"; (2) "the extent to which the regulation has interfered with distinct investment-backed expectations"; and (3) "the character of the governmental action."[177]

This discretionary standard makes it rather difficult to predict how a court would rule on the question of whether there was a taking. As a general rule, however, courts tend to "focus[] on the economic effect of the government regulations and the extent to which they interfere with reasonable expectations of the property owner."[178]

In this instance, the issuance of the Net Worth Sweep, in effect, removed all economic value of the preferred stockholders' liquidation preference.[179] Because the FHFA is liquidating the Companies in a way that make the private investors unable to obtain the benefit of their bargained-for liquidation rights,[180] the liquidation rights are worthless.[181] Therefore, if the Companies are, in fact, put out of business, the preferred stockholders should be permitted to obtain the benefit of their bargain with the Companies by receiving a liquidation preference because the FHFA's action appears to constitute a taking under the Fifth Amendment.[182]

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177. Connolly v. Pension Benefit Guar. Corp., 475 U.S. 211, 224–25 (1986) (quoting Penn Cent. Transp. Co. v. New York City, 438 U.S. 104, 124 (1978)).

178. CHEMERINSKY, *supra* note 146, at 647. In other words, does the regulation leave a "reasonable economically viable use of the property?" *Id.*

179. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶¶ 36, 67 (indicating that the Treasury's liquidation right is superior to those held by the private investors and that the Net Worth Sweep has made privately held securities worthless).

180. By siphoning off every bit of the Companies' assets, there will likely be nothing upon a final liquidation-based distribution to distribute to the preferred stockholders. *See* Fairholme Funds Fed. Cl. Complaint, *supra* note 103, ¶ 70. It is worth pointing out that if the stockholders are not given their liquidation preference, the Treasury could "receive $189.5 billion as a result of the potential liquidation of the Companies." *See* Washington Federal Complaint, *supra* note 30, ¶ 160.

181. *See supra* note 179.

182. *See supra* notes 172–81 and accompanying text.

B. THE CLAIMS UNDER THE ADMINISTRATIVE PROCEDURE ACT

This Sub-Part discusses the claims that the plaintiff-stockholders of the Companies make on grounds provided by the Administrative Procedure Act ("APA").[183] The APA contains the overall framework that governs how federal agencies must conduct their affairs.[184] It also incorporates its own set of review procedures to guide federal courts on claims brought pursuant to the APA.[185] These procedures include various grounds for a reviewing court to use in deciding whether to overturn an agency's action.[186] The plaintiffs are likely to prevail against both the FHFA and the Treasury on both of the asserted APA grounds: (1) exceeding statutory authority and (2) arbitrary and capricious action.

1. Exceeding Statutory Authority

The APA holds, in pertinent part: "[t]he reviewing court shall . . . (2) hold unlawful and set aside agency action, findings, and conclusions found to be . . . (C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right."[187] Simply put, "[a]n agency's power is not greater than that delegated to it by Congress."[188] It follows, then, that any agency action taken outside of the agency's statutory grant of power is *ultra vires*[189] and should, therefore, be overturned by the reviewing court.[190]

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183. Administrative Procedure Act, 5 U.S.C. §§ 551–59 (2012).
184. *See id.*
185. *See id.* §§ 701–06.
186. *See id.* § 706.
187. *Id.* § 706(2)(C).
188. Lyng v. Payne, 476 U.S. 926, 937 (1986).
189. "*Ultra vires*" action is anything that is "[u]nauthorized" or "beyond the scope of power allowed or granted . . . by law." BLACK'S LAW DICTIONARY 1662 (9th ed. 2009).
190. Transohio Sav. Bank v. Dir., Office of Thrift Supervision, 967 F.2d 598, 621 (D.C. Cir. 1992) (citing 5 U.S.C. § 701, 706(2)(C); WALTER GELLHORN ET AL., ADMINISTRATIVE LAW 66 (8th ed. 1987)).

When determining whether an agency action is *ultra vires*, courts must look to the agency's enabling statute[191] and compare "the claimed excessive action [against] the pertinent statutory authority."[192] To make this comparison, the *Chevron* test, first set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*,[193] will most likely be implemented.[194] The *Chevron* test is a two-step analysis in which the reviewing court must first establish whether "Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[195] "To decide whether Congress has addressed the precise question at issue, the court analyzes the text, purpose, and structure of the statute. When the statute is not ambiguous, the text controls and no deference is extended to the agency's interpretation in conflict with the text."[196] If, however, the statute is ambiguous and does not directly address the issue at hand, the court must look to the agency's action to determine whether it is "based on a permissible construction of the statute."[197]

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191. *See* Univ. of D.C. Ass'n/NEA v. D.C. Fin. Responsibility & Mgmt. Assistance Auth., 163 F.3d 616, 620–21 (D.C. Cir. 1998).

192. W. Union Tel. Co. v. Fed. Commc'n Comm'n, 541 F.2d 346, 354 (3d. Cir. 1976).

193. 467 U.S. 837 (1984).

194. *See id*. at 842–43.

195. *Id*.

196. Adirondack Med. Ctr. v. Sebelius, 891 F. Supp. 2d 36, 43 (D.D.C. 2012) (citing Chase Bank U.S.A., N.A. v. McCoy, 131 S.Ct. 871, 882 (2011); Ranbaxy Labs. Ltd. v. Leavitt, 469 F.3d 120, 124 (D.C. Cir. 2006)) (citations omitted).

197. *Chevron*, 467 U.S. at 843. Under the *Chevron* test, "a court determines the level of deference due to the agency's interpretation of the law it administers." *Adirondack*, 891 F. Supp. 2d at 43 (citing Mount Royal Joint Venture v. Kempthorne, 477 F.3d 745, 754 (D.C. Cir. 2007)).

a. The FHFA Exceeded Its Statutory Authority: The Exclusivity Concept

On September 7, 2008, the FHFA placed the Companies into conservatorship.[198] Upon doing so, the FHFA, as the conservator, was permitted to take any action "necessary to put the [Companies] in a sound and solvent condition."[199] The preferred stockholders contend that the Net Worth Sweep is not only outside the scope of the FHFA's authority as conservator but is in direct contravention of the FHFA's responsibilities as conservator of the Companies because the ability to wind down the Companies is only available to the FHFA when acting as a receiver.[200]

Under the *Chevron* test, the first step is to determine whether HERA[201] clearly grants the FHFA the authority to enact the Net Worth Sweep.[202] Upon a plain-meaning interpretation, HERA does appear to contain the requisite statutory authority for the FHFA to enter into the Net Worth Sweep with the Treasury and to liquidate the Companies.[203] This power, however, may only be exercised if the FHFA is acting as the *receiver* of the Companies.[204] If the Companies are only placed in *conservatorship*, which is what then-current FHFA Director James B. Lockhart announced in 2008,[205] the FHFA was limited to operating and preserving the Companies.[206] Moreover, the FHFA had stated that the

198. *See supra* notes 106–107 and accompanying text.

199. 12 U.S.C. § 4617(b)(2)(D) (2012).

200. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶¶ 79–87; Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 84–93. Again, it should be reemphasized that the Net Worth Sweep was intended to "wind[] down Fannie Mae and Freddie Mac." *See* Treasury 2012 Press Release, *supra* note 126.

201. *See supra* text accompanying notes 103–107.

202. *See Chevron*, 467 U.S. at 842–43; *see also supra* notes 103–107 and accompanying text.

203. *See* 5 U.S.C. § 4617(b)(2)(E).

204. *See id.* HERA holds that when FHFA "is *acting as receiver*, [FHFA] shall place the regulated entity in liquidation and proceed to realize upon the assets of the regulated entity in such manner as [FHFA] deems appropriate." *Id.*

205. *See supra* note 106 and accompanying text.

206. *See* 12 U.S.C. §§ 4617(b)(2)(B), (D).

Companies were placed in conservatorship, as opposed to receivership.[207]

Furthermore, in 2011, when the final rules "establishing a framework for conservatorship and receivership operations"[208] were being promulgated under the rulemaking process, the FHFA responded to the private-investor shareholders' concerns regarding the conservatorship and receivership frameworks[209] by issuing the following:

> The ultimate responsibility of FHFA as receiver is to resolve and liquidate the existing entity. 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. While operating an entity in conservatorship, continuation of the mission of the institution and fostering liquid, efficient, competitive and resilient national housing markets may be in the regulated entity's best interest, and are consistent with the Safety and Soundness Act's provisions governing operating entities. These activities of a conservator may not be aligned with the ultimate duty of a receiver, although in the process of finally resolving a regulated entity FHFA will need to strike the proper balance between continuing certain operations pending liquidation and terminating other operations. This balance may include temporarily operating in support of the failed institution's mission. FHFA agrees with the [private investors] that some activities appropriate in conservatorship are less consistent with a receivership.[210]

Clearly, then, the FHFA understood that it had available two separate arrays of authority under HERA: conservatorship and receivership.[211]

While some of the powers in these separate arrays of authority might not remain exclusively within only one array, some powers must.

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207. *See* 76 Fed. Reg. 35,724, 35,724–25 (June 20, 2011).

208. *Id.* at 35,724.

209. *See id.* at 35,730–31. It should be noted that HERA gave the FHFA the authority to place the Companies into receivership and provided a skeletal set of guidelines; however, the final rules promulgated by the FHFA developed these base rules by expounding upon what Congress had already laid out. *See supra* notes 103–105, 207–208 and accompanying text.

210. 76 Fed. Reg. at 35,730.

211. *See id.*

In this case, it is wholly inconsistent with the purpose and responsibilities of conservatorship to cause the Companies to liquidate their assets and begin closing them down.[212] This exclusivity concept is evidenced in the FHFA's final rule that sets forth eight separate powers that may be exercised by the agency whether it is acting as conservator or receiver for the Companies.[213] Conversely, the power to liquidate the Companies and employ any of the other receivership provisions is reserved for when the FHFA is specifically acting as the receiver for the Companies.[214]

Because this power to liquidate the Companies is reserved only for an entity acting as a *receiver*, it is difficult to perceive how a court reviewing the FHFA's actions in the agency's role as *conservator* of the Companies would find that the FHFA acted properly in liquidating two enterprises that showed strong indications of sustained growth and profits.[215] Conceivably, a court might find that by instituting the Net Worth Sweep, the Companies were being transitioned from conservatorship to receivership, which is permitted under the rules.[216] Placing a profitable business into receivership, however, makes little economic sense. Moreover, the transitioning argument could be countered by contending that even though the supposed transition to receivership is generally permitted under the rules, it would be impermissible, as conservator, for the FHFA to place *profitable* enterprises into receivership[217] because the FHFA's goal, as conservator,

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212. *Cf. id.* Under the Federal Regulations, the role of the conservator of the Companies is to "rehabilitate [the Companies] and return [them] to a safe, sound and solvent condition." *Id.* Obviously, this is not possible if the Companies are, instead, shut down.

213. *See* 12 C.F.R. § 1237.3(a), (c) (2013).

214. *Cf.* 12 C.F.R. § 1237.3(b) (stating that "[t]he [FHFA], as receiver, shall place the [Companies] in liquidation, employing the additional powers expressed in 12 U.S.C. 4617(b)(2)(E)).

215. *See supra* notes 118–121 and accompanying text.

216. *Cf.* 12 C.F.R. § 1237.4 (discussing the accounting of expenses "[i]f a receivership immediately succeeds a conservatorship").

217. The profitable Companies' situations should be contrasted to a failed conservatorship. In other words, once the Companies became profitable under the conservatorship, the conservator's only course of action was to continue the growth and profitability until the Companies could be turned back over to the private investors.

is "to continue the operations of [the Companies], rehabilitate [them] and return [them] to a safe, sound and solvent condition."[218]

Accordingly, by liquidating the Companies, the FHFA strayed from its stated responsibilities as conservator, and therefore, acted outside of its scope of authority.[219] A reviewing court should find that the FHFA acted improperly as conservator by engaging in activity that was in direct contravention of its role as conservator of the Companies.[220]

b. The Treasury Exceeded Its Statutory Authority

The private investors have initiated a similar complaint against the Treasury by arguing that it also exceeded its statutory authority under HERA because the Net Worth Sweep modification was made after the Treasury's authority to purchase and modify the Companies' stock had expired.[221] The plaintiffs also contend that the Treasury did not properly consider the necessary factors before enacting the Net Worth Sweep, which also constitutes an unauthorized agency action.[222]

Under HERA, the Secretary of the Treasury was permitted to "purchase any obligations and other securities issued by the [the Companies] under any section of [HERA], on such terms and conditions as the Secretary may determine and in such amounts as the Secretary may determine."[223] When exercising this authority, the Secretary of the

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Once conservatorship began, the option to transition to a receivership should only be available if the conservatorship is failing. *Cf.* 12 C.F.R. § 1237.3–.4.

It should also be noted that even a mere "contracting" of the Companies is arguably impermissible under HERA unless the FHFA can show that is makes good business sense to do so. *See* 12 U.S.C. § 4617(b)(2)(D) (2012). Changing the structure of the Companies as the FHFA saw fit was not within the purview of HERA. *See generally id.*

218. 76 Fed. Reg. 35,724, 35,730 (June 20, 2011).

219. *See supra* notes 198–214 and accompanying text.

220. *See supra* notes 187–214 and accompanying text.

221. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶¶ 58–68; Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 100–20.

222. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶¶ 58–68; Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 100–20; *see infra* note 264 and accompanying text.

223. 12 U.S.C. §§ 1719(g)(1)(A), 1455(*l*)(1)(A) (2012).

Treasury must conclude that the Treasury's actions would: "(i) provide stability to the financial markets; (ii) prevent disruptions in the availability of mortgage finance; and (iii) protect the taxpayer."[224] In determining whether the actions would protect the taxpayers, the Secretary of the Treasury must consider the following factors:

> (i) The need for preferences or priorities regarding payments to the Government;
> (ii) Limits on maturity or disposition of obligations or securities to be purchased;
> (iii) The corporation's plan for the orderly resumption of private market funding or capital market access;
> (iv) The probability of the corporation fulfilling the terms of any such obligation or other security, including repayment;
> (v) The need to maintain the corporation's status as a private shareholder-owned company; and
> (vi) Restrictions on the use of corporation resources, including limitations on the payment of dividends and executive compensation and any such other terms and conditions as appropriate for those purposes.[225]

The Treasury announced its initial PSPA on September 7, 2008.[226] Under this purchase, the Treasury received "senior preferred stock in each [of the Companies]."[227] The PSPA was amended twice in 2009 to increase the amount the Companies could borrow from the Treasury.[228]

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224. 12 U.S.C. §§ 1719(g)(1)(B), 1455(*l*)(1)(B).

225. 12 U.S.C. §§ 1719(g)(1)(C)(i)-(vi), 1455(*l*)(1)(C)(i)-(vi) (emphasis added).

226. *See Treasury Fact Sheet*, *supra* note 111, at 30; *see also supra* notes 108–112 and accompanying text.

227. *Treasury Fact Sheet*, *supra* note 111, at 30.

228. *See* U.S. DEP'T OF THE TREASURY & FED. NAT'L MORTG. ASS'N, AMENDMENT TO AMENDED & RESTATED SENIOR PREFERRED STOCK PURCHASE AGREEMENT ¶ 4 (May 6, 2009), *available at* http://www.fhfa.gov/webfiles/23892/FannieMae509Amendment.pdf; U.S. DEP'T OF THE TREASURY & FED. NAT'L MORTG. ASS'N, SECOND AMENDMENT TO AMENDED & RESTATED SENIOR PREFERRED STOCK PURCHASE AGREEMENT ¶ 3 (Dec. 24, 2009), *available at* http://www.fhfa.gov/webfiles/23899/FanniesecondAmendment.pdf; U.S. DEP'T OF THE TREASURY & FED. HOME LOAN MORTG. CORP., AMENDMENT TO AMENDED & RESTATED SENIOR PREFERRED STOCK PURCHASE AGREEMENT ¶ 3 (May 6, 2009), *available at*

The Treasury's authority to enter into or modify these purchases statutorily expired on December 31, 2009.[229] The Net Worth Sweep, however, was not announced until August 17, 2012.[230]

First, not *all* of the Treasury's authority under the statutes expired at the end of 2009.[231] Beginning in 2010, the Treasury was effectively limited to exercising the rights of and selling off the GPS that it already owned.[232] Nowhere under the terms of the PSPA or GPS did the Treasury have the right to modify the stock that it held to receive all of the profits, rather than a simple ten percent dividend, of the Companies after 2009.[233] Thus, it appears that the plaintiffs correctly contend that the Treasury acted outside the boundaries of its power by enacting the Net Worth Sweep because after 2009, the Treasury's stock-purchase authority under HERA was limited to selling and exercising the rights of the stock it already possessed.[234]

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http://www.fhfa.gov/webfiles/23893/FreddieMac509Amendment.pdf; U.S. DEP'T OF THE TREASURY & FED. HOME LOAN MORTG. CORP., SECOND AMENDMENT TO AMENDED & RESTATED SENIOR PREFERRED STOCK PURCHASE AGREEMENT ¶ 3 (Dec. 24, 2009), *available at* http://www.fhfa.gov/webfiles/ 23901/FreddiesecondAmendment.pdf; *see also* Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 53–54.

229. *See* 12 U.S.C. §§ 1719(g)(4), 1455(*l*)(4).

230. *See* Fannie Mae Net Worth Sweep, *supra* note 123, at 1; Freddie Mac Net Worth Sweep, *supra* note 123, at 1.

231. *See* 12 U.S.C. §§ 1719(g)(4), 1455(*l*)(4).

232. *See* 12 U.S.C. §§ 1719(g)(2), (4), 1455(*l*)(2), (4). Additionally, the Treasury was still permitted to expend funds to exercise its rights under the GPS. *See* 12 U.S.C. §§ 1719(g)(3)–(4), 1455(*l*)(3)–(4). It is worth pointing out that these funding subsections, which do survive the 2009 sunset on the Treasury's authority, also discuss "modification" of the previously obtained stock. *See id.* In defending this claim, the Treasury may point to this provision as giving them authority to modify the GPS after 2009. Doing so, however, would contravene the plain meaning of the subsection, which simply states, in pertinent part: "[a]ny funds expended for the purchase of, or modifications to, obligations and securities, or the exercise of any rights received in connection with such purchases under this subsection shall be deemed appropriated at the time of such purchase, modification, or exercise." 12 U.S.C. §§ 1719(g)(3), 1455(*l*)(3). In other words, this subsection is not granting any additional authority to the Treasury. Rather, it is simply an accounting subsection stating when funds should be considered "appropriated." *See id.*

233. *See generally* sources cited *supra* notes 109, 224–225.

234. *See supra* notes 221–233 and accompanying text.

Alternatively, the plaintiffs contend that the Treasury acted beyond its statutorily conferred authority because the Treasury, when it entered into the Net Worth Sweep, did not appropriately consider the factors mandated by HERA[235] in order for the Treasury to purchase or modify any stock of the Companies.[236] The third and fifth elements, which are somewhat similar in purpose, are of import here. They indicate that when taking action regarding the stock in the Companies, the Treasury must consider that the Companies will eventually return to normal operations as privately-owned and privately-operated entities, and the FHFA's actions must further this end.[237]

A court reviewing the Treasury's actions should again apply the *Chevron* test to determine whether the agency's actions were within the statutory scope of authority.[238] Accordingly, the court must first establish whether the Congressional intent was clear.[239] With HERA, it is relatively clear that Congress intended that the Companies return to private control and ownership once the housing market stabilized and the Companies' cash crises were adverted.[240] Because HERA is clear in setting forth Congress's intentions, the Treasury must give it the proper effect. Accordingly, the court should not consider the Treasury's interpretation of the statute because "the court, as well as the [Treasury], must give effect to the unambiguously expressed intent of Congress."[241]

The Net Worth Sweep flouts congressional intent by effectively discouraging private investment and winding down the Companies' operations.[242] Obviously, this is not what Congress intended because it directly contravenes the statute.[243] It appears, therefore, that the Treasury did not properly consider Congress's intent when it entered

235. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶¶ 58–68; Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 100–20.

236. *See supra* notes 224–225 and accompanying text.

237. *See* 12 U.S.C. §§ 1719(g)(1)(C)(iii), (v), 1455(*l*)(1)(C)(iii)-(v).

238. *See supra* notes 193–197 and accompanying text.

239. *See* Chevron U.S.A. Inc. v. NRDC, 467 U.S. 837, 842–43 (1984).

240. *See* 12 U.S.C. §§ 1719(g)(1)(C)(iii), (v), 1455(*l*)(1)(C)(iii)-(v).

241. *Chevron*, 467 U.S. at 842–43.

242. *See supra* notes 128–131 and accompanying text.

243. *Compare* sources cited *supra* note 224 *with* 12 U.S.C. §§ 1719(g)(1)(C)(i)-(vi), 1455(*l*)(1)(C)(i)-(vi).

into the Net Worth Sweep. Thus, this action should be overturned as exceeding the Treasury's authority under HERA.

The Treasury might attempt to counter-argue that when it entered into the Net Worth Sweep, the Treasury *was*, in fact, protecting the taxpayers.[244] These modifications to wind down the Companies, it might contend, benefit the taxpayers by ensuring that the U.S. housing market would avoid future housing bubbles. This argument, however, would require ignoring, at least part of, Congress's intentions, which were to return the Companies to private control.[245] Whether returning the Companies to private control would *truly* benefit the taxpayers is not important because Congress believed it would be beneficial to taxpayers and drafted HERA to further that end.[246] Therefore, the Treasury was bound by Congress's intent but acted in contravention of it, thereby constituting an unauthorized agency action under the agency's enabling statute.

2. Arbitrary and Capricious Actions

A court must set aside agency action under the APA if that court deems the action to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[247] The "'arbitrary and capricious' standard is narrow and a court is not to substitute its judgment for that of the agency. Nevertheless, the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[248]

In determining whether an action is arbitrary and capricious, the court must decide whether the agency examined the factors that

244. *See* 12 U.S.C. §§ 1719(g)(1)(B)-(C), 1455(*l*)(1)(B)-(C).
245. *See* 12 U.S.C. §§ 1719(g)(1)(C)(iii), (v), 1455(*l*)(1)(C)(iii), (v).
246. *See id.*
247. 5 U.S.C. § 706(2)(A) (2012). This is generally known as the "arbitrary and capricious" standard. *Cf.* Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Ins. Co., 463 U.S. 29, 43 (1983).
248. *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43 (quoting Burlington Truck Lines v. United States, 371 U.S. 156, 168 (1962)).

Congress intended the agency to rely on before taking action.[249] If an agency disregards the statutory factors that Congress built into the enabling statute, the agency's action may be deemed arbitrary and capricious.[250] Moreover, the agency must "provide [a] reasoned explanation for its action" to be upheld on review.[251] A court is not obligated to "defer to [an] agency's conclusory or unsupported suppositions."[252]

a. The FHFA's Actions Were Arbitrary and Capricious

The private-investor plaintiffs argue that the FHFA, by entering into the Net Worth Sweep, acted arbitrarily and capriciously because the agency offered no reasoned explanation for amending the PSPA.[253] According to one of the lawsuits, "[t]here is no public record evidence that FHFA engaged in a reasoned decision-making process or considered important aspects of the problem it believed it faced. Nor did it establish an evidentiary basis nor provide an adequate explanation for its decision."[254] This contention, however, is not *entirely* correct.

When the FHFA announced the Net Worth Sweep, it issued a simultaneous statement that signaled that the actions were in furtherance of the FHFA's *A Strategic Plan for the Conservatorship of Fannie Mae and Freddie Mac*, which was previously submitted to Congress.[255] The

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249. *See id.* In other words, the agency must demonstrate that "the grounds upon which the agency acted in exercising its powers were those upon which its action can be sustained." SEC v. Chenery Corp., 318 U.S. 80, 95 (1943).

250. *See* Minn. Milk Producers Ass'n v. Yeutter, 851 F. Supp. 1389, 1398 (D. Minn. 1994) (finding that the Secretary of Agriculture's failure to consider the factors set forth in the Agricultural Marketing Agreement Act before deciding on an agricultural price structure was arbitrary and capricious).

251. *See* F.C.C. v. Fox Television Stations, Inc. 556 U.S. 502, 515 (2009).

252. *See* McDonnell Douglas Corp. v. U.S. Dep't of the Air Force, 375 F.3d 1182, 1186–87 (D.C. Cir. 2004) (citing *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43).

253. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶¶ 88–94; Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 94–99.

254. Fairholme Funds D.D.C Complaint, supra note 12, ¶ 96.

255. *See* Statement, Fed. Housing Fin. Agency, Statement of FHFA Acting Director Edward J. DeMarco on Changes to Fannie Mae and Freddie Mac Preferred Stock Purchase Agreements (Aug. 17, 2012), *available at* http://www.fhfa. gov/webfiles/

complication, however, of relying upon this plan as "evidencing" well-reasoned action is that the plan appears to be, at least partially, outside of the FHFA's scope of authority. This is because a primary tenet of the plan is to "[g]radually contract the [Companies'] dominant presence in the marketplace while simplifying and shrinking their operations."[256] Contracting the Companies' presence and shrinking their operations, however, is not part of the FHFA's scope of authority in its role as conservator of the Companies.[257] Unless the FHFA can show evidence that scaling the Companies back was necessary for their continued existence in the marketplace, these FHFA actions are not part of the conservator's powers.[258] As such, the FHFA should not be permitted to rely on this plan as evidence to support their decision to implement the Net Worth Sweep.[259]

It appears that, at least in some ways, the FHFA's decision to act was arbitrary and capricious because the agency put forth insufficient evidence to support its decision.[260] Moreover, the "evidence" that was put forth was, at least in part, impermissible for the agency to rely upon because reducing the size of the Companies was not within the FHFA's purview of power when acting as conservator.[261] Therefore, the FHFA's actions must be overturned, and the investors should be compensated for any losses incurred.

24203/FINAL_FHFA_PSPA_8172012.pdf (referencing *A Strategic Plan for the Conservatorship of Fannie Mae and Freddie Mac*, FED. HOUSING FIN. AGENCY (Feb. 21, 2012) [hereinafter *Strategic Plan*]).

256. *Strategic Plan*, *supra* note 255, at 2.

257. *See supra* notes 210–214 and accompanying text. As previously discussed, the FHFA, as conservator, is operating under a limited set of powers. *See id.*

258. *See supra* notes 249–250 and accompanying text.

259. *See* Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Ins. Co., 463 U.S. 29, 43 (1983) (stating that "an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider").

260. *See supra* notes 249–256 and accompanying text.

261. *See id*.

b. The Treasury's Actions Were Arbitrary and Capricious

The plaintiff-investors have lodged a similar arbitrary-and-capricious claim against the Treasury[262] and pointed to the statute that authorized the Treasury to purchase the GPS in the Companies.[263] Again, prior to entering into these purchases and, presumably, before making any modifications thereto,[264] the Treasury had to consider whether its action would "protect the taxpayer" and "maintain the [Companies'] status as . . . private shareholder-owned compan[ies]."[265] Because the Treasury failed to sufficiently consider these factors, it acted arbitrarily and capriciously, so its action must be overturned.

An agency action is considered arbitrary and capricious if the agency "failed to consider mandatory factors set forth by statute."[266] In the present case of the Treasury's action, when Congress enacted the relevant statute, Congress insisted that the Treasury "*must* determine" that the GPS purchases and their modifications "are necessary to . . . protect the taxpayer."[267] Furthermore, in determining whether purchasing the GPS would "protect the taxpayer," the Treasury "*shall* take into consideration" the plan to return the Companies to private funding and private stockholder ownership.[268]

From a plain-meaning interpretation of the statute, the factors set forth by Congress are clearly not optional proposals.[269] Rather, all of the

262. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶¶ 69–89; Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 111–20.

263. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶ 71; Fairholme Funds D.D.C Complaint, *supra* note 12, ¶ 113.

264. *Cf.* Fairholme Funds D.D.C Complaint, *supra* note 12, ¶ 114 (stating that if the statutes regulating the Treasury did not apply to modifications, as well as initial purchases, the "Treasury could fundamentally alter its investments in the Companies at any time, including after its investment authority has expired, without making the required determinations or considering the necessary factors").

265. 12 U.S.C. §§ 1719(g)(1)(C)(iii), (v), 1455(*l*)(1)(C)(iii), (v) (2012).

266. NRDC v. EPA, 638 F.3d 1183, 1190 (9th Cir. 2011) (citing NRDC v. EPA, 526 F.3d 591, 602 (9th Cir. 2008); Cerrillo-Perez v. INS, 809 F.2d 1419, 1422 (9th Cir. 1987)).

267. 12 U.S.C. §§ 1719(g)(1)(B)(iii), 1455(*l*)(1)(B)(iii) (emphasis added).

268. 12 U.S.C. §§ 1719(g)(1)(C)(iii), (v), 1455(*l*)(1)(C)(iii), (v) (emphasis added).

269. *See supra* notes 264–268.

statutory factors are mandatory considerations for the Treasury to analyze and abide by when undertaking the purchase and modification of the GPS.[270] Clearly, the Treasury did not do so here because it is impossible to reconcile shrinking, liquidating, or preventing the Companies from retaining profits with Congress's mandate that the Companies should ultimately be returned to private ownership via private funding.[271] Because the Treasury failed to consider Congress's required factors before modifying the GPS, the Treasury's actions were arbitrary and capricious. Therefore, its actions must be overturned, and the investors should receive compensation for their losses.

C. Breach of Contract Against the FHFA as Conservator for the Companies

The private investors also contend that the FHFA, as conservator of the Companies, breached the stockholders' contractual rights under the terms of the preferred stock certificates.[272] The plaintiffs argue that by enacting the Net Worth Sweep, the FHFA, in acting for the Companies, "breached [the Companies'] obligations to [the] Plaintiffs by nullifying entirely the contractual rights of"[273] the private stockholders to receive a "specified, noncumulative dividend and . . . a contractually specified liquidation preference."[274] Although this is a state law claim, it is not necessary to separately analyze the claims against Fannie Mae and Freddie Mac because Virginia and Delaware contain extremely similar elements for breach-of-contract claims.[275]

Under Delaware state law, the following elements must be shown for a breach of contract claim: "(1) a contractual obligation; (2) a breach of that obligation by the defendant; and (3) resulting damage to the

270. *See id*.

271. *Cf. id*.

272. *See* Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 121–128.

273. *Id.* ¶ 123.

274. *Id.* ¶ 122.

275. As stated above, Delaware law should govern any state law claims against Fannie Mae while Virginia law would be applicable to these claims against Freddie Mac. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶ 75.

plaintiffs."[276] Similarly, to establish a *prima facie* breach-of-contract claim in Virginia, the plaintiffs must prove: "(1) a legally enforceable obligation of a defendant to a plaintiff; (2) the defendant's violation or breach of that obligation; and (3) injury or damage to the plaintiff caused by the breach of obligation."[277] Essentially, both of these state laws consist of an obligation, a failure to comply with that obligation, and a measurable level of damages.[278]

First, the plaintiffs contend that they were contractually obligated to receive dividends and certain liquidation rights upon dissolution,[279] which, if true, would seem to satisfy the initial element of the breach of contract test.[280] This contention, however, appears to overlook the fact that the plaintiffs' right to receive dividend payments is completely contingent upon the decisions of the Companies' Boards of Directors to make such a distribution, and if a dividend is not paid in a given year, the obligation does *not* accumulate in subsequent years.[281] Therefore, a private stockholder has only the contractual right to receive dividend payments *if and only if* the Boards declare a dividend.[282] Until this event occurs, the right to receive the payment does not materialize.[283] Because there was no contractual obligation to pay dividends, there can be no breach. Finally, even if there were an obligation and a breach thereof, a court would likely find that because it is impossible to determine if, how often, or when the Boards would declare dividends in the future, the damages would be too speculative to award any compensation.[284]

Arguably, however, the plaintiffs' contractual right to receive a certain liquidation preference *does* currently exist because the FHFA

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276. Greenstar, LLC v. Heller, Civ. No. 10-746-SLR, 2013 WL 1285420, at *11 (D. Del. Mar. 28, 2013) (citing WaveDivision Holdings, LLC v. Millennium Digital Media Sys., LLC, Civ. No. 2993, 2010 WL 3706624, at *13 (Del. Ch. Sept. 17, 2010)).

277. Sunrise Continuing Care, LLC v. Wright, 671 S.E. 2d 132, 135 (Va. 2009).

278. *See supra* notes 276–277.

279. *See* Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 122–23.

280. *Compare id. with supra* note 276.

281. *See supra* notes 159–160 and accompanying text.

282. *See id.*

283. *Cf. id.*

284. *See Sunrise Continuing Care*, 671 S.E. 2d at 135; Wise v. W. Union Tele. Co., 181 A. 302, 303 (Del. 1935) (indicating that a plaintiff cannot recover damages that are "remote, speculative and contingent").

made clear that it intended to shut the Companies down.[285] Unfortunately for the private stockholders there does not appear to be any breach of this contractual obligation either because the liquidation provisions of the Companies' preferred stock state that these stockholders have a preference over common stockholders and any other stock that ranks junior to the preferred stockholders.[286] No one has insisted that junior stockholders would be paid out upon dissolution before the preferred stockholders because the stockholders that are *senior* to the preferred stockholders would receive the preferential treatment.[287] In other words, because no shareholders that are junior to the preferred stockholders will receive a liquidation distribution before the preferred stockholders, these provisions in the stock certificates have not been violated.[288] Therefore, under a plain-meaning reading of the stock certificates, there has been no breach of the plaintiffs' liquidation rights, so this claim must fail.[289]

D. BREACH OF THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING AGAINST THE FHFA

Some of the plaintiff-investors have raised a second claim based on contract theory, asserting that the FHFA breached the covenant of good faith and fair dealing that is "[i]mplicit in every contract."[290] Because

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285. *See* Treasury 2012 Press Release, *supra* note 126. The stockholders' liquidation rights are triggered if there is a "voluntary or involuntary dissolution, liquidation or winding up of" the Companies. Cacciapalle Class Action Complaint, *supra* note 15, ¶¶ 36–37.

286. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶¶ 36–37.

287. *Cf. id.*; Paulson, *supra* note 110.

288. *Cf.* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 43; Paulson, *supra* note 110.

289. It should be possible to more accurately determine the amount of damages here by simply subtracting the outstanding balance due the Treasury under the PSPA from the net assets of the Companies, which should yield the amount of damage to the plaintiffs; however, the failure of the plaintiffs to meet the "breach" element renders this analysis moot.

290. Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 129–35.

> Although every contract implies good faith and fair dealing between the parties to it, the jurisdictions are divided on whether a covenant of good faith and fair dealing is an independent source of duties

contract claims are grounded in state law, it is necessary to turn to Virginia and Delaware contract law.[291]

1. Breach of the Implied Covenant Against Fannie Mae

Pursuant to Delaware contract law, "an implied covenant of good faith and fair dealing inheres in every contract."[292] This covenant requires each contracting party to "act reasonably upon contractual language that is on its face reasonable"[293] and is used to protect the "spirit" of the contract when one party uses "oppressive or underhanded tactics to deny the other side the fruits of the parties' bargain."[294] Importantly, however, the reviewing court is not permitted to use this doctrine to contravene the terms of the original contract or go beyond its initial scope.[295] Accordingly, if the parties specifically spoke to a

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> assumed by the parties. In some jurisdictions, a breach of such covenant does not, by itself, create a cause of action, while in others a breach of a covenant of good faith and fair dealing does create a cause of action. . . . In some jurisdictions, a breach of such covenant does not, by itself, create a cause of action. A claim for breach of good faith and fair dealing is, in such jurisdictions, nothing more than a breach of a contract claim and is analyzed like a claim for the breach of any other contractual duty. Thus, a claim for breach of an implied duty of good faith is duplicative of a breach of contract claim.

17B C.J.S. *Contracts* § 826 (2011).

291. *See* Perry Capital Complaint and Prayer for Declaratory & Injunctive Relief, *supra* note 109, ¶ 75.

292. Chamison v. Healthtrust, Inc., 735 A.2d 912, 920 (Del. Ch. 1999).

293. *Id.* To prevail on this issue, the claimant must show that the defending-party acted "arbitrarily or unreasonably." Nemic v. Shrader, 991 A.2d 1120, 1126 (Del. 2010). Additionally, a plaintiff must satisfy the following elements: "[1] a specific implied contractual obligation, [2] a breach of that obligation by the defendant, and [3] resulting damage to the plaintiff." Kelly v. Blum, No. C.A. 4516-VCP, 2010 WL 629850, at *13 (Del. Ch. Feb. 24, 2010) (quoting Fitzgerald v. Cantor, No. C.A. 16297-NC, 1998 WL 842316, at *1 (Del. Ch. Nov. 10, 1998)).

294. *Chamison*, 735 A.2d at 920. This implied covenant generally cannot be waived by contracting parties. E. ALLEN FARNSWORTH, CONTRACTS § 7.17 (4th ed. 2004).

295. *See Chamison*, 735 A.2d at 921. "[T]he covenant [of good faith and fair dealing] is a limited and extraordinary legal remedy." *Nemic*, 991 A.2d at 1128.

particular issue, the court may not rewrite the contract to give one of the parties a better bargain.[296]

At first blush, this appears to be a cogent claim because the plaintiffs were certainly denied the "fruits of [their] bargain."[297] Due to the Net Worth Sweep, the Treasury will now begin hoarding all of Fannie Mae's profits, thereby preventing the plaintiffs from obtaining their contracted-for dividends.[298] From the investors' point of view, this could certainly be viewed as arbitrary, unreasonable, oppressive, and underhanded.[299]

The biggest obstacle in the plaintiffs' path, however, is that arguably, this situation is expressly covered by the provisions of the Companies' stock, which provides that the private stockholders are only entitled to a dividend if and when declared by the Fannie Mae Board of Directors.[300] This would impair the plaintiffs' case because *express* provisions cannot constitute an *implied* covenant of good faith and fair dealing.[301] Moreover, the stock gives the Board sole discretion over whether a dividend should be declared.[302] Therefore, a reviewing court, when applying Delaware law, could find that because the stock terms spoke to the issue by specifically granting sole discretion to the Board (or in this case, the FHFA acting on behalf of the Board), it is not a breach of the implied covenant of good faith and fair dealing to take action that would not declare a dividend.[303]

2. Breach of the Implied Covenant Against Freddie Mac

This claim appears to be even more black-and-white under Virginia law because "Virginia law does not recognize a claim for breach of a covenant of good faith and fair dealing. Virginia Circuit courts that

296. *See Nemic*, 991 A.2d at 112–26; *Chamison*, 735 A.2d at 921.

297. *Cf. Chamison*, 735 A.2d at 920.

298. *See supra* notes 122–126 and accompanying text.

299. *See Chamison*, 735 A.2d at 920.

300. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 36.

301. *See* Kelly v. Blum, No. C.A. 4516-VCP, 2010 WL 629850, at *13 (Del. Ch. Feb. 24, 2010) (quoting Fitzgerald v. Cantor, 1998 WL 842316, at *1) (explaining that the first element of the claim requires "a specific *implied* contractual obligation") (emphasis added).

302. *See* Cacciapalle Class Action Complaint, *supra* note 15, ¶ 36.

303. *See supra* notes 292–302 and accompanying text.

have considered such claims have consistently rejected them."[304] Therefore, if the reviewing court applies Virginia law to the Freddie Mac stock, this claim should fail.[305]

E. BREACH OF FIDUCIARY DUTIES

Finally, the investors also raise a claim against the FHFA for breach of fiduciary duty, namely a duty of loyalty, to the stockholders in its role as conservator of the Companies.[306] This type of claim lies within the purview of state law, but the laws of Delaware and Virginia appear to be similar enough to be analyzed together.

Given Delaware's rich history of corporate cases, the Delaware courts have been able to thoroughly examine the duty of loyalty to the corporation and its shareholders.

The relationship between a corporation and its preferred stockholders is "primarily . . . contractual in nature," involving "rights and obligations created contractually by the certificate of designation." On the other hand, fiduciary duties as well may be owed to preferred stockholders in limited circumstances. A corporation's directors "are fiduciaries for the [p]referred stockholders, whose interests they have a duty to safeguard, consistent with the fiduciary duties owed by those

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304. Spiller v. James River Corp., No. LW-2216-3, 1993 WL 946387, at *6 (Va. Cir. Ct. Dec. 23, 1993); *see also* Sneed v. Am. Bank Stationary Co., 764 F. Supp. 65, 67 (W.D. Va. 1991) (stating that "the cause of action [for breach of an implied covenant of good faith and fair dealing] is not recognized under Virginia law").

305. *See supra* note 304.

306. *See* Fairholme Funds D.D.C Complaint, *supra* note 12, ¶¶ 136–45.

> Majority, dominant, or controlling shareholders owe a fiduciary duty to the minority shareholders, as well as to the other majority shareholders and the corporation, and where a majority or controlling shareholder is also a director, then fiduciary duties apply in both capacities. The applicable standard or test is that of intrinsic or inherent fairness. In any event, the majority stockholders have a real duty to protect the interests of the minority in the management of the corporation, especially where they undertake to run the corporation without giving the minority a voice in it.

18A AM. JUR 2D *Corporations* § 644 (2004).

directors to [the corporation's] other shareholders and to [the corporation] itself."[307]

This duty to safeguard the shareholders and the corporation trumps a director's, officer's, or controlling shareholder's own interest that would not benefit the "stockholders generally."[308] Furthermore, the "Delaware courts have not hesitated to state that a fiduciary duty of loyalty is one such right shared equally between the common and preferred stockholders."[309] It should follow, then, that the FHFA, in acting as Fannie Mae's controlling entity, owes an equal duty of loyalty to the holders of the GPS, the preferred stock, the common stock, and the company itself.[310]

Virginia corporate law is relatively similar to Delaware's with respect to the duty of loyalty owed to the shareholders of a corporation. "It is well-settled that '[a] Virginia corporation's directors and officers owe a duty of loyalty both to the corporation and to the corporation's

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307. Jackson Nat'l Life Ins. Co. v. Kennedy, 741 A.2d 377, 386 (Del Ch. 1999) (quoting HB Korenvaes Invs., L.P. v. Marriott Corp., No. 12922, 1993 WL 205040, at *9 (Del Ch. June 9, 1993) (alterations in original); Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1062 (Del. Ch. 1987)).

308. *See* Carsonaro v. Bloodhound Techs., Inc. 65 A.3d 618, 637 (Del. Ch. 2013). This may be termed the "entirely fairness standard." *Id.* at 637–38. This exacting rule requires of

> a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. The occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale.

Id. (quoting Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)).

309. *Jackson Nat'l Life Ins.*, 741 A.2d at 387.

310. *Cf. supra* notes 207–209 and accompanying text.

shareholders.'"[311] In all transactions that affect the corporation or its shareholders, it is impermissible for a director to gain "any personal advantage . . . or make any profit for himself"[312] and the director must take steps to "guard the interests of the corporation."[313]

When looking at the effects of the Net Worth Sweep, it does not appear to be an entirely fair transaction for the stockholders as a whole. This presumably final amendment to the PSPA greatly benefits the Treasury, as the holder of the senior GPS, to the detriment of the preferred and common stockholders.[314] The FHFA arguably used its position as the Companies' controlling entity to broker a deal with a sister federal agency to amend the terms of the GPS that would be mutually beneficial while squeezing out all of the private stockholders.[315] Using one's position as a director for gain at the expense of the shareholders is impermissible under Delaware and Virginia corporate law.[316] The FHFA's actions fly in the face of this straightforward rule and should, therefore, be struck down as a violation

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311. Byelick v. Vivadelli, 79 F. Supp. 2d 610, 623 (E.D. Va. 1999) (quoting WLR Foods v. Tyson Foods, Inc., 869 F. Supp. 419, 421 (W.D. Va. 1994) (alteration in original)).

312. *Id.* (quoting Rowland v. Kable, 6 S.E. 2d 633, 642 (Va. 1940)).

313. *Cf. id.* (quoting *Rowland*, 6 S.E. 2d at 642). The Code of Virginia also states that "[a] director shall discharge his duties as a director . . . in accordance with his good faith business judgment *of the best interests of the corporation.*" VA. CODE ANN. § 13.1-690 (2013) (emphasis added).

314. *Cf.* sources cited *supra* note 122–126 and accompanying text.

315. Initially, it looks as if the FHFA is "throwing out the baby with the bath water" by shutting down two major profit centers in the housing market. It appears, however, the FHFA's motives are largely political in nature because roughly a year after the announcement of the Net Worth Sweep, President Barack Obama gave a speech indicating that he wishes to see the Companies shut down. *See Obama to Urge Congress in Speech to Shutter Fannie Mae and Freddie Mac*, FOX NEWS (Aug. 6, 2013), http://www.foxnews.com/politics/2013/08/06/obama-to-urge-congress-in-speech-to-shutter-fannie-mae-and-freddie-mac/; *see also U.S. Housing Regulator Files Paperwork for New Securitization Firm*, REUTERS (Oct. 7, 2013) (stating that "the regulator overseeing . . . Fannie Mae and Freddie Mac . . . said it filed legal paperwork to create a common platform for the two firms to issue mortgage-backed securities . . . called the Common Securitization Solutions, LLC[, which will] consolidate some of functions [sic] currently replicated by Fannie Mae and Freddie Mac").

316. *See supra* notes 307–313 and accompanying text.

of its fiduciary duties to the preferred and common stockholders and entitle the plaintiffs to compensation.[317]

V. THE GOVERNMENT ANSWERS THE FIFTH AMENDMENT CLAIMS

Since the inception of this Article, the Federal Government has responded to only the aforementioned Fifth Amendment claims.[318] In its motion to dismiss, the United States replied with a litany of procedural maneuvers to have at least one of the cases thrown out.[319] Some of these procedural claims, such as the contention that the only party that has standing to sue the FHFA is the FHFA itself,[320] are quite unique and interesting. In addition to procedural grounds, the defendant also raises some of the substantive arguments (or variations thereof) set forth above regarding the inapplicability of the Fifth Amendment's Takings Clause to the seizure of the dividend payments.[321]

CONCLUSION

The private investors' angered reaction to the Net Worth Sweep is definitely a rational one. These individual and corporate investors purchased stock in the Companies with an expectation of, *inter alia*, dividends. Although the declaration of dividends is subject to the Boards' sole discretion, a reasonable, prudent investor would not expect the Companies to abruptly change their business strategies so that no dividends would ever be issued again. Though the Companies are government-chartered, they have been transitioned to private ownership

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317. *See supra* notes 307–316.

318. *See* Defendant's Motion to Dismiss, Wash. Fed. v. United States, No. 13-385C (Fed. Cl. Nov. 7, 2013).

319. *See id.* at 11–22.

320. *See id.* at 18–19.

321. *See id.* at 22–31; *see also supra* notes 141–171. For an interesting analysis of the defendant's motion that takes a contradictory viewpoint than that espoused in this Article, see Richard Epstein's blog entry on the topic. Richard A. Epstein, *An Unconstitutional Bonanza*, DEFINING IDEAS (Nov. 11, 2013), http://www.hoover.org/publications/ defining-ideas/article/161456.

and control.[322] The housing market crash should not have permanently affected this structure.

Moreover, if the Companies now need to be shut down or completely restructured, this author wonders why the federal government bothered infusing the Companies with so much capital after the housing crash. If the public-private hybrid structure is so incredibly flawed that the Companies must now liquidate or rebuild from the ground up, why not just avoid this litigation altogether by letting the Companies fail in 2008? It is strange to spend so many taxpayer dollars to bail out two entities that will ultimately be shut down soon after returning them to profitability.[323]

In any event, this is the path that the government started upon, and the lawsuits discussed herein are the result. Though some of the investor-plaintiffs' claims appear to be doomed from the outset, some should be able to prevail, resulting in the reversal of the FHFA's and Treasury's Net Worth Sweep.[324]

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322. *See supra* notes 14, 29 and accompanying text.

323. *See supra* notes 114, 119–21 and accompanying text.

324. *See generally* discussion *supra* Part IV.