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UPDATE: Fannie & Freddie Investors Turn to Congress After S. Ct. Declines to Resurrect Their Legal Claims

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July 25, 2018

UPDATE: On July 16, 2018, the U.S. Court of Appeals for the Fifth Circuit, in [Collins v. Mnuchin](#), became the [fourth](#) U.S. Court of Appeals to dismiss statutory claims asserted by Fannie Mae and Freddie Mac shareholders challenging the terms of the mortgage companies' financial assistance agreements with the Department of the Treasury and the Federal Housing Finance Agency (FHFA). In a 2-1 decision, the Fifth Circuit rejected the shareholders' statutory challenges to the agreements' so-called "net worth sweep," utilizing essentially the [same legal reasoning](#) applied by U.S. Courts of Appeals for the [Sixth](#) and [Seventh](#) Circuits, as well as the [U.S. Court of Appeals for the District of Columbia](#), which was the subject of the original post below.

In contrast to its sister courts, however, the Fifth Circuit also addressed a constitutional issue, [holding](#) that the FHFA's structure violated the separation of powers and Article II of the U.S. Constitution because "Congress encased the FHFA in so many layers of insulation—by limiting the President's power to remove and replace the FHFA's leadership, exempting the Agency's funding from the normal appropriations process, and establishing no formal mechanism for the Executive Branch to control the Agency's activities." To rectify these constitutional infirmities, the court [severed](#) the FHFA Director's for-cause removal protections, thus making him removable by the President at will and essentially transforming the FHFA from an independent agency to an executive branch agency subject to Presidential supervision and control. The Fifth Circuit majority's constitutional reasoning is similar to that of a [dissenting opinion](#), penned by Supreme Court nominee Brett Kavanaugh, in a [case](#) contesting the constitutionality of the Consumer Financial Protection Bureau's similar structure. The constitutional issues at play in the CFPB case are analyzed in Legal Sidebars [here](#) and [here](#).

The original post from March 16, 2018, is below.

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On February 20, 2018, the U.S. Supreme Court [declined](#) to review *Perry Capital LLC v. Mnuchin*, a United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit) decision that [dismissed](#) almost all of the legal claims asserted against the federal government by a consolidated group of Fannie Mae and Freddie Mac shareholders. The lawsuits focused on the 2012 amendments to the Treasury Department's 2008 agreement with the Federal Housing Finance Agency (FHFA), which governs how Fannie and Freddie (together, the companies, Government Sponsored Enterprises, or GSEs) will compensate the Treasury for [providing](#) them billions of dollars in financial assistance during the U.S. housing crisis. The 2012 amendments require the companies to transfer their entire net worth, other than small capital reserves, to the Treasury, thereby largely precluding other GSE shareholders from benefitting from any future profits of Fannie and Freddie. Although a few of the *Perry Capital* plaintiffs' judicial claims remain alive and other litigation is pending, the Supreme Court's denial of certiorari in *Perry Capital* was a [major setback](#) for the GSE shareholders' efforts to challenge the 2012 amendments through litigation. With the available routes to legal victory in the courts [dwindling](#), some [shareholders](#) are seeking to secure similar relief [legislatively](#), as a component of the comprehensive housing finance reform proposals currently being considered in the 115th Congress.

Origins of the Litigation. [Fannie Mae and Freddie Mac](#) are congressionally chartered, shareholder-owned companies that support the U.S. housing market by buying mortgages, issuing securities backed by those mortgages, and guaranteeing against default on close to [\\$5 trillion](#) in mortgage debt. In July 2008, with the [housing market roiling and Fannie and Freddie struggling financially](#), Congress passed the [Housing and Economic Recovery Act of 2008](#) (HERA). HERA [established](#) the FHFA as the GSEs' new regulator and temporarily [authorized](#) the Treasury to make unlimited financial investments in the GSEs in order to "prevent disruptions in the availability of mortgage finance." With Fannie and Freddie on the brink of [default](#), the FHFA, exercising [HERA](#) authorities, [appointed](#) itself conservator of the GSEs in September 2008.

In one of its first acts as conservator, the FHFA signed the [Senior Preferred Stock Purchase Agreements](#) (PSPAs) that are the subject of the Fannie and Freddie shareholder lawsuits. Under the original terms of the PSPAs, the Treasury offered each GSE up to \$100 billion in financial support (referred to as the funding commitment) in exchange for several forms of [consideration](#), including: the acquisition of senior preferred shares in both Fannie and Freddie that are prioritized above all other stock classes; rights to quarterly dividend payments; and warrants to purchase up to 79.9% of each GSE's common stock. The original PSPAs were [amended](#) twice, chiefly to increase the funding commitments. In late 2012, the parties made a [third amendment](#) to the PSPAs, which modified how the Treasury's dividend payment would be calculated. The third PSPA amendment converted a fixed 10% dividend into a "[net worth sweep](#)," which "requires Fannie Mae and Freddie Mac to pay a quarterly dividend to Treasury equal to the *entire net worth* of each [GSE]," except for a [\\$3 billion capital buffer](#) for each company. Thus, the net worth sweep largely precludes the GSEs' common and non-senior preferred shareholders from benefitting from any future profits of Fannie and Freddie. By the end of 2017, [Fannie](#) had made a total of \$122.8 billion in draws from the funding commitment with the Treasury, while paying the Treasury \$166.4 billion in dividends, while [Freddie](#) had drawn \$74.6 billion and paid \$112.4 billion in dividends.

Beginning in 2013, groups of Fannie and Freddie shareholders filed a [series of lawsuits](#) against the FHFA and the Treasury challenging the legality of the net worth sweep. Many of these suits were consolidated in *Perry Capital*. The *Perry Capital* shareholders [alleged](#), among other things, that the net worth sweep constituted a taking without just compensation in violation of the Fifth Amendment of the U.S. Constitution; exceeded the FHFA's statutory authority under HERA; was arbitrary and capricious in violation of the Administrative Procedure Act (APA); breached various provisions of the plaintiffs' stock certificate contracts; and constituted breaches of implied covenants of good faith and fair dealing under common law.

Court Decisions in *Perry Capital*. The U.S. District Court for the District of Columbia (D.C. District Court) [dismissed](#) all of the *Perry Capital* plaintiffs' claims. The court generally held that (i) the plaintiffs "fail[ed] to plead a cognizable property interest" for the purpose of the Takings Clause; (ii) the shareholders' statutory claims and common law tort claims were [barred](#) by a provision of HERA, [12 U.S.C. §4617\(f\)](#), which establishes that "no court may take any action to restrain or affect the exercise of powers or functions of the Agency as a conservator;" (iii) claims brought derivatively (i.e., by shareholders on behalf of the GSEs) were barred by HERA's "[succession clause](#)," which provides that the FHFA, as conservator, assumes "all rights, titles, powers, and privileges" of the GSEs' shareholders; and (iv) some of the plaintiffs' breach of contract and implied covenant of good faith and fair dealing claims were not yet ripe for review because they were based upon an event that might never occur—the liquidation of Fannie or Freddie.

On appeal, the D.C. Circuit [affirmed](#) the lower court's dismissal of almost all of the plaintiffs' claims. (The *Perry Capital* plaintiffs did not appeal the D.C. District Court's constitutional holding, but [a separate case](#) raising almost identical Takings Clause claims is currently pending in the discovery phase at the U.S. Court of Federal Claims.) However, the D.C. Circuit [remanded](#) a few of the shareholders' common law claims to the D.C. District Court for reconsideration on the grounds that the lower court had applied the wrong legal standard to some of the claims and that other claims were ripe for review.

Although plaintiffs likely will continue to [pursue](#) the claims that survived dismissal, the Supreme Court's [order](#) denying review precludes the bulk of the shareholders' claims.

Housing Finance Reform & Legacy GSE Shareholders. Some shareholders are attempting to get [Congress](#) to provide the financial relief they, at least thus far, have failed to secure through litigation. Since 2009, Congress has considered a number of [GSE-reform bills](#) without a consensus proposal emerging, but there are [signs](#) of progress in the 115th Congress. It is possible that any broad GSE reform package that becomes law would address the rights of legacy shareholders in Fannie and Freddie, and Congress appears to have a number of potential options to address this issue. For example, a GSE reform bill [could](#) terminate the FHFA-run conservatorships and the PSPAs, along with all of the Treasury's rights under the agreements (e.g., dividends, senior preferred shares, warrants to purchase common stock) and allow Fannie and Freddie to resume operations as private, shareholder-owned companies. In such a scenario, legacy shareholders might share the GSEs' profits and losses, as the companies' shareholders did prior to the conservatorships. On the other side of the spectrum, a GSE reform bill [could](#) eliminate Fannie and Freddie, force them to liquefy their assets, and compensate legacy shareholders and other claimants (e.g., the Treasury) in accordance with a statutorily established priority scheme. In such a scenario, legacy common and non-senior preferred shareholders might be paid pennies on the dollar or possibly nothing at all depending on the funds the asset sales generate and the priority position of other claimants. Congress also [might](#) choose to eliminate Fannie and Freddie, transfer their assets to new, congressionally chartered entities, and compensate legacy shareholders with some form of ownership stake in the new replacements.

Considerations for Congress. A number of issues might be relevant to congressional consideration of these and other legislative options. For instance, policymakers might [consider](#) whether or not the federal government, and by extension American taxpayers, has been sufficiently compensated for the financial assistance it provided the GSEs, and what rights the Treasury should be [allowed](#) to exercise in conjunction with a housing finance reform package. While both GSEs have paid more in dividends than either borrowed, those payments have not reduced either firm's "liquidation preference," (the amount contemplated by the PSPAs to compensate the Treasury as each GSE's senior preferred stock holder if either company was liquidated), which totaled \$193.1 billion at the end of 2017. The Treasury also has not exercised its authority to purchase 79.9% of each GSE's common stock.

Another question Congress might [consider](#) is whether reform should treat GSE shareholders, who invested before the FHFA took over as conservator and entered into the PSPAs with the Treasury, the

same as those who invested after. The stock prices of both GSEs plummeted from around **\$30 per share** in early 2008 to below \$1.00 per share after the conservatorships. Many of the hedge funds that are behind some of the lawsuits challenging the net worth sweep invested in the GSEs after the FHFA became the companies' conservator but before the third amendment to the PSPA. From a legal perspective, the D.C. Circuit **suggested** that, on remand, plaintiffs who purchased their shares after the GSEs were placed into conservatorships might have weaker legal claims than plaintiffs who bought their shares before the conservatorships. From a GSE reform perspective, policymakers might consider whether these two groups of shareholders should be treated differently, as well as how that treatment might impact the future behavior of participants in the housing finance system that develops after legislative reforms are implemented.
