# Securities Regulation Daily Wrap Up, TOP STORY—D.C. Cir.: Fannie/ Freddie investors can't challenge deal giving net worth to Treasury, (Feb. 22, 2017)

Securities Regulation Daily Wrap Up

Click to open document in a browser

By Anne Sherry, J.D.

Fannie Mae and Freddie Mac stockholders have little basis to challenge the companies' contractual obligation to pay their net worth to Treasury, the D.C. Circuit held. The stock purchase agreement between the Federal Housing Finance Agency, as conservator, and Treasury was amended in 2012 to replace a fixed-percentage dividend with the net worth payment. The Housing and Economic Recovery Act's strict limits on judicial review precluded the stockholders' statutory challenge to the amendment and all but a few common-law claims (*Perry Capital LLC v. Mnuchin*, February 21, 2017, Millett, P., and Ginsburg, D.).

**Conservatorship and capital infusion.** Fannie and Freddie were placed into conservatorship in 2008, shortly after the Recovery Act established FHFA. To keep the companies afloat, FHFA obtained billions in emergency capital from Treasury in exchange for preferred shares of stock. Fannie and Freddie also agreed to pay Treasury a quarterly dividend of 10 percent of the total funds drawn from Treasury. In practice, the companies often had to borrow more from Treasury to pay the dividends, which borrowing also increased the dividend payment for future quarters. In response to this debt spiral, FHFA and Treasury amended the stock purchase agreement in 2012 to replace the 10 percent dividend with a formula by which Fannie and Freddie paid roughly their quarterly net worth. This meant that the companies would never have to borrow to make their dividend payments, but also that they would not be able to accrue capital.

**Stockholder lawsuits.** In 2013, a number of Fannie and Freddie stockholders filed suit challenging the amendment. Institutional stockholders argued that the amendment exceeded the parties' authority under the Recovery Act and constituted arbitrary and capricious conduct in violation of the Administrative Procedure Act. A class of stockholders, joined by a few institutional stockholders, alleged that the amendment constituted a breach of certain terms and covenants of the companies' stock certificates. The class also alleged breaches of fiduciary duty. The district court dismissed both complaints on the motions of FHFA and Treasury.

**Judicial bar applies.** On appeal, the D.C. Circuit wrote that it takes Congress at its word: Section 4617(f) of the Recovery Act provides, "no court may take any action to restrain or affect the exercise of powers or functions of the Agency as a conservator or a receiver." Although an exception to the bar on judicial review has been recognized where the agency has exceeded or violated its statutory powers or functions, the court held that FHFA's actions fall within its statutory activity for four reasons.

First, the Recovery Act endows FHFA with broad flexibility to carry out its role as conservator. The statute does not contain any directive that the agency build up capital for stockholders' benefit. Second, even if there were such a duty, nothing in the statute requires FHFA to do so in a manner that returns the companies to their prior condition for all stockholders. Tellingly, the court wrote, the institutional stockholders (and dissenting judge) accept that the original stock agreement and prior amendments fit within FHFA's statutory authority. Although the dissent argued that the amendment transformed the conservatorship into a de facto receivership or liquidation, the majority rejected the premise that there is a rigid boundary between the conservator and receiver roles. The argument also overlooks that Fannie and Freddie remain operational, with $5 trillion in combined operating assets, eight years into the conservatorship.

Third, the court rejected the institutional stockholders' argument that the amendment violated FHFA's fiduciary and statutory obligations to rehabilitate Fannie and Freddie to normal business operations because the

amendment was not needed to prevent further indebtedness and, instead, was meant to secure a windfall for Treasury at stockholders' expense. The motive behind the amendment is not germane to FHFA's authority, nor to the application of the ban on judicial review. Fourth, references to common-law and historical resources to demonstrate how a conservator normally acts do nothing to show that FHFA exceeded statutory bounds. The Recovery Act empowers FHFA to take any authorized action in the best interests of the regulated entity or of FHFA itself, undermining the supposition that Congress intended FHFA to act as a common-law conservator.

In dissent, Judge Brown pointed out that the Recovery Act's discretionary appointment provision allows for the appointment of FHFA as conservator *or* receiver. The disjunctive "or" means that FHFA may act as conservator or receiver, but cannot do both simultaneously. The Recovery Act's conservatorship standards derive verbatim from FIRREA, which brings with it the history of common-law fiduciary conservatorships, the judge reasoned. The dissent also took issue with the majority's reasoning that because FHFA is empowered to take action in the best interests of the regulated entity or the agency, the common-law definition of conservator does not apply. A more appropriate reading is that the provision merely allows FHFA to engage in self-dealing transactions; FIRREA's nearly identical provision has not stopped courts from limiting the FDIC to its statutory role.

**Some contract claims survive.** The Recovery Act's judicial bar also foreclosed the remaining statutory claims under the APA. As to the common-law claims against Treasury, even insofar as the court had subject-matter jurisdiction and Congress waived the agency's immunity, the Recovery Act nevertheless barred the claims. Only a few claims—contract-based claims against FHFA and the companies regarding liquidation preferences and dividend rights—survived and are remanded to the district court.

The case is No. 14-5243.

Attorneys: Douglas R. Cox (Gibson Dunn & Crutcher LLP) for Perry Capital LLC. Mark B. Stern, U.S. Department of Justice, for Steven T. Mnuchin.

Companies: Perry Capital LLC

MainStory: TopStory CorporateFinance DistrictofColumbiaNews