IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF FLORIDA

ANTHONY R. EDWARDS, *et al.*,

Case No.: 1:16-cv-21224

Plaintiffs,

v.

PRICEWATERHOUSECOOPERS, LLP

Defendant.
_____/

PLAINTIFFS' REPLY TO PWC'S RESPONSE IN OPPOSITION TO PLAINTIFFS' MOTION FOR REMAND

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Introduction

In its Response in Opposition to Plaintiffs' Motion for Remand (Doc. 37) ("Response"), PwC argues that the Motion for Remand (Doc. 28) should be denied for three reasons: (1) the Federal Home Loan Mortgage Corporation ("Freddie") is the real party in interest, conferring jurisdiction under 12 U.S.C. § 1452(f); (2) Plaintiffs' claims require resolution of disputed, important issues of federal law; and (3) Plaintiffs' fiduciary duty claims arise under federal law due to Freddie's bylaws. Each argument lacks merit.

I. PwC's Real Party in Interest Argument Does Not Confer Federal Jurisdiction.

PwC's first asserted basis for federal jurisdiction, 12 U.S.C. § 1452(f), requires a finding that Plaintiffs' claims are derivative, resulting in Freddie being the real party in interest. PwC's argument fails for two reasons: (1) the mere existence of a dispute as to the nature of the claims does not confer federal jurisdiction; and (2) Plaintiffs' claims are direct.

A. Removal Pursuant to Section 1452(f) Would Be Premature.

Whether a shareholder claim is direct or derivative is undoubtedly a state law determination. *See* Response, p. 4. Yet, PwC improperly asks this Court to rule on this substantive issue of state law as a predicate to finding federal jurisdiction. In *Steel Co. v. Citizens for a Better Environment*, 523 U.S. 83, 94 (1998), the Supreme Court declined to endorse the "doctrine of hypothetical jurisdiction" as diverging from a "long and venerable line" of cases holding that "[w]ithout jurisdiction the court cannot proceed at all in any cause," and the "requirement that jurisdiction be established as a threshold matter…is inflexible and without exception." (internal citations omitted).

Consequently, this Court cannot accept jurisdiction on the hypothetical premise that it may have jurisdiction pending the resolution of a state law question. Rather, the proper course of

action would be to permit either Freddie or PwC to remove this action in the event Freddie is found by the state court to be the real party in interest.

Despite PwC's burden to show removal was proper under this basis, *see Adventure Outdoors, Inc. v. Bloomberg*, 552 F. 3d 1290, 1294 (11th Cir. 2008), PwC cites no authority extending section 1452(f) to permit removal of a case in which a defendant disputes the nature of a plaintiff's claims and argues that Freddie should be found to be the real party in interest. Nor does PwC cite a case in which a district court accepts jurisdiction after analyzing a predicate state law issue.

Instead, PwC cites inapposite cases where courts did not engage in a predicate analysis of the nature of the plaintiffs' claims. The three cases cited by PwC for the proposition that courts "have frequently found federal question jurisdiction by looking to the real party in interest," Response, p. 3, n. 4, involve the Government's removal of cases in which it was "readily apparent" that the Government was the real party in interest by virtue of the party defendants being Medicare contractors or IRS managers. Thus the Government was the real party in interest entitled to remove the cases as suits against the Sovereign.

Here, state law mandates a detailed analysis of whether a claim is direct or derivative. *See Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004). These merits determinations are required before jurisdiction would be established under section 1452(f)—a practice the Supreme Court has condemned. As a result, this Court does not have jurisdiction.

B. Plaintiffs' Claims are Direct.

Plaintiffs explained in their Motion for Remand that Delaware law treats claims as direct if they challenge a controlling shareholder's "improper extraction or expropriation . . . of economic value" from minority shareholders. *Gentile v. Rosette*, 906 A.2d 91, 102 (Del. 2006);

see also, e.g., *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319, 330–32 (Del. 1993); *In re Activision Blizzard, Inc. Stockholder Litig.*, 124 A.3d 1025, 1052–54 (Del. Ch. 2015). While these cases involved the expropriation of both voting rights and economic value, their underlying logic is not so limited. Rather, these cases make clear that a minority shareholder suffers a direct injury when the corporation's capital structure is rearranged in any way that transfers a portion of the value of his investment to the controlling shareholder. Without offering any rationale for a narrower reading of the Delaware precedents, PwC proposes to limit them to scenarios in which the corporation transfers value to the controlling shareholder through the formal issuance of excessive stock. But the Delaware Chancery Court has explained that minority shareholders have a broader right to bring direct claims in expropriation cases:

> [T]he expropriation principle actually applies to insider transfers generally, regardless of whether the nature of the consideration received by the insider is cash, stock, or other corporate property. Whenever the value of the transfer to the insider exceeds the share of the loss that the insider suffers through its stock ownership, the insider transfer expropriates value from the unaffiliated investors. This effect happens precisely because the insider receives benefits to the exclusion of other investors, resulting in a distinct injury to the other investors and a corresponding benefit to the insider.

In re El Paso Pipeline Partners, L.P., 132 A.3d 67, 107 (Del. Ch. 2015). Decisions of the Delaware Supreme Court are to similar effect. *See Gatz v. Ponsoldt,*, 925 A.2d 1265, 1278, 1280–81 (Del. 2007) (looking beyond "transactional form" to "underlying concerns and substantive effects" and allowing direct suit in circumstances raising the same policy concerns as *Rossette*); *Gradient OC Master, Ltd. v. NBC Universal, Inc.*, 930 A.2d 104, 130 (Del. Ch. 2007) ("[W]hen a controlling shareholder extracts financial benefit from the shareholders and procures a financial benefit exclusive to himself, the non-controlling shareholders have a direct claim…").

The lone case PwC cites to the contrary is the Delaware Chancery Court's unpublished decision in *Caspian Select Credit Master Fund Ltd. V. Gohl*, 2015 WL 5718592, at *3–5 (Del.

Ch. Sept. 28, 2015). But in *Caspian Select* the defendant majority shareholder was alleged to have injured minority shareholders by entering into an unfair loan agreement with the corporation that was separate and distinct from the defendant's investment in the corporation's stock. *Id.* at *1–2. Thus, even while benefiting the *Caspian Select* defendant in its capacity *as a lender*, the challenged agreement diminished the value of the majority shareholder's stock in exactly the same way that it harmed the investments of minority shareholders. The Net Worth Sweep, in contrast, increased the value of Treasury's equity investment in Freddie by adding to Treasury's senior preferred stock the entire economic value of Plaintiffs' junior preferred stock. Treasury, in other words, received a benefit *as a shareholder* "to the exclusion of other investors, resulting in a distinct injury to the other investors." *El Paso Pipeline Partners*, 132 A.3d at 107. Accordingly, Delaware law would treat Plaintiffs' claims as direct.

"[E]ven in cases involving derivative claims, the same claims can have direct aspects when the allegedly faithless transaction involves an extraction from one group of stockholders, and a redistribution to another, of 'a portion of the economic value and voting power embodied in the minority interest." *CMS Investment Holdings, LLC v. Castle*, No. 9468, 2015 WL 3894021, *8 (Del. Ch. Jun. 23, 2015). Accordingly, claims that are traditionally derivative under Virginia law may have direct aspects because of the nature of the conduct that led to the Net Worth Sweep. Again, the court expanded the expropriation principle to include the "economic value" of minority shareholders who "essentially were squeezed out for less than fair value." *Id.* In such a scenario, the minority shareholders *individually and not on a pro rata basis along with all the [stockholders]*…that will be the principal recipient of any recovery." *Id.* (emphasis added). That Freddie may have been harmed or that Plaintiffs may anecdotally allege that FHFA

and Treasury breached duties owed to Freddie "makes no difference here, however, because Plaintiff[s] [have] limited the claims…solely to breaches that Plaintiff[s] can pursue directly." *Id.*

Moreover, PwC is wrong when it contends that the Virginia courts would not follow the Delaware courts in permitting minority shareholders to press direct claims in a case like this one. The Virginia Supreme Court has taken care to leave open the possibility that in an appropriate case it would follow the Delaware Supreme Court's decision in *Tooley*, *see Remora Invs., LLC v. Orr*, 673 S.E.2d 845, 848 (Va. 2009), and has even followed the substance of the *Tooley* test. *See Keepe v. Shell Oil Co.*, 260 S.E. 2d 722, 724 (Va. 1979) ("a stockholder has no standing to sue in his own right for *an injury to the corporation*…") (emphasis added). Lower Virginia courts often look to Delaware corporation law in the absence of contrary guidance from the Virginia Supreme Court, *see, e.g.*, *U.S. Inspect Inc. v. McGreevy*, 2000 WL 33232337, at *4 (Va. Cir. Ct. Nov. 27, 2000); *see also Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 799–800 (E.D. Va. 1982). Delaware law thus provides a reliable guide for how the Virginia courts would examine the question of corporation law presented here, and, as discussed above, Delaware law would permit Plaintiffs to press their claims directly.

II. Plaintiffs' Claims Do Not Raise Substantial Questions of Federal Law.

PwC attempts to steer this Court far from the long-standing principle that a "right or immunity created by the Constitution or laws of the United States must be an element, and an essential one, of the plaintiff's cause of action" to confer federal jurisdiction. *Franchise Tax Bd. v. Constr. Laborers Vacation Tr.*, 463 U.S. 1, 10-11 (1983). But Plaintiffs' state law claims do not require the resolution of substantial federal issues.

A. HERA's Succession Clause is a Defense to the Merits of Plaintiffs' Claims.

Recognizing the parties' disagreement about HERA's succession clause, PwC argues that "all that matters for this Court's jurisdictional analysis is that this disputed question of federal

law is central to this case…" Response, p. 11. Contrary to PwC's argument, Plaintiffs do not have to defeat the succession clause as an *essential element* of their claims. Rather, the succession clause provides a defense to the merits of Plaintiffs' claims, which is insufficient to confer federal jurisdiction.

The standing element of Plaintiffs' claims is not difficult to meet and can be easily established without reference to federal law. Virginia law provides that "one has standing to sue when he or she has sufficient interest at stake in the controversy which will be affected by the outcome of the litigation." *Milstead v. Bradshaw*, 43 Va. Cir. 428, 430 (Va. Cir. Ct. 1997). Plaintiffs allege they own Freddie stock and were damaged by PwC's conduct, *see* Complaint, ¶¶ 11, 109, 116, which is all that is required under Virginia law to have standing to sue.

To the extent they are relevant, Plaintiffs also meet federal standing requirements. Generally, to satisfy the "case" or "controversy" requirement of Article III, a plaintiff must generally demonstrate that he has suffered "injury in fact," that the injury is "fairly traceable" to the actions of the defendant, and that the injury will likely be redressed by a favorable decision. *Bennett v. Spear*, 117 S. Ct. 1154, 1161 (1997). The requirement of standing focuses on the party seeking to get his complaint before a federal court and not on the issues he wishes to have adjudicated. *Valley Forge Christian Coll. V. Ams. United for Separation of Church & State, Inc.*, 454 U.S. 464, 484 (1982). This Court recognizes that a shareholder of a company has standing to assert claims in which he or she has a direct, personal interest. *See Elandia Intn'l, Inc. v. Koy,* No. 09-20588, 2010 WL 2179770, at *6 (S.D. Fla. Feb. 22, 2010).

PwC fails to cite any authority to support its statement that HERA's succession clause "is not a defense but instead a threshold question…" that could possibly support removal. The most recent court to address the issue, while applying Virginia law, found the exact opposite—that

HERA's succession clause does not bar a shareholder's standing, but rather provides a merits-based defense. *See Pagliara v. Federal Home Loan Mortgage Corporation,* No. 1:16-cv-337, 2016 WL 4441978, *4 (E.D. Va. Aug. 23, 2016). The *Pagliara* court dispensed with PwC's identical argument when it was advanced by Freddie on a Rule 12(b)(1) motion to dismiss, finding that "Pagliara unquestionably seeks to assert his own right as a stockholder…" which "satisfies Pagliara's obligation regarding standing." *Id.* The court found that, despite HERA's succession clause, a Freddie stockholder had standing to sue to inspect the company's books and records.

HERA did not take Plaintiffs' standing to sue Freddie's auditor, a right they seek to assert as stockholders. "Only if the Court accepts [PwC's] interpretation of HERA" would Plaintiffs no longer possess the rights they seek to enforce, which "goes to the merits…not to [their] jurisdictional allegations." *Id.* Because PwC's succession clause argument is "better framed as a merits challenge," and defeating HERA's succession clause is not required to establish standing, any dispute about the scope of the clause is not related to an element of Plaintiffs' claims and insufficient to confer federal jurisdiction.

B. Plaintiffs' Fiduciary Duty Claims Do Not Raise Substantial Federal Issues.

Plaintiffs explained in their Motion for Remand why state law fiduciary duty standards govern the duties owed by either Freddie's officers, FHFA, or Treasury to Plaintiff minority shareholders. PwC cites *Robinson v. FHFA*, No. 15-cv-109-KKC-EBA, 2016 WL 4726555, at *4, n.3 (E.D. Ky. Sept. 9, 2016)—a case in which the plaintiff brought only equitable claims under the Administrative Procedure Act—for the proposition that state fiduciary duty law does not apply to Treasury. Response, p. 16. Besides being *dicta* in a footnote relating to an issue that was only "briefly" argued, the court's statement that "there is no evidence of Congressional

intent to graft state fiduciary duties onto the Treasury's responsibilities under HERA," is unsupported and inaccurate.

As Freddie's dominant shareholder, Treasury had a fiduciary duty to take minority shareholders' interests into account before entering into the Net Worth Sweep. *See Kahn v. Lynch Commc'n Sys. Inc.*, 638 A.2d 1110, 1115 (Del. 1994); *Parsch v. Massey*, 79 Va. Cir. 446, 2009 WL 7416040, at *11 (Va. Cir. Ct. 2009). "Dominant shareholders" are those that "exercise[] control over the business affairs of the corporation," as demonstrated by "actual control of corporation conduct." *See Kahn*, 638 A.2d at 1113–14. Any dealings between such control persons and the corporation must meet a rigorous test to ensure that the transaction was fair to the minority shareholders. *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983); *see also Kahn*, 638 A.2d at 1115; *Upton v. Southern Produce Co.*, 133 S.E. 576, 580 (Va. Special Ct. App. 1926).

Nothing in HERA dispels these state law duties or suggests that Treasury's purported public mandate is inconsistent with fiduciary duties to shareholders. HERA nowhere authorizes or requires Treasury to take action that would violate its fiduciary duties to minority shareholders. Indeed, HERA's grant of temporary authority to Treasury to invest in Freddie's stock expressly requires Treasury to take into consideration the economic rights of the company's shareholders, including the company's plans "for the orderly resumption of private market funding or capital market access" and the "need to maintain [Freddie's] status as . . . private shareholder-owned company." 12 U.S.C. § 1719(g)(1)(C). Thus, requiring Treasury to comply with the same fiduciary duties that apply to any other dominant shareholder is fully consistent with Treasury's obligations under HERA.

As conservator, FHFA stands in the shoes of Freddie's officers, whose fiduciary obligations are rooted in state law. Similarly, because Congress did not disavow those duties by enacting HERA, this Court should not presume they no longer exist. *See O'Melveny & Myers v. FDIC*, 114 S. Ct. 2048, 2054 (1994).

C. Plaintiffs' Alternative Causation Theories Do Not Each Raise a Substantial Federal Issue.

To be sure, causation is an element of Plaintiffs' claims, but it can be proven by various theories. PwC attempts to curtail the well-pleaded complaint rule by deciding which of Plaintiffs' alternative causation theories they must pursue and by mischaracterizing various causation allegations as "boilerplate allegations." Response, p. 19.

In fact, Plaintiffs plead multiple causation theories that do not implicate federal law. First, Plaintiffs allege that PwC helped FHFA and Freddie to materially misstate Freddie's financial statements, including falsely certifying non-cash accounting losses, causing harm to Plaintiffs' stock. Compl. ¶¶ 27-28. Second, Plaintiffs allege that the Net Worth Sweep would not have been possible without the assistance of PwC, ¶ 43, and that its implementation resulted in Plaintiffs losing the value of their stock. ¶ 32. Third, Plaintiffs allege that PwC's 2012 Audit Opinion omitted material information that should have been disclosed, ¶¶ 68, 74, 107, and that Plaintiffs' reliance on PwC's negligent audit reports resulted in substantial losses. ¶¶ 108, 109.

Further, as described in the Motion for Remand, an allegation in the complaint that Freddie would have been able to exit the conservatorship does not alone raise a substantial

federal issue that cannot be adequately addressed by the state court. To the extent the state court must apply federal law, it ably can. *See Allen v. McCurry,* 101 S. Ct. 411, 420 (1980).[1]

III. Plaintiffs' Claims Do Not Arise Under Federal Law.

That Freddie was organized under federal law does not confer federal jurisdiction. 28 U.S.C. § 1349. Nor do Plaintiffs' state law claims, as describe above and in the Motion for Remand. As a last resort, PwC argues that Freddie's bylaws and stock certificates require application of federal law, thereby conferring federal jurisdiction. Response, pp. 19-20. This is not the case.

A private company's bylaws and stock certificates cannot simply declare that all disputes about the rights or obligations of its shareholders arise under federal law. Rather, federal courts must derive their jurisdiction from Article III of the Constitution or statutes enacted by Congress. *Gunn v. Minton,* 133 S. Ct. 1059, 1064 (2013). The federal law creating Freddie, 12 U.S.C. § 1452, provides for federal jurisdiction in defined situations, namely, when Freddie is a party to a lawsuit. The statute does not provide for federal jurisdiction in cases involving Freddie's shareholders, corporate governance, or internal affairs. "Where Congress explicitly enumerates certain exceptions to a general prohibition, additional exceptions are not to be implied, in the absence of evidence of a contrary legislative intent." *Andrus v. Glover Constr. Co.*, 446 U.S. 608, 616–617 (1980). Accordingly, Congress did not grant Freddie the authority to create federal jurisdiction for all cases involving its shareholders, and Freddie's decision to follow federal law cannot circumvent strict jurisdictional rules by creating its own species of "arising under" jurisdiction. Accordingly, this Court should remand this case to state court.

[1] HERA includes no instruction on when Freddie may or should exit the conservatorship. As such, it is unclear, and unexplained by PwC, how the issue is a federal one or how a federal court could address the issue more ably than a state court.

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on September 30, 2016, the foregoing document was filed with the Court's CM/ECF system, which will send electronic notice to all counsel of record.

/s/ Brad F. Barrios
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