UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

TIMOTHY J. PAGLIARA

Plaintiff,

v.

FEDERAL HOME LOAN MORTGAGE CORPORATION,

Defendant.

Civil Action No. 1:16-cv-00337-JCC-JFA

PLAINTIFF'S OPPOSITION TO MOTION TO DISMISS OR, IN THE ALTERNATIVE, TO SUBSTITUTE THE FEDERAL HOUSING FINANCE AGENCY AS PLAINTIFF

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Plaintiff Timothy J. Pagliara ("Mr. Pagliara" or the "Plaintiff") hereby opposes the Motion to Dismiss or, in the Alternative, to Substitute the Federal Housing Finance Agency as Plaintiff (the "Motion," ECF No. 34) filed by Defendant Federal Home Loan Mortgage Corporation ("Freddie Mac") and its conservator, the Federal Housing Finance Agency ("FHFA," and with Freddie Mac, the "Movants").

INTRODUCTION

Mr. Pagliara is a stockholder in Freddie Mac, a publicly traded, privately owned corporation that has elected to follow Virginia law in its corporate governance. Mr. Pagliara asserts just one claim, seeking to inspect certain corporate records of Freddie Mac, which is his individual right as a stockholder under the Virginia Stock Corporation Act ("VSCA"). He seeks to inspect the records because of the so-called "Net Worth Sweep," under which Freddie Mac delivers every quarter, in perpetuity, its entire positive net worth to the United States Treasury. The VSCA plainly gives Mr. Pagliara, as an owner of Freddie Mac, the individual right to inspect its corporate records to investigate potential wrongdoing and to value his stockholdings in light of Freddie Mac's decision to give all of its multi-billion dollar profits to the government and nothing to any of its private stockholders.

Mr. Pagliara's lone claim in this case is narrow and straightforward. Under the VSCA, Mr. Pagliara is entitled to inspect the corporate records of Freddie Mac if he owned stock in Freddie Mac for six months before he made a written inspection demand on Freddie Mac and his inspection demand complied with the requirements of the VSCA. Proof that these requirements are satisfied is established by the documents attached to his Complaint. Indeed, when FHFA improperly rejected Mr. Pagliara's inspection demand, it did not dispute his stock ownership or that his demand complied with the requirements of the VSCA. Because FHFA nonetheless

rejected his demand, the VSCA gives Mr. Pagliara the individual right to seek an order permitting the requested inspection, and the VSCA provides explicitly that such actions should be decided on an "expedited basis." Va. Code Ann. § 13.1-773B.

For the second time since Mr. Pagliara filed this case, Freddie Mac and FHFA attempt to block this suit by invoking the Housing and Economic Recovery Act ("HERA"). For the second time, they are wrong.

Freddie Mac and FHFA rely first on HERA's succession provision, 12 U.S.C. § 4617(b)(2)(A)(i). That provision states that FHFA, as conservator of Freddie Mac, succeeds to "all rights, titles, powers, and privileges of the regulated entity, and of any stockholder . . . *with respect to the regulated entity and the assets of the regulated entity*." *Id.* (emphasis added). Courts have applied the succession provision to transfer a stockholder's right to bring *derivative* claims, which seek to enforce a right of the corporation itself—*i.e.*, a right "with respect to the regulated entity." No court has ever applied the provision in HERA to transfer a stockholder's right to bring *direct* claims, which seek to enforce the stockholder's individual rights. Interpreting an essentially identical provision in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), the Seventh Circuit has held explicitly that it provides for succession to *only* derivative claims, *not* direct claims. *See Levin v. Miller*, 763 F.3d 667, 672 (7th Cir. 2014). Indeed, an interpretation of the succession provision allowing FHFA to take over Mr. Pagliara's direct claims would raise the specter of a taking without just compensation. *Id.* Under Virginia law, a suit to inspect corporate records is a direct claim to enforce an individual right. Because HERA's succession provision applies only to derivative claims, FHFA has no right to take over Mr. Pagliara's suit for inspection of corporate records.

Next, Freddie Mac and FHFA repurpose their succession argument to contend that Mr. Pagliara's inspection request fails to meet the requirements of the VSCA. They argue that, because Mr. Pagliara's inspection might lead to him to assert, at some point in the future, a suit asserting derivative claims to which the succession provision applies, the inspection itself lacks a "proper purpose." *See* Va. Code § 13.1-771(D)(2). But Movants cite no Virginia authority to support performing such a "pass-through" analysis of hypothetical future claims as a basis to bar a stockholder's pending, independent request for inspection of corporate records. In any event, should Mr. Pagliara choose to pursue claims after his inspection of Freddie Mac corporate records, some of those claims are likely to be direct claims to which HERA's succession provision plainly does not apply. (Compl. ¶¶ 105-06). Others are likely to be derivative claims where FHFA has a patent conflict of interest and the succession provision, under analogous FIRREA case law, again does not apply. (*See, e.g.*, *id.* ¶¶ 110-12). Freddie Mac and FHFA cannot bootstrap into this limited records request possible defenses they might have to potential claims that might be asserted in another lawsuit that might be filed at some point in the future. Those potential defenses can be raised and addressed on their merits if and when a future suit is brought; they provide no justification for Movants' request to take over and dismiss Mr. Pagliara's current suit for inspection of corporate records.

Last, Freddie Mac and FHFA turn to HERA's anti-injunction provision, 12 U.S.C. § 4617(f). That provision prohibits a court from taking action "to restrain or affect the exercise of powers or functions of [FHFA] as a conservator." *Id.* As with the succession provision, Movants over-read HERA. The anti-injunction provision has been interpreted to bar (1) restrictions on FHFA's exercise of its business judgment and (2) derivative suits. This case involves neither.

Compliance with the non-discretionary statutory obligation to disclose the requested corporate records at issue in this case in no way "restrain[s] or affect[s]" FHFA's role as conservator.

Movants ask this Court to adopt an unprecedented expansion of FHFA's powers under HERA. No other court has ever done so. Movants give this Court no basis to be the first. For those reasons and the reasons set forth below, the Motion should be denied.

BACKGROUND

Mr. Pagliara Is a Stockholder in Freddie Mac, a Publicly Traded Corporation Governed by Virginia Law.

Defendant Freddie Mac is a privately owned corporation with publicly traded preferred and common stock. (Compl. ¶ 23; Def.'s Financial Interest Disclosure Statement (Local Rule 7.1), ECF No. 7). Freddie Mac was created by Congress through the Federal Home Loan Mortgage Corporation Act to improve liquidity in the home mortgage market. (Compl. ¶¶ 24-26). There is no federal corporate law, and Freddie Mac has elected to "follow the corporate governance practices and procedures of the law of the Commonwealth of Virginia, including without limitation the Virginia Stock Corporation Act as the same may be amended from time to time." (*Id.* ¶¶ 25-28). Mr. Pagliara is a private owner of publicly traded preferred stock in Freddie Mac, and the certificates of designation for Mr. Pagliara's preferred stock, which are contracts between Freddie Mac and Mr. Pagliara, are expressly governed by Virginia law. (*Id.* ¶¶ 29-31).

Under the VSCA, Freddie Mac is governed by a board of directors (the "Board"): "all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors." Va. Code Ann. § 13.1-673B. The Board owes fiduciary duties to Freddie Mac, and it must discharge those duties in the best interests of the corporation. *See* Va. Code Ann. § 13.1-690A ("A director shall

discharge his duties as a director, including his duties as a member of a committee, in accordance with his good faith business judgment of the best interests of the corporation.").

FHFA Appointed Itself Conservator in 2008 and Admitted That Stockholders Retained Rights.

As a response to the financial crisis in 2008, Congress passed HERA, which created FHFA and made it the primary regulator of Freddie Mac. HERA also gave FHFA the ability to appoint itself as either conservator or receiver of Freddie Mac and certain other regulated entities. *See* 12 U.S.C. § 4617(a). On September 7, 2008, FHFA appointed itself as conservator of Freddie Mac. (Compl. ¶ 55). HERA provides that, as conservator, FHFA temporarily succeeds to the rights of Freddie Mac and certain rights of its stockholders, board of directors, and managers to act on behalf of the corporation. *See* 12 U.S.C. § 1367(b)(2)(A); *U.S. ex rel Adams v. Aurora Loan Servs., Inc.*, 813 F.3d 1259, 1261 (9th Cir. Feb. 22, 2016) (slip op.) ("We agree that the FHFA has 'all the rights, titles, powers and privileges of' Fannie Mae and Freddie Mac. However, this places FHFA in the shoes of Fannie Mae and Freddie Mac, and gives the FHFA *their* rights and duties, not the other way around.") (emphasis in original, internal citations omitted). These corporate powers to which FHFA has succeeded are defined and governed by the VSCA. (Compl. ¶¶ 65-67).

Contrary to Movants' position now, when the conservatorship was announced, FHFA and its then-Director, James Lockhart, admitted that FHFA's succession to the rights of Freddie Mac did not include each and every right of its stockholders. Freddie Mac's common and preferred stock continued to trade on the New York Stock Exchange, and FHFA acknowledged that "stockholders will continue to retain all rights in the stock's financial worth; as such worth is determined by the market." Director Lockhart also assured Congress that Freddie Mac's

"shareholders are still in place; both the preferred and common shareholders have an economic interest in the companies . . . ." (Compl. ¶ 62).

FHFA's exercise of its finite powers as conservator is also limited by the statutory purpose of conservatorship. At the time it appointed itself as conservator, FHFA acknowledged that "conservatorship is the legal process in which a person or entity is appointed to establish control and oversight of a Company to put it in sound and solvent condition." (*Id*. ¶ 57). Director Lockhart further explained that conservatorship was "a statutory process designed to stabilize a troubled institution with the objective of returning the entities to normal business operations [and that] FHFA will act as the conservator until they are stabilized." (*Id*.). These statements comported with the language of HERA itself, which authorizes FHFA to exercise conservator powers only as "(i) necessary to put the regulated entity in a *sound and solvent condition*, and (ii) appropriate to carry on the business of the regulated entity and *preserve and conserve the assets and property of the regulated entity*." 12 U.S.C. § 4617(b)(2)(D) (emphasis added).

FHFA Displaced the Freddie Mac Board and Executed the Senior Preferred Stock Purchase Agreement with Treasury.

Upon appointing itself conservator of Freddie Mac, FHFA displaced and dismissed Freddie Mac's then-current directors. (Compl. ¶ 65). FHFA then entered into on behalf of Freddie Mac a senior preferred stock purchase agreement (the "PSPA") with the Treasury Department. (*Id*. ¶ 73). Under the PSPA, Treasury received 1,000,000 shares of Freddie Mac's newly created Senior Preferred Stock in exchange for a funding commitment that initially allowed Freddie Mac to draw up to $100 billion from Treasury. (*Id.* ¶ 75). The 1,000,000 shares of Senior Preferred Stock had an initial aggregate liquidation preference equal to $1 billion ($1,000 per share), which would be increased by any additional amounts drawn on Treasury's funding commitment. (*Id.* ¶ 76). Basically, Treasury's liquidation preference on its Senior

Preferred Stock increased by one dollar for each dollar Freddie Mac received from Treasury under the funding commitment. (*Id.*) The Senior Preferred Stock initially provided for a cash dividend to Treasury equal to 10% of the outstanding liquidation preference. (*Id.* ¶ 79).

The Senior Preferred Stock Certificate of Designation for Treasury's Senior Preferred Stock, consistent with the VSCA, vested the Board with discretion to declare dividends thereunder: "holders of outstanding shares of Senior 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 therefor, cumulative cash dividends at the annual rate per share equal to the then-current Dividend Rate on the then-current Liquidation Preference." (*Id.* ¶ 80).

FHFA Reconstituted Freddie Mac's Board and Delegated Authority to That New Board.

On November 24, 2008, having succeeded to the Board's powers and executed the PSPA, FHFA reconstituted Freddie Mac's Board and delegated responsibility to which it had succeeded back to the new Board. (*Id.* ¶¶ 63-66). Because the Board's corporate powers that FHFA succeeded to as conservator are governed by Virginia's corporate law, the powers FHFA delegated back to the new Board likewise are governed by Virginia law. (*See id.* ¶ 67). Under the structure that FHFA established, certain Board actions were subject to FHFA approval, and FHFA could block Freddie Mac from taking some actions approved by the Board if consistent with fiduciary duties FHFA itself owes to Freddie Mac. (*Id.* ¶ 68). But FHFA could not make the Board take or approve any action. (*Id.*).

FHFA and the New Board Agreed to a Third Amendment to the PSPA, Giving Away Freddie Mac's Entire Net Worth, Every Quarter, Forever.

On August 17, 2012, just two weeks after Freddie Mac announced positive net income of $3 billion for the second quarter of 2012, Freddie Mac entered into a Third Amendment to the PSPA, which contained the Net Worth Sweep, transforming Freddie Mac's quarterly dividend to

Treasury from 10% of the outstanding liquidation preference (annualized) to all of the net worth in Freddie Mac at the end of every quarter, leaving only a small and decreasing capital reserve. (Compl. ¶¶ 92-96). Treasury openly asserted that this agreement would "help expedite the wind down of . . . Freddie Mac" and that Freddie Mac "will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in [its] current form." (*Id.* ¶ 99). Treasury further admitted that the Net Worth Sweep would "make sure that every dollar of earnings [the] firm generates is used to benefit taxpayers." (*Id.*). The Net Worth Sweep thus plainly violates both the purposes of conservatorship under HERA and contradicts FHFA's own statements back in 2008 that conservatorship was "a statutory process designed to stabilize a troubled institution with the objective of returning the entit[y] to normal business operations" and "to put it in sound and solvent condition." (*Id.* ¶ 57).

The result is the improper and ongoing transfer of tens of billions of dollars from a private corporation to the Treasury. Absent the Net Worth Sweep, even assuming no redemptions of Treasury's Senior Preferred Stock, Freddie Mac would have paid roughly $23 billion in dividends to Treasury from 2013 through the first quarter of 2016. Instead, under the Net Worth Sweep, Freddie Mac has paid more than $74.4 billion in dividends over the same period, without redeeming any of the Senior Preferred Stock. (*Id.* ¶ 97). In total, Freddie Mac has paid to Treasury over $98 billion in dividends under the PSPA—$27 billion more than Treasury provided to Freddie Mac under the PSPA—*without* reducing Treasury's $72 billion liquidation preference that has to be redeemed before any distributions can be made to the other stockholders. (*Id.* ¶ 15). And there is no end in sight. (*Id.* ¶¶ 14-15). The declaration and payment

of the Net Worth Sweep dividends are plainly not actions taken based on any good faith business judgment of the best interest of Freddie Mac and its stockholders. (*Id.* ¶¶ 98-103). 1/

Mr. Pagliara Made a Proper Inspection Demand Under the VSCA, and FHFA Rejected It.

Given the ever-growing gulf between Treasury's funding and the dividends paid by Freddie Mac to Treasury, conflicting statements about the conservatorship, and a dearth of public information about the Board's involvement in approving Net Worth Sweep dividends to Treasury, on January 19, 2016, Mr. Pagliara served a written demand to inspect certain corporate records of Freddie Mac in accordance with Section 13.1-771 of the VSCA. (Compl. ¶¶ 122-28, Ex. A thereto). 2/ That section gives stockholders like Mr. Pagliara a right to inspect corporate records after making an inspection demand on the corporation. The records Mr. Pagliara asked to inspect relate to, among other things, the involvement of the Board—which is responsible for declaring dividends under the VSCA and Treasury's Senior Preferred Stock Certificate of Designation and owes fiduciary duties to Freddie Mac—in adopting the Third Amendment and declaring quarterly Net Worth Sweep dividends thereunder, as well as accounting records

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1/ Although FHFA has attempted to defend the Net Worth Sweep as beneficial to Freddie Mac, several documents unsealed recently in another case, *Fairholme Funds, Inc. v. United States*, No. 13-cv-00465 (Fed. Cl.), confirm that the Net Worth Sweep is nothing more than what Treasury said it is: a money grab by Treasury in which FHFA and the Board were complicit. *See* Gretchen Morgenson, *Documents Undercut U.S. Case for Taking Mortgage Giant Fannie Mae's Profits*, N.Y. Times (April 12, 2016), http://www.nytimes.com/2016/04/13/business/fannie-mae-suit-bailout.html?smid=tw-share&_r=0. The documents reveal that the Net Worth Sweep was enacted just after FHFA learned Freddie Mac and Fannie Mae were entering "the golden years" of profitability and enacted to ensure the two private companies could not "repay their debt and escape" and to "close off [the] possibility they ever go . . . private again." *See* Gretchen Morgenson, *How Freddie and Fannie are Held Captive*, N.Y. Times (May 20, 2016), http://www.nytimes.com/2016/05/22/business/how-freddie-and-fannie-are-held-captive.html.

2/ Mr. Pagliara also sent the Board a second letter on January 19, 2016, asking the Board to publicly clarify its role in declaring and paying dividends to Treasury. (Compl. ¶ 119 & Ex. E thereto). The Board never responded to this letter. Instead, FHFA responded and told Mr. Pagliara that the Board owes no duties to anyone other than FHFA. (Compl., Ex. B thereto).

relating to Freddie Mac's financial condition at the time those dividends were declared. (Compl. ¶¶ 123-25, and Ex. A thereto).

In responding to the inspection demand, neither Freddie Mac nor FHFA disputed that Mr. Pagliara met all the statutory requirements in his inspection demand. Yet FHFA refused the demand on January 28, 2016, arguing that FHFA succeeded under HERA to all of Mr. Pagliara's rights as a stockholder of Freddie Mac, including his individual right to inspect corporate records under the VSCA. (Compl. ¶¶ 126-128, and Ex. B thereto).

Mr. Pagliara Files This Suit to Permit Inspection, and Freddie Mac Moves to Dismiss.

On March 14, 2016 in the Circuit Court for Fairfax County, Virginia, Mr. Pagliara filed an application under Sections 13.1-771 and -773 of the VSCA for an order permitting inspection of the requested records. Shortly thereafter, Freddie Mac removed Mr. Pagliara's case to this District.

FHFA then noticed this case as a "tag-along" action to a Motion to Transfer pending before the Judicial Panel on Multidistrict Litigation ("JPML"). FHFA also then moved to stay this case pending the JPML's transfer decision, and moved in the alternative to substitute for Mr. Pagliara as plaintiff. (*See* Mot. to Stay or, in the Alternative, to Substitute, ECF No. 10). This Court granted the motion to stay and denied the motion to substitute without prejudice. (*See* Mem. Op., ECF No. 29).

On June 2, 2016, the JPML denied FHFA's motion to centralize pretrial proceedings in this case and others. (*See* Notice of JPML's Denial, ECF No. 31). Freddie Mac and FHFA then filed the Motion at issue. This Motion repeats nearly verbatim the arguments from the "substitution" half of their prior motion to stay or substitute. For the same reasons that Mr. Pagliara previously explained, the Motion should be denied.

ARGUMENT

Freddie Mac and FHFA offer three theories why Mr. Pagliara cannot bring a claim for the inspection of corporate records under Section 13.1-771 of the VSCA: (1) HERA's succession provision has transferred his claim to FHFA; (2) Mr. Pagliara lacks a "proper purpose" as required by the VSCA; and (3) HERA's anti-injunction provision bars such a suit. Although framed differently, each of these three theories turns on the same mistaken belief that HERA strips shareholders of all rights and claims of any kind relating to a company in conservatorship, including the stockholders' individual rights and their direct claims to enforce them. No court has ever adopted that over-reading of the statute. This Court should not become the first to hand FHFA the wide-ranging new authority it seeks here.

I. HERA's Succession Provision Does Not Strip Mr. Pagliara of His Direct Claims.

Freddie Mac and FHFA first argue that HERA's succession provision, 12 U.S.C. § 4617(b)(2)(A)(i), transfers Mr. Pagliara's claim to FHFA. They repeatedly contend that the statute transfers to FHFA "all rights . . . of any stockholder," full stop. (*See, e.g.*, Mot. 4, 8, 9). The text of the statute, they assert, is "clear," "unequivocal, "unambiguous," and the like. (*E.g.*, Mot. 4, 5, 7). But Movants quote the full text exactly once, on the first page of their background section. (*See* Mot. 2). The full succession provision in fact states:

> The Agency shall, as conservator or receiver, and by operation of law, immediately succeed to—(i) all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity *with respect to the regulated entity and the assets of the regulated entity*.

12 U.S.C. § 4617(b)(2)(A)(i) (emphasis added). Contrary to the abridged version Movants repeat in their paper, the full provision transfers not "all rights" without qualification, but only those rights "*with respect to the regulated entity and the assets of the regulated entity*." The critical "with respect to" qualification undercuts Movants' singular reliance on the term "all rights."

Movants repeatedly urge the Court to "read the statute." Mr. Pagliara agrees. He asks that the Court read *all* of the relevant statutory provision, not just the half sentence that Movants cite, along with the case law interpreting the entire relevant provision and the identical language in FIRREA.

There are two possible readings of the "with respect to" qualification. The first, and the one that Freddie Mac and FHFA presumably adopt, is that the succession provision transfers all stockholder claims *that relate in any way to Freddie Mac*. The second, and the correct one that Mr. Pagliara adopts, is that the succession provision transfers all stockholder claims *that are brought on behalf of Freddie Mac or its assets*. A unanimous and ever-growing group of courts has adopted the latter reading of the statute: As conservator, a government agency like FHFA succeeds to *derivative* claims that stockholders might otherwise assert on behalf of the corporation. Accordingly, FHFA does not take ownership of an individual stockholder's stock, (*see* Compl. ¶ 62), and it does not succeed to *direct* claims that an individual stockholder might bring on his or her own behalf to enforce individual rights. The inspection claim that Mr. Pagliara asserts here is a textbook example of a direct claim that remains with the stockholder. Thus, as explained below, the succession provision is no bar to his claim for inspection of corporate records.

A. HERA Transfers Derivative Claims Only.

1. Courts Analyzing Succession Provisions Have Uniformly Distinguished Between Direct and Derivative Claims.

Even though this is their second chance, Movants fail once again to confront the overwhelming weight of the case law against them. Instead, Movants suggest that courts have "consistently" adopted their preferred interpretation of HERA. (Mot. 5; *see also id.* at 7 (discussing the supposedly supportive "decisions of multiple courts")). Not so. In fact, every case

that Movants cite either affirmatively endorses the distinction between derivative and direct claims or adheres to that rule without comment.

For decades, courts have interpreted what FHFA itself contends is a "materially-identical" succession provision in FIRREA. (Mot. to Stay, or in the Alternative, Substitute 9, ECF No. 10). 3/ Those courts have established a uniform rule that FIRREA's succession provision bars stockholders from bringing derivative claims, but not direct claims. *See, e.g., Barnes v. Harris*, 783 F.3d 1185, 1193 (10th Cir. 2015); *Levin*, 763 F.3d at 672; *In re Beach First Nat'l Bancshares, Inc.*, 702 F.3d 772, 778-79 (4th Cir. 2012); *Pareto v. FDIC*, 139 F.3d 696, 699-700 (9th Cir. 1998); *Lubin v. Skow*, 382 F. App'x 866, 870 (11th Cir. 2010). As the Seventh Circuit observed in *Levin* two years ago, "[n]o federal court has read the statute" to bar direct stockholder claims. 763 F.3d at 672. That remains true today. Judge Easterbrook explained why in *Levin*:

> At oral argument the court asked counsel whether § 1821(d)(2)(A)(i) should be understood . . . to transfer to the FDIC *all* claims held by any stockholder of a failed bank—even claims that . . . do not depend on an injury to the failed bank. No federal court has read the statute that way, however, and counsel for all of the litigants declined to adopt that understanding. Section 1821(d)(2)(A)(i) transfers to the FDIC only stockholders' claims "with respect to . . . the assets of the institution"—in other words, those that investors (but for § 1821(d)(2)(A)(i)) would pursue derivatively on behalf of the failed bank. This is why we have read § 1821(d)(2)(A)(i) as allocating claims between the FDIC and the failed bank's shareholders rather than transferring to the FDIC every investor's claims of every description. Any other reading of § 1821(d)(2)(A)(i) would pose the question whether . . . stockholders would be entitled to compensation for a taking; our reading of the statute (which is also the FDIC's) avoids the need to tackle that question.

Id. (emphasis in original).

3/ *See* 12 U.S.C. § 1821(d)(2)(A)(i) (FDIC "shall, as conservator or receiver, and by operation of law, immediately succeed to . . . all rights, titles, powers, and privileges of the insured depository institution, and of any stockholder, member, accountholder, depositor, officer, or director of such institution with respect to the institution and the assets of the institution").

Courts have used this well-established construction of FIRREA's succession provision to interpret HERA's "materially-identical" provision. Another court in this district, for example, was "persuaded by" FIRREA decisions in holding that "HERA bars derivative suits by shareholders of the affected companies." *In re Fed. Home Loan Mortg. Corp. Deriv. Litig.*, 643 F. Supp. 2d 790, 795 (E.D. Va. 2009), *aff'd sub nom, La. Mun. Police Emps. Ret. Sys. v. FHFA*, 434 F. App'x 188 (4th Cir. 2011). Several other courts have come to the same conclusion. *See, e.g.*, *Kellmer v. Raines*, 674 F.3d 848, 850 (D.C. Cir. 2001) (explaining that HERA "plainly transfers shareholders' ability to bring derivative suits"); *Perry Capital LLC v. Lew*, 70 F. Supp. 3d 208, 232 (D.D.C. 2014) (concluding that "HERA's plain language bars shareholder derivative suits"); *Esther Sadowsky Testamentary Trust v. Syron*, 639 F. Supp. 2d 347, 350 (S.D.N.Y. 2009) (granting motion to substitute in a derivative "action on Freddie Mac's behalf"); *In re Fed. Nat'l Mortg. Ass'n Secs., Derivative, & ERISA Litig.*, 629 F. Supp. 2d 1, 4 (D.D.C. 2009) (granting motion to substitute "for the shareholder derivative plaintiffs"). Movants cite almost every one of these FIRREA and HERA decisions—without acknowledging that not a single one permitted a conservator to commandeer, under either HERA or FIRREA, a stockholder's direct claims.

In determining what rights a conservator obtains by succession, this well-established distinction between derivative and direct claims makes perfect sense. As conservator, FHFA has the right and authority to operate Freddie Mac, which includes succession to the rights that the shareholders have to make decisions for the corporation and to bring certain claims on the corporation's behalf. But FHFA does not need Mr. Pagliara's individual rights as a stockholder to perform its statutory duties as conservator, and FHFA does not succeed to those individual rights. Mr. Pagliara still owns his stock, and he remains free to sell his stock or buy more shares

in Freddie Mac without FHFA's permission. Plainly then, FHFA has not succeeded to "all" of Mr. Pagliara's rights as a stockholder as Movants would have the Court rule. FHFA is the conservator *of Freddie Mac*, not the conservator *of Mr. Pagliara*. FHFA cannot take over his individual claims and prevent him from suing to protect his individual rights as a stockholder.

2. Movants' Counterarguments Are Unavailing.

Freddie Mac and FHFA propose three reasons why this Court should reject the well-established direct/derivative rule and be the first to hold that HERA transfers a shareholder's direct claims to FHFA. None is persuasive.

First, Freddie Mac and FHFA argue that the uniform direct/derivative rule is not all that compelling because "the question of a conservator or receiver's succession to non-derivative claims was not squarely presented or briefed" in prior cases. (Mot. 8 n.6). The premise is (at least partially) right, but the conclusion is wrong. That is because the FDIC (under FIRREA) and FHFA (under HERA) have both previously followed the distinction between direct and derivative claims, just as Mr. Pagliara asks the Court to do here. In *Levin*, for example, the FDIC *conceded* that the stockholder retained ownership of certain direct claims, which had not been transferred to the agency. *See* 763 F.3d at 670, 672. 4/ Similarly, FHFA moved to substitute in the *Kellmer* litigation "only with respect to the derivative claims asserted by Fannie Mae

4/ Movants are incorrect, however, to suggest that the direct/derivative rule was not an issue before the Seventh Circuit in *Levin*. (*See* Mot. 8 n.6). The lower court had dismissed all seven claims asserted by the shareholder plaintiff, holding that all were derivative claims and "belong to the FDIC." *Levin*, 763 F.3d at 670. While the FDIC did not dispute that two of those claims "belong to [the shareholder]" (*i.e.*, were direct), the other defendants did and asked the Seventh Circuit to affirm the lower court's decision that they were barred by the succession provision. *Id.* Thus, in order to vacate the lower court's dismissal of those direct claims, the *Levin* court necessarily had to decide both whether the claims were direct and whether direct claims were barred by the succession provision. *Id.* at 672. The fact that, as Movants note, the FDIC did not dispute that the shareholder could pursue its direct claims only reinforces the direct/derivative rule. (Mot. 8 n.6).

shareholders," and FHFA *did not dispute* that the shareholder plaintiff could continue to pursue claims brought "in his individual capacity." (Mot. of FHFA as Conservator for Fannie Mae to Substitute for Shareholder Derivative Plaintiffs at 1 n.1, *Kellmer v. Raines*, No. 07-1173 (D.D.C. Feb. 2, 2009), ECF No. 68, Ex. 1 hereto). 5/ Thus, the fact that the federal government has in the past taken a much narrower view of the succession provisions in FIRREA and HERA should make this Court *more* skeptical of FHFA's power grab here, not less so.

Second, Freddie Mac and FHFA argue that the direct/derivative rule "reads into HERA restrictions that Congress did not provide" and thus contradicts "the statute's plain language." (Mot. 8). This argument again depends on Movants' blinkered view of the statute. Because Freddie Mac and FHFA stop reading the succession provision after "all rights," it is no surprise that they view the direct/derivative rule as an extra-textual limitation. But the subsequent qualification in the text itself—"with respect to the regulated entity and the assets of the entity"—does important work. That qualification limits the succession provision to those claims "that investors (but for [the succession provision]) would pursue derivatively on behalf of" Freddie Mac. *Levin*, 763 F.3d at 672. Again, Mr. Pagliara still owns his stock, and FHFA cannot prevent Mr. Pagliara from suing to protect his individual rights as a stockholder.

Third, Freddie Mac and FHFA contend that the canon against superfluity demands that the succession provision transfer direct claims. Under their theory, HERA's succession provision would be meaningless if limited to derivative actions because derivative actions already belong

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5/ Movants cite *Kellmer* for the proposition that "HERA's unequivocal succession language applies to all claims 'fairly described as [relating to] a right[] or power[] of owning stock.'" (Mot. 7) (internal quotations omitted)). Neither *Kellmer's* holding, nor the statement actually quoted, was so broad. The full sentence quoted by Movants actually confirms the court's analysis was limited to derivative claims: "But regardless of its origins, a shareholder's ability to sue *derivatively* given certain conditions is fairly described as a 'right[]' or 'power[]' of owning stock." *Kellmer*, 674 F. 3d at 848 (emphasis added).

to the corporation and thus to FHFA as conservator. (*See* Mot. 9-10). In other words, because FHFA immediately succeeded to Freddie Mac's rights, succeeding only to a stockholder's right to bring a derivative claim on behalf of the company "would add nothing." (*Id.* at 10). As Mr. Pagliara has already explained, there is a glaring flaw in that argument. Derivative claims always *belong to* the company; nevertheless, they are always *brought by* a stockholder. (*See id.* at 9 (citing *Ross v. Bernhard*, 396 U.S. 531, 538 (1970)). Without the succession provision, Freddie Mac stockholders could still bring derivative claims on Freddie Mac's behalf—notwithstanding the fact that those claims ultimately belong to Freddie Mac or its conservator. With the succession provision, stockholders cannot. Thus, under Mr. Pagliara's interpretation, and applying the direct/derivative rule, the succession provision is in no way superfluous.

Instead, it is *Movants'* reading of the statute that renders a key provision superfluous. Their reading of the statute would give virtually no meaning to the qualification "with respect to the regulated entity and the assets of the regulated entity." Movants have previously argued that the qualification is necessary to make clear that Congress stripped stockholders of their rights as holders of Freddie Mac stock, and that FHFA did not succeed to Mr. Pagliara's "rights flowing from his stock holdings in other companies." (Reply in Supp. of Mot. to Stay or Substitute 12, ECF No. 25). Surely, Congress did not add "with respect to the regulated entity and the assets of the entity" to clarify that FHFA, when acting as a conservator of Freddie Mac, does not succeed to all the rights of all Freddie Mac shareholders in all the stock they own in other companies. The notion that anyone would think that, without the qualification, HERA might otherwise allow FHFA to take over all of Mr. Pagliara's rights as a stockholder in say, Microsoft or General Motors, is preposterous. The qualification provision is there, just as *Levin* holds, in order to make

the direct/derivative distinction. So it is Movants' proposed interpretation that would render a key portion of the statute superfluous, providing yet another reason to reject that interpretation.

3. Constitutional Avoidance Requires Mr. Pagliara's Interpretation.

Even if Movants and Mr. Pagliara had offered competing "plausible interpretations" of HERA, this Court must presume "that Congress did not intend the alternative which raises serious constitutional doubts." *Clark v. Martinez*, 543 U.S. 371, 381 (2005). Movants' interpretation raises a serious constitutional question under the Takings Clause of the Fifth and Fourteenth Amendments. After all, a direct claim is, by its very nature, Mr. Pagliara's individual property. *See* Va. Code § 13.1-771 (affording inspection rights to individual stockholders); *see also, e.g., Alliance of Descendants of Texas Land Grants v. United States*, 37 F.3d 1478, 1481 (Fed. Cir. 1994) (concluding that "a legal cause of action is property within the meaning of the Fifth Amendment"). If HERA were construed to strip Mr. Pagliara of his property and to transfer that property to a government agency without just compensation, the statute would violate the Takings Clause. By contrast, construing HERA to leave direct claims untouched "avoids the need to tackle that [Takings-Clause] question." *Levin*, 763 F.3d at 672. For that reason, too, this Court should reject Freddie Mac and FHFA's interpretation of the succession provision.

B. Mr. Pagliara's Claim for Inspection of Corporate Records Is a Direct Claim.

The sole question, then, is whether Mr. Pagliara's claim for inspection of corporate records is direct or derivative. That question is an easy one in Virginia: an inspection claim under Section 13.1-773 is a prototypical direct stockholder claim. *See* Allen C. Goolsby & Steven M. Haas, *Goolsby & Haas on Virginia Corporations* § 8.1 ("[A]n action . . . demanding the right to inspect books and records, is an individual action."); American Law Institute, *Principles of Corp.*

Governance: Analysis and Recommendations § 7.01 (1994) (listing actions "to inspect corporate books and records" among the actions that courts have "properly considered" direct). 6/

The direct-versus-derivative analysis is straightforward. "A derivative action is an equitable proceeding in which a shareholder asserts, on behalf of the corporation, a claim that belongs to the corporation rather than the shareholder." *Simmons v. Miller*, 544 S.E.2d 666, 674 (Va. 2001). A direct action, by contrast, is a proceeding in which the stockholder seeks to redress an injury he has sustained, or to enforce a right he possesses, in his individual capacity. *Cf. id.*; *see also Remora Invs. LLC v. Orr*, 673 S.E.2d 845, 847-48 (Va. 2009). Under Section 13.1-771 of the VSCA, the right to inspect a corporation's records is a right that each stockholder possesses in an individual capacity. As the Virginia Supreme Court has explained, the statute allows a stockholder to request inspection so long as the "request is made in good faith and for the purpose of protecting *his rights* as an owner of stock." *Retail Prop. Inv'rs, Inc. v. Skeens*, 471 S.E.2d 181, 183 (Va. 1996) (emphasis added). Because inspection is ultimately Mr. Pagliara's right as a stockholder and not Freddie Mac's right as a corporation—why would Freddie Mac ever need a right to demand inspection of its own records?—the Complaint here asserts a direct claim.

6/ Freddie Mac and FHFA assert that Mr. Pagliara's right of inspection arises under Freddie Mac's bylaws, not under Virginia law. (Mot. 6 n.4). It is an odd assertion. Freddie Mac is a publicly traded, privately owned corporation that is required by federal regulation to select a body of law for its corporate governance. *See* 12 C.F.R. § 1239.3(b). It has selected "the corporate governance practices and procedures of the law of the Commonwealth of Virginia, including without limitation the Virginia Stock Corporation Act as the same may be amended from time to time." Bylaws of the Federal Home Loan Mortgage Corporation § 11.3(a) (as amended and restated July 7, 2016), http://www.freddiemac.com/governance/pdf/bylaws.pdf. Thus, the VSCA governs this suit. Movants do not point to any relevant legal consequence that might flow from the fact the VSCA applies here because Freddie Mac itself chose to be governed by Virginia law, as there is none.

Freddie Mac and FHFA do not appear to disagree. They never contest that an inspection claim is a direct claim. They do, however, argue that the nature of the *claim* "has no bearing on the succession analysis here" because FHFA has purportedly succeeded to "the *right* upon which" that claim is based. (Mot. 10). In other words, even if Mr. Pagliara could bring a direct claim to enforce his right to inspect corporate records, Movants contend he does not have the underlying right to inspect corporate records. *Id.*

Movants cite no support for this argument; it appears to be a mere repackaging of their argument that the HERA succession provision strips Freddie Mac stockholders of all rights, not just those "with respect to" the company and its assets. After all, a direct claim is *by definition* a claim to enforce an individual right. *See Simmons*, 544 S.E.2d at 674; *Remora Invs.*, 673 S.E.2d at 847-48. Under Virginia law, the individual right to bring suit for court-ordered inspection tracks, naturally, the individual right of inspection. *See* Va. Code § 13.1-771C (right of inspection); *id.* § 13.1-773B (right to obtain court-ordered inspection); *see also Cattano v. Bragg*, 727 S.E.2d 625, 631 (Va. 2012) (explaining that "Code § 13.1-773 . . . affords redress for a corporation's failure to permit a shareholder to inspect documents in accordance with Code § 13.1-771"). Where vindication of the shareholder right at issue does not require proof of harm to the corporation, the claim to enforce that right is direct, and the succession provision does not transfer either the underlying individual right or the claim to enforce that right. *See Levin*, 763 F.3d at 670-72.

II. Mr. Pagliara Has Identified a "Proper Purpose" Under Virginia Law.

Under Virginia law, a stockholder's demand for inspection must be "made in good faith and for a proper purpose." Va. Code § 13.1-771(D)(2); *Retail Prop.*, 471 S.E. 2d at 183. Freddie Mac and FHFA argue that—at the motion-to-dismiss stage—Mr. Pagliara has not pleaded a proper purpose because he cannot possibly bring "any claim with respect to matters arising from

an inspection of books and records." (Mot. 10). Movants contend that Mr. Pagliara must, at the threshold of this case, demonstrate standing to bring a hypothetical subsequent suit, using the hypothetical information unearthed in the inspection of corporate records that Movants have to date prevented him from conducting. For that proposition, they cite *United Technologies Corp. v. Treppel*, 109 A.3d 553 (Del. 2014). There are two major problems with their argument.

First, Movants do not cite any authority that a "proper purpose" in Virginia Code Section 13.1-773 is so restricted. *United Technologies* is a Delaware case that focuses on the corporate inspection right under the Delaware General Corporation Law. 7/ It says nothing about Virginia law, and it is telling that Movants have found no comparable limitation in Virginia. Virginia courts have never required a "pass-through" analysis of all potential claims that the inspection might unearth. Instead, a stockholder pursues a proper purpose so long as his request is designed "to protect his rights as a shareholder." *Retail Prop.*, 471 S.E.2d at 183; *see also Bank of Giles Cnty. v. Mason*, 98 S.E.2d 905, 908 (Va. 1957) (a proper purpose is "some reasonable purpose germane to his interest as a stockholder"). Mr. Pagliara's suit easily clears that low bar. He seeks to: investigate potential breaches of duty and corporate waste injuring the company, as well as potential contract-based claims for injury to his individual rights; determine the company's corporate governance positions and practices, its safety and soundness, and the extent of the independence and disinterestedness of the Board; and value his own stock in Freddie Mac, among a number of other proper purposes. (*See, e.g.*, Compl. ¶¶ 122-124; Ex. A thereto, at 4-5).

Second, even if Virginia law required a showing of standing in a potential subsequent suit to establish a "proper purpose" for this action, Mr. Pagliara more than meets any such

7/ Even if it did apply, *United Technologies* does not establish a hard-and-fast rule that an inspecting stockholder must always demonstrate his standing to bring a subsequent suit; it simply describes the substantial discretion that Delaware courts have exercised in determining when to permit inspections. *See* 109 A.3d at 558-59.

requirement. For example, many of the potential claims he seeks to investigate are themselves direct, including claims for breach of contract and breach of the covenant of good faith and fair dealing. (*See* Compl. ¶¶ 105-06; *see generally id.* ¶¶ 98-114). If Mr. Pagliara is right that HERA's succession provision does not bar this direct suit, then he is equally right that HERA's succession provision does not bar a potential direct suit for breach of contract or breach of the covenant of good faith and fair dealing.

Furthermore, Mr. Pagliara seeks to investigate a number of derivative claims in which FHFA and/or Treasury may have a conflict of interest. (*See, e.g.*, Compl. ¶¶ 53-56, 81-83, 90-97, 123). At least two courts of appeals have adopted a conflict-of-interest exception to the "materially-identical" succession provision in FIRREA. *See Delta Savings Bank v. United States,* 265 F.3d 1017, 1021-23 (9th Cir. 2001); *First Hartford Corp. Pension Plan & Trust v. United States*, 194 F.3d 1279, 1295-96 (Fed. Cir. 1999); (Compl. ¶ 128). Mr. Pagliara thus may be entitled to bring the potential derivative claims he seeks to investigate, depending on the ultimate results of his investigation. Those unknown eventualities further underscore the impropriety of conducting a "pass-through" analysis based on hypothetical claims that Mr. Pagliara might or might not assert in a future lawsuit.

In sum, Mr. Pagliara has numerous proper purposes for his records demand under the VSCA, many of which do not contemplate any subsequent lawsuit. Even for his purposes involving investigation of potential breaches of duty and contract, there is no requirement under Virginia law that Mr. Pagliara establish in this records suit standing to bring a hypothetical future suit seeking relief with respect to those potential breaches. And even if there were such a requirement, he plainly has standing to bring, at a minimum, direct contract-based claims to enforce his individual rights as a shareholder.

III. HERA's Anti-Injunction Provision Does Not Bar the Requested Relief.

Finally, Movants argue that permitting the inspection of Freddie Mac's corporate records would violate HERA's anti-injunction provision, 12 U.S.C. § 4617(f). (*See* Mot. 11-12). The anti-injunction provision states that "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." 12 U.S.C. § 4617(f). According to Movants, Mr. Pagliara's exercise of his statutorily guaranteed right to review corporate documents would somehow "restrain or affect" FHFA's power to act as a conservator. (*See* Mot. 12).

Not so. The relevant case law addressing the anti-injunction provision makes clear that Section 4617(f) prohibits courts from interfering with FHFA's ability to exercise its business judgment. A good-faith shareholder request to inspect corporate documents does absolutely nothing to diminish FHFA's power as conservator. Although Movants claim that other courts have invoked the anti-injunction provision to foreclose "shareholders from pursuing claims such as Plaintiff's during conservatorship," (Mot. 12), they are mistaken. No other court has applied the provision to bar claims like this one.

Instead, courts have applied HERA's anti-injunction provision in two contexts—both in which a private suit might "restrain or affect" the exercise of FHFA's business judgment. In the first set of cases, the plaintiffs expressly sought to prohibit or compel specific business decisions. For example, the Ninth Circuit recently rebuffed a challenge to FHFA's directive that Freddie Mac discontinue purchasing certain risky assets. As the court explained, Section 4617(f) barred the suit because "the ability to decide which mortgages to buy is an inherent component of FHFA's charge." *Cnty. of Sonoma v. FHFA*, 710 F.3d 987, 993 (9th Cir. 2013). The Second Circuit likewise applied Section 4617(f) to block a challenge to the same FHFA directive, explaining that FHFA has the power to take "protective measures against perceived risks"

without judicial intervention. *Town of Babylon v. FHFA*, 699 F.3d 221, 227 (2d Cir. 2012). In the analogous FIRREA context, courts have similarly applied the statute's anti-injunction provision to forbid courts from imposing restrictions on the FDIC's ability to dispose of property as it sees fit. *See, e.g.*, *Bank of America Nat'l Ass'n v. Colonial Bank*, 604 F.3d 1239, 1244 (11th Cir. 2010) (listing cases).

The second set of cases—including each of the cases Movants rely upon—involves unauthorized *derivative* suits. *See Gail C. Sweeney Estate Marital Trust v. U.S. Treasury Dep't*, 68 F. Supp. 3d 116, 125-26 (D.D.C. 2014); *In re Fed. Home Loan Mortg. Corp. Derivative Litig.*, 643 F. Supp. 2d at 797; *Sadowsky*, 639 F. Supp. 2d at 350-51; *In re Fed. Nat'l Mortg. Ass'n Secs., Derivative, & ERISA Litig.*, 629 F. Supp. at 4 n.4. Because such derivative suits are brought on Freddie Mac's behalf, they may encroach upon FHFA's authority over Freddie Mac's business decisions. *See Sweeney*, 68 F. Supp. 3d at 125-26.

Neither category covers the suit here. Mr. Pagliara's inspection claim does not seek to impose any restriction on the exercise of FHFA's business judgment as conservator; Freddie Mac (and FHFA as conservator) has no discretion in responding to the inspection demand. *See* Va. Code Ann. §§ 13.1-771, -773. Nor is this a derivative claim brought on behalf of Freddie Mac. (*See supra* Part I.B). Enforcement of the individual right to inspect Freddie Mac's corporate records thus will not "restrain or affect" FHFA's "exercise of powers or functions" as conservator. In circumstances like these, no court has ever suggested that the anti-injunction provision applies. *See In re Fed. Nat. Mort. Ass'n Secs., Derivative, & ERISA Litig.*, 725 F. Supp. 2d 147, 155 (D.D.C. 2010) ("All [Section 4617(f)] means is that [a court] cannot affect FHFA's power and authority to manage Fannie Mae or to act on its behalf.").

HERA's anti-injunction provision, like its succession provision, therefore poses no obstacle to Mr. Pagliara's suit or the relief he seeks.

CONCLUSION

For the foregoing reasons, Plaintiff respectfully requests that the Motion be denied.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on this 19th day of July, 2016, a true and complete copy of the foregoing was filed via the court's CM/ECF system and notice of electronic filing was sent to the following counsel of record:

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EXHIBIT 1

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UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

In re Federal National Mortgage Association Securities, Derivative, and "ERISA" Litigation	MDL No. 1668
Kellmer v. Raines, et al.	Civil Action No. 1:07-cv-01173 Judge Richard J. Leon
Middleton v. Raines, et al.	Civil Action No. 1:07-cv-01221 Judge Richard J. Leon
Arthur v. Mudd, et al.	Civil Action No. 1:07-cv-02130 Judge Richard J. Leon
Agnes v. Raines, et al.	Civil Action No. 1:08-cv-01093 Judge Richard J. Leon

MOTION OF THE FEDERAL HOUSING FINANCE AGENCY AS CONSERVATOR FOR FANNIE MAE TO SUBSTITUTE FOR SHAREHOLDER DERIVATIVE PLAINTIFFS AND STATEMENT OF POINTS AND AUTHORITIES IN SUPPORT THEREOF

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MOTION OF THE FEDERAL HOUSING FINANCE AGENCY AS CONSERVATOR FOR FANNIE MAE TO SUBSTITUTE FOR SHAREHOLDER DERIVATIVE PLAINTIFFS AND STATEMENT OF POINTS AND AUTHORITIES IN SUPPORT THEREOF

Pursuant to the Housing and Economic Recovery Act of 2008, Pub. L. 110-289, 122 Stat. 2654 (codified at 12 U.S.C.§ 4617) (the "HERA"), and Fed. R. Civ. P. 25(c), the Federal Housing Finance Agency (the "FHFA" or the "Conservator") in its capacity as Conservator for the Federal National Mortgage Association ("Fannie Mae") respectfully moves this court to substitute the Conservator for the shareholder derivative plaintiffs ("Fannie Mae Shareholders" or "Plaintiffs") in the above-captioned actions.[1]

[1] Plaintiff in *Agnes v. Raines* (No. 1.08-cv-01093) (D.D.C.) has sued both derivatively and in his individual capacity. (Complaint ¶ 1). FHFA moves to substitute only with respect to the derivative claims asserted by Fannie Mae shareholders. Accordingly, FHFA seeks to substitute for plaintiff Agnes only insofar as he asserts derivative claims; Agnes's individual claims should

Footnote continued on next page

Upon its appointment as Conservator for Fannie Mae, the FHFA succeeded to all of the "rights, titles, powers, and privileges" of Fannie Mae and "of any stockholder, officer, or director" of Fannie Mae. *See* 12 U.S.C. § 4617(b)(2)(A)(i). In addition, as Conservator, the FHFA has been charged with the power to "take over the assets of and operate [Fannie Mae] with all the powers of [Fannie Mae's] shareholders, . . . directors, and . . . officers," and conduct all of the business of Fannie Mae and its shareholders. *See* 12 U.S.C. § 4617(b)(2)(B)(i). Pursuant to these statutory powers, the Conservator now has the sole right to pursue claims on behalf of Fannie Mae, including the shareholder derivative claims at issue. Because the Conservator is the only party with standing to pursue shareholder derivative claims on behalf of Fannie Mae, the Court should grant the Conservator's Motion to Substitute for Plaintiffs in the above-captioned actions.

Factual and Statutory Background

A. Fannie Mae

Together with the Federal Home Loan Mortgage Corporation ("Freddie Mac"), Fannie Mae is one of the nation's two largest housing finance institutions. Fannie Mae was established as a government agency in 1938 to create a secondary market for residential loans jointly guaranteed by the Federal Housing Administration and the Department of Veterans Affairs. In 1968, Fannie Mae was quasi-privatized into a government-sponsored entity, and its charter was expanded to include all types of residential loans. Its aim was to improve capital availability for these loans across regions and over real estate cycles.

Fannie Mae's activities remain confined to the secondary mortgage market. The enterprise buys mortgages from commercial banks, thrift institutions, mortgage banks, and other primary lenders, and either holds these mortgages in its own portfolio or packages them into

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Footnote continued from previous page
be consolidated with the other non-derivative securities actions against Fannie Mae that are pending before this Court.

mortgage-backed securities for resale to investors. These secondary mortgage market operations play a major role in creating a ready supply of mortgage funds for American homebuyers.

B. The Federal Housing Finance Agency and the FHFA Conservatorship Appointment

The FHFA was established by the Housing and Economic Recovery Act of 2008 ("HERA"),[2] which was signed into law on July 30, 2008. Under HERA, the Director of the FHFA may, at his discretion, appoint the FHFA conservator of a "regulated entity" for the purpose of reorganizing, rehabilitating, or winding up the affairs of the regulated entity.[3] 12 U.S.C. § 4617(a). The grounds and terms for appointment are derived from virtually identical language found in the statutes empowering the federal banking agencies to appoint conservators and receivers. On September 6, 2008, FHFA Director James Lockhart appointed the FHFA as Conservator for Fannie Mae.[4]

As Conservator for Fannie Mae, the FHFA is now vested with broad statutory powers to act on behalf of Fannie Mae and its shareholders, directors, and officers. Pursuant to 12 U.S.C. § 4617(b)(2)(A), upon its appointment as Conservator, the FHFA "immediately succeed[ed]" to:

> (i) all rights, titles, powers, and privileges of [Fannie Mae], and of any stockholder, officer, or director of [Fannie Mae] with respect to the regulated entity and the assets of [Fannie Mae].

In addition, pursuant to 12 U.S.C. § 4617(b)(2)(B), the FHFA as Conservator is empowered to:

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[2] *See* Housing and Economic Recovery Act of 2008, Pub. L. 110-289, 122 Stat. 2654.

[3] Under the statute the term "regulated entity" means: (1) Fannie Mae and its affiliates, (2) Freddie Mac and its affiliates, and (3) any Federal Home Loan Bank. *See* 12 U.S.C. § 4502(20).

[4] At the same time, Freddie Mac was also placed into conservatorship by the Director. The Director's actions were widely supported by other senior U.S. officials, including the Treasury Secretary and the Chairman of the Federal Reserve Board, both of whom stated publicly that placing Fannie Mae and Freddie Mac into FHFA Conservatorships was an action necessary to promote stability in the U.S. housing and financial markets. *See* Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://www.treas.gov/press/releases/hp1129.htm; Statement by Federal Reserve Board Chairman Ben Bernanke (Sept. 7, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/20080907a.htm.

> (i) take over the assets of and operate [Fannie Mae] with all the powers of the shareholders, the directors, and the officers of [Fannie Mae] and conduct all business of [Fannie Mae].

The Conservator is given these powers to "preserve and conserve the assets and property of [Fannie Mae]," *id.* at § 4617(b)(2)(B)(iv).

ARGUMENT

A. As Conservator For Fannie Mae, the FHFA Has the Sole Authority to Exercise the Rights of Fannie Mae's Shareholders.

Upon its appointment as Conservator for Fannie Mae, the FHFA succeeded to all of Fannie Mae's "rights, titles, powers, and privileges," and to all of the rights, titles, powers, and privileges of its shareholders with respect to Fannie Mae. *See* 12 U.S.C. § 4617(b)(2)(A)(i). Thus, by the plain terms of the statute, *all* of the "rights, titles, powers, and privileges" of Fannie Mae's shareholders -- including the right to bring derivative claims on Fannie Mae's behalf -- are now held solely by the FHFA. These rights are no longer the shareholders' to exercise. This plain reading of the statute is buttressed by Section 4617(b)(2)(B)(i), which grants the FHFA the authority to operate Fannie Mae and conduct all of its business "with all the powers of the shareholders . . . ." As a result, the FHFA is the sole party with standing to assert the rights of the Fannie Mae Shareholders.

The Court of Appeals for the District of Columbia has granted a motion by the FHFA identical to the motion presented here, approving the substitution of the FHFA as Conservator for Fannie Mae in place of shareholder plaintiffs who attempted to sue derivatively in Fannie Mae's name. *See* Exhibit 1, *Pirelli Tire* Order (D.C. Cir. Dec. 24, 2008).[5] In the *Pirelli* case, the Fannie Mae shareholder plaintiffs brought derivative claims in the D.C. District Court that were dismissed pursuant to Fed. R. Civ. P. 23.1 for failure to make a demand. *In re Fannie Mae*

[5] Presently, there are no other shareholder derivative actions pending against Fannie Mae. With respect to Freddie Mac, the Conservator has moved to substitute for Freddie Mac shareholder derivative plaintiffs in a similar action pending in the United States District Court for the Eastern District of Virginia. That action is now stayed until May 1, 2009 and the Court has not ruled on the Conservator's motion.

Derivative Litig., 503 F. Supp. 2d. 9, 11 (D.D.C. 2007). Thereafter, shareholder plaintiffs appealed this ruling, and the D.C. Circuit denied their appeal. *Pirelli Armstrong Tire Corp. v. Raines*, 534 F.3d 779 (D.C. Cir. 2008). Shareholder plaintiffs then petitioned for panel re-hearing or re-hearing *en banc*. After appointment as Conservator for Fannie Mae, the FHFA moved to substitute for the *Pirelli* shareholder plaintiffs, arguing, as here, that under § 4617(b)(2) of HERA, the Conservator has succeeded to all of the powers of Fannie Mae's shareholders, and that to allow the *Pirelli* shareholders to continue with their claims would "restrain or affect" the Conservator's free exercise of its powers in violation of § 4617(f). The D.C. Circuit granted the FHFA's motion, ordered that the Conservator be substituted for the Fannie Mae shareholder derivative plaintiffs, and approved the Conservator's request to withdraw the petition for panel rehearing or rehearing *en banc*. *See* Exhibit 1, *Pirelli Tire* Order (D.C. Cir. Dec. 24, 2008).

Similarly, a United States Magistrate Judge for the Southern District of New York recently recommended that the Conservator should be substituted for the shareholder plaintiffs in a derivative action similar to those before this Court. *See* Exhibit 2, *Sadowsky Testamentary Trust* Report and Recommendation (S.D.N.Y. Jan. 28, 2009). In *Sadowsky*, the Magistrate Judge held that "[T]he plain language of [HERA] vests in the FHFA all rights and powers of a shareholder to bring an action on Freddie Mac's behalf . . . . As the FHFA is the true party in interest in this litigation, it is proper to substitute it as the plaintiff in this action." *See* Exhibit 2, *Sadowsky Testamentary Trust* Report and Recommendation (S.D.N.Y. Jan. 28, 2009) (citations omitted).[6]

Additional Federal case law confirms that the Conservator has succeeded to all the rights and privileges of the Fannie Mae Shareholders. The D.C. Circuit in *Pirelli* and the S.D.N.Y. magistrate in *Sadowsky* are the definitive rulings on the Conservator's powers under HERA since

[6] The magistrate judge's ruling in *Sadowsky* is not yet final because the time for filing objections has not yet expired.

the statute was enacted in July 2008. However, the provisions of HERA setting forth the Conservator's powers are materially identical to those in the Financial Institutions Reform, Recovery and Enforcement Act of 1992 ("FIRREA"), which granted the FDIC the authority to act as conservator and receiver for failed financial institutions.[7] *Compare* 12 U.S.C. § 4617(b)(2) *with* 12 U.S.C. § 1821(d)(2) *and* 12 U.S.C. § 1787(b)(2). Interpreting these analogous provisions, several courts, including the Ninth Circuit, have held that the rights and privileges granted to the FDIC when acting as a receiver or conservator include the right to bring derivative suits, and that the shareholders of the institutions placed into receivership or conservatorship lack standing to bring such actions. *See e.g.*, *Pareto v. FDIC*, 139 F.3d 696 (9th Cir. 1998); *Lafayette Fed. Credit Union v. Nat'l Credit Union Admin.*, 960 F. Supp. 999 (E.D. Va. 1997), *aff'd*, 133 F.3d 915, 1998 WL 2881 (4th Cir. Jan. 7, 1998); *In re Southeast Banking Corp.*, 827 F. Supp. 742 (S.D. Fla. 1993), *rev'd in part on other grounds*, 69 F.3d 1539 (11th Cir. 1995).

In *Pareto*, the Ninth Circuit held that the plain language of Section 1821(d)(2) -- which is identical to the language of Section 4617(b)(2) -- "vests all rights and powers of a stockholder of the bank to bring a derivative action in the FDIC." *Pareto*, 139 F.3d at 700. Focusing on Section 1821(d)(2)(A)(i), the Ninth Circuit noted the Congressional purpose to grant to the FDIC not only the "rights" of the officers and the shareholders of the institution, but also the "titles, powers and privileges." *Id.* This language, the court concluded, functions as a catch-all, and is far too broad to *exclude* the shareholders' right to bring derivative actions: "Congress . . . transferred everything it could to the FDIC, and that includes a stockholder's right, power, or

[7] Congress intended HERA to provide to the FHFA "expanded conservatorship and receivership authority similar to that of federal bank regulators" under FIRREA. The Housing & Economic Recovery Act of 2008, H.R. 3221 (Detailed Summary), accompanying Press Release, House Committee on Financial Services, Today: House to Consider H.R. 3221 (July 23, 2008), *available at* http://financialservices.house.gov/detailed_summary_of_hr_3221.pdf (last visited Jan. 22, 2009).

privilege to demand corporate action or to sue directors or others when action is not forthcoming." *Id*.

The Ninth Circuit also looked to the policy intentions of Congress, reasoning that the plain reading of the statute is most compatible with the statute's purpose of ensuring the orderly stewardship of a troubled entity: "[receivership or conservatorship] helps assure the expeditious and orderly protection of all who are interested in the bank by placing the pursuit of its rights, protection of its assets, and payment of its liabilities firmly in the hands of a single, congressionally designated agency." *Id*. Permitting shareholders to bring suits would "allow a wholesale invasion of the FDIC's control over [the] proceedings." *Id*. at 701.

In *Pareto*, the Ninth Circuit granted a motion by the FDIC receiver to dismiss the pending derivative claims of the seized bank's shareholders. The Ninth Circuit rejected the argument that dismissal of the shareholder derivative suits would leave stockholder interests unprotected, concluding that "the FDIC can decide to bring an action against the directors for their wrongdoing, if any there was." *Id*. at 700. Construing Section 1821(d)(2) as part of an overall statutory scheme materially identical to the one at issue here, the Ninth Circuit held that:

> When Congress enacted FIRREA, it put in place a tessellated scheme which was designed to provide an orderly method of ending the destabilization taking place in the financial industry, a destabilization that was destroying the institutions themselves and the rights of depositors, creditors, insurers, and investors. Part of that statutory mosaic vested great power in the FDIC, and that included giving it all of the rights, powers, and privileges of the failing institutions, their depositors, account holders, officers, directors, and stockholders. In fine, all of the accouterments of ownership were gathered into the hands of a single entity so that it would be in a position to develop a consistent approach to dealing with the institution's various problems.

Id. at 701.

The Ninth Circuit's reading of 12 U.S.C. § 1821(d)(2) accords with the interpretations given to conservatorship and receivership powers of federal banking agencies in several other decisions. In an opinion affirmed by the Fourth Circuit, the Eastern District of Virginia held that

identical statutory language, *see* 12 U.S.C. § 1787(b)(2), grants the receiver of failed federal credit unions the sole right to pursue any derivative claims of a credit union's shareholders. *Lafayette Fed. Credit Union v. Nat'l Credit Union Admin.*, 960 F. Supp. 999, 1005 (E.D. Va. 1997), *aff'd*, 133 F.3d 915, 1998 WL 2881 (4th Cir. Jan.7, 1998). Similarly, in *Southeast Banking Corp.*, the Southern District of Florida granted the FDIC's motion for leave to assert sole and exclusive ownership over the derivative claims of an institution in receivership. 827 F. Supp. at 746. The court based its decision on the plain language of 12 U.S.C. § 1821(d)(2), stating that "any possible doubt on this issue has been legislatively dispelled by Congress [because the statute] specifically provides that such derivative claims belong exclusively to the FDIC." *Id*. In addition, the Seventh Circuit has also acknowledged that, under Section 1821(d)(2), the FDIC, "[b]y virtue of its status as receiver, . . . succeed[s] to the rights of the Bank and its shareholders, one of which is the ability to sue the Bank's directors and officers." *FDIC v. American Casualty Co. of Reading, Pa.*, 998 F.2d 404, 406, 409 (7th Cir. 1993). *American Casualty Co. of Reading, Pa. v. FDIC*, 16 F.3d 152 (7th Cir. 1994) (acknowledging that the FDIC as receiver can both take over derivative suits brought by shareholders and bring its own derivative suits).

Two decisions, both decided before the Ninth Circuit's *Pareto* decision, have read the statutory language at issue here more narrowly, but they are each inapplicable to the facts at issue herein, and should not guide this Court.

In *Branch v. FDIC*, 825 F. Supp. 384 (D. Mass. 1993), the Massachusetts district court focused on the shareholder's right under 12 U.S.C. § 1821(d)(2)(B) to maintain a residual economic interest in a receivership, and determined that this retention of rights somehow trumps the statutory language granting the FDIC receiver "all" of the shareholders' former rights vis-a-vis the seized entity. *Id.* at 404. The Ninth Circuit in *Pareto* expressly considered and rejected this analysis, finding that the *Branch* court's interpretation created unnecessary conflict in the statute, and elevated shareholder rights above the authority plainly granted to the FDIC receiver:

> The mere fact that any residue will go to the stockholders is not surprising. Indeed, where else would it go after all depositors, creditors, other claimants, and administrative expenses had been paid? One would hardly expect Congress to order an escheat. But that remaining vestige of the stockholders' rights can hardly be said to allow a wholesale invasion of the FDIC's control over proceedings.

Pareto, 139 F.3d at 701.

A second pre-*Pareto* case decided by the Court of Federal Claims held that shareholders maintain the right to pursue derivative claims during the pendency of a receivership, *see Suess v. U.S.*, 33 Fed. Cl. 89, 94-95 (1995), but the court in that case confronted a significantly different statutory regime and did not grapple with the broader statutory language confronted by the *Pareto* court or the policy implications that led Congress to vest "all of the accouterments of ownership . . . into the hands of [the receiver] . . . ." *Pareto*, 139 F.3d at 701. Instead, the *Suess* court relied on the superseded line of decisions that construed the statutory powers of federal banking agencies to act as receiver *before* Congress enacted new legislation expanding the receivership statutes to include language that granted the receiver "all the powers of the shareholders." *See Suess*, 33 Fed. Cl. at 94-96 (citing *e.g.*, *Landy v. FDIC*, 486 F.2d 139, 147 (3d Cir. 1973)). Accordingly, the narrow statutory scheme applied by the *Suess* court is neither relevant nor persuasive.

* * *

The pertinent provisions of HERA, like Section 1821(d)(2), set forth a comprehensive scheme whereby, upon appointment of a conservator, "all of the accouterments of ownership [of Fannie Mae are] gathered into the hands of a single entity so that it [will] be in a position to develop a consistent approach to dealing with the institution's various problems." *Pareto*, 139 F.3d at 701. Here the Conservator has all the powers of Fannie Mae's shareholders so that it can focus on managing and rehabilitating this essential pillar of the American economy without interference from competing actors with potentially conflicting ideas about Fannie Mae's financial best interests. Even more so than in the case of an FDIC conservatorship of a failed

bank, the Conservator here must be allowed the discretion and power that the plain language of the statute authorizes; the ramifications of a failure of Fannie Mae on the national economy are too great to take decision-making authority away from the Federal agency that has been statutorily appointed as the immediate successor to all rights, powers, and privileges of Fannie Mae's Shareholders.

B. The Shareholders' Continued Presence In These Actions Is Barred By 12 U.S.C. § 4617(f)

In addition to granting the Conservator the affirmative power to "operate [Fannie Mae] with all the powers of the shareholders," 12 U.S.C. § 4617(b)(2)(B)(i), HERA explicitly proscribes any court action that would interfere with the Conservator's powers and responsibilities. Section 4617(f) states that "no court may take any action to restrain or affect the exercise of powers or functions of the FHFA as a Conservator." By its plain language, this provision constrains this Court from entertaining a lawsuit or granting relief inconsistent with the Conservator's exercise of its statutory powers to, among other things, (1) preserve and conserve the assets and property of Fannie Mae, 12 U.S.C. § 4617(b)(2)(B)(iv), (2) collect all obligations and money due to Fannie Mae, 12 U.S.C. § 4617(b)(2)(B)(ii), and (3) perform all functions of this regulated entity that are consistent with the appointment of the conservator, 12 U.S.C. § 4617(b)(2)(B)(v).

Thus, Section 4617(f) bars the Fannie Mae Shareholders from continuing to prosecute these derivative claims. Through these claims, the Fannie Mae Shareholders purport to act in the name of Fannie Mae to "collect obligations and money" that Fannie Mae is owed, and they have contracted with private attorneys to pursue that objective. But now only the Conservator has authority to perform these functions, and only the Conservator has the power to decide, in its sole discretion, the administration of any lawsuit undertaken in Fannie Mae's name or by Fannie Mae's shareholders. It is within the Conservator's sole discretion to appoint counsel to pursue such litigation. To compel the Conservator to continue to pursue the current derivative claims, through counsel whom the Conservator has neither hired nor approved, would "restrain or affect"

the Conservator's exercise of its powers and functions -- powers and functions that Congress specifically identified and reserved solely to the Conservator. Therefore, Section 4617(f) prohibits the Fannie Mae Shareholders and their counsel from pursuing these derivative suits.

The Third Circuit has held that an identical provision appearing in the FDIC conservatorship statute, 12 U.S.C. § 1821(j), "by its terms, can preclude relief even against a third party . . . where the result is such that the relief 'restrain[s] or *affect[s]* the exercise of powers or functions of the [FDIC] as a conservator or a receiver.'" *Hindes v. FDIC*, 137 F.3d 148, 159-61 (3d Cir. 1998) (emphasis in original). The Third Circuit explained that "an action can 'affect' the exercise of powers by an agency," within the meaning of Section 1821(j) "without being aimed directly at it." *Id.* Here, the Fannie Mae Shareholders' claims, though aimed at Fannie Mae's former directors and officers, ask this Court to entertain an assertion of power that will allow Fannie Mae's Shareholders to pursue Fannie Mae's legal claims in any manner that they see fit, regardless of what action the Conservator deems strategically appropriate or necessary. This conduct is inconsistent with the Conservator's statutory powers and duties. Because derivative claims asserted by the Fannie Mae Shareholders "restrain and affect" the Conservator's exercise of its powers, Section 4617(f) strips the Fannie Mae Shareholders of any standing to pursue these lawsuits.

CONCLUSION

For the foregoing reasons, the motion of the FHFA as Conservator for Fannie Mae should be granted in its entirety, the FHFA should be substituted for the Fannie Mae Shareholder Plaintiffs in the above-captioned actions, and the captions herein should be amended to list plaintiffs as "Federal Housing Finance Agency as Conservator for the Federal National Mortgage Association ("Fannie Mae") and as legal successor to all of the rights, titles, powers, and privileges of Fannie Mae and its shareholders." Present counsel for the Fannie Mae Shareholder Plaintiffs should be substituted out as counsel in these matters.

Respectfully Submitted:

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Dated: February 2, 2009

CERTIFICATE OF SERVICE

I hereby certify that on February 2, 2009, I caused the foregoing to be electronically filed with the clerk of Court. I understand that the Court will provide electronic notification of such filing to the counsel of record in this matter who are registered on the CM/ECF.

_/s/ Joshua P. Wilson
Joshua P. Wilson