IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

PERRY CAPITAL LLC, et al., *Plaintiffs-Appellants*, v. STEVEN T. MNUCHIN, et al., *Defendants-Appellees*.	Nos. 14-5243 (L), 14-5254 (con.), 14-5260 (con.), 14-5262 (con.)

CLASS PLAINTIFFS' REPLY IN SUPPORT OF THEIR PETITION FOR PANEL REHEARING

This Court does not normally decide issues on appeal that were not briefed or passed upon by the district court, and FHFA's response to Class Plaintiffs' petition for panel rehearing illustrates why. In defending the panel's resolution of a complex issue the parties had not previously addressed, FHFA advances for the first time the novel theory that the sale of a corporation's stock on the secondary market effects a novation that alters the corporation's underlying contractual obligations. Although this is not the appropriate place for a full airing of the merits of FHFA's theory, Class Plaintiffs submit this short filing to identify some of its most significant flaws.

Today's global financial markets are built on the bedrock principle that shares of a given security are fungible and may be freely traded, a principle that is expressly reflected in Fannie's and Freddie's charters. *See* 12 U.S.C. § 1718(a)

(providing for the "free transferability" of Fannie's stock); 12 U.S.C. § 1453(b) (same for Freddie). Delaware law goes so far as to codify this important rule, specifying that upon delivery of a security to a purchaser, the purchaser "acquires all rights in the security that the transferor had or had power to transfer." DEL. CODE ANN. tit. 6, § 8-302(a). This ensures that "the several holders are entitled to equal rights irrespective of the time when they acquired their shares." *In re Activision Blizzard, Inc. Stockholder Litig.*, 124 A.3d 1025, 1047 (Del. Ch. 2015). Yet according to FHFA's argument, the buyer of a security acquires something ***different*** from what the seller owns, with the result being that the sale of a security on the secondary market may destroy some or all of its value. Such a rule would expose corporations to potentially conflicting contractual obligations, with different duties owed to different holders of the same class of stock depending on when the holders purchased their shares. More troubling still, FHFA's novation theory would badly undermine financial markets by extinguishing the ability of investors to freely buy and sell certain interests in a corporation.

Moreover, it is beyond serious dispute that once a shareholder's breach of contract claim accrues, it travels with the security into the hands of a subsequent purchaser. *See, e.g.*, *id.* at 1050 ("When a share of stock is sold, the property rights associated with the shares, including any claim for breach of those rights and the ability to benefit from any recovery or other remedy, travel with the shares.");

Class Plaintiffs' Petition at 10 n.3. The shareholder claims at issue here accrued when the Net Worth Sweep was announced on August 17, 2012. Under FHFA's novation theory, whether the Net Worth Sweep constituted a breach would depend on what the investors who held Fannie and Freddie stock on that date reasonably expected with respect to their contractual rights at the various times when they acquired their shares. A post-Sweep purchaser thus might be treated differently depending on whether he or she bought shares from someone who had held them since 2006, as opposed to 2011. In a world in which the vast majority of securities transactions are handled by financial intermediaries that do not disclose a seller's identity to the buyer, such a rule would be wholly unworkable and render securities of the same class non-fungible, and it therefore would undermine the fundamental policy of corporate law "to ensure certainty in the instruments upon which the corporation's capital structure is based." *Grimes v. Alteon, Inc.*, 804 A.2d 256, 260 (Del. 2002).

Conspicuously absent from FHFA's brief is any citation to a case decided within the last 80 years that treats the sale of a security on the secondary market as a novation. FHFA's reliance on the "authoritative" Williston treatise does not fill the gap; the two cases Williston cites for this proposition date from the nineteenth century. 17 WILLISTON ON CONTRACTS § 51:74, at 850 n.27 (Richard A. Lord ed., 4th ed. 2015) (citing *Cecil Nat'l Bank v. Watsontown Bank*, 105 U.S. 217 (1881)

and *West Nashville Planing-Mill Co. v. Nashville Sav. Bank*, 6 S.W. 340 (Tenn. 1888)). Notably, FHFA's ancient cases say that the corporation's *act of recording a sale of stock on its books* effects a novation. *See Raybestos-Manhattan, Inc. v. United States*, 296 U.S. 60, 62–63 (1935) (novation becomes effective upon corporation's "recognition of a new shareholder" and "issu[ance] to him of a new certificate of stock"); *Squire v. Borton & Borton*, 5 N.E. 2d 479, 481 (Ohio 1936) (novation occurs "[w]hen a stockholder sells his stock to another and the transfer is entered upon the corporation records"). Such individualized treatment of public stockholders has not existed in our capital markets for over 40 years, since the SEC adopted a policy of share immobilization in the 1970s, and the Depository Trust Company ("DTC"), through its nominee Cede & Company, became the record owner of almost all stock traded on our public markets.[1] Novations require the

[1] The Delaware Court of Chancery explained the role of DTC as follows:

> DTC's place in the ownership structure results from the federal response to a paperwork crisis on Wall Street during the late 1960s and early 1970s. Increased trading volume in the securities markets overwhelmed the back offices of brokerage firms and the capabilities of transfer agents. No one could cope with the burdens of documenting stock trades using paper certificates. The markets were forced to declare trading holidays so administrators could catch up. With trading volumes continuing to climb, it was obvious that reform was needed. Congress directed the SEC to evaluate alternatives that would facilitate trading.
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> After studying the issue, the SEC adopted a national policy of share immobilization. To carry out its policy, the SEC placed a new entity—the depository institution—at the bottom the ownership chain. DTC emerged as the only domestic depository. Over 800 custodial banks and brokers are participating members of DTC and maintain accounts with that institution. DTC holds shares on their behalf in fungible bulk, meaning that none of the shares are issued in the

consent of all parties, and it is far from clear that the same analysis would apply to modern financial markets in which corporations have largely abandoned the practice of issuing new stock certificates or altering their books and records every time their shares are traded. Instead, changes in beneficial ownership in a company's stock typically are reflected in the records of a securities intermediary, which at all times remains the registered owner in the company's records.

In all events, even when past generations of lawyers spoke of the transfer of stock on the secondary market as a "novation" rather than an "assignment," they were merely making clear that such trades transfer shareholder obligations as well as rights. Thus, in *Witters v. Sowles*, 38 F. 700, 703 (D. Vt. 1889), the court was concerned with the application of a statute that made shareholders liable for a failed bank's debts and explained that a transfer of stock on the secondary market is a "novation" that "substitutes the transferee in the place of, and subjects him to the liabilities of, the original subscriber." This case does not concern the

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> names of DTC's participants. Instead, all of the shares are issued in the name of Cede. Through a Fast Automated Securities Transfer account (the "FAST Account"), DTC uses an electronic book entry system to track the number of shares of stock that each participant holds.
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> By adding DTC to the bottom of the ownership chain, the SEC eliminated the need for the overwhelming majority of legal transfers. Before share immobilization, custodial banks and brokers held shares through their own nominees, so new certificates had to be issued frequently when shares traded. With share immobilization, legal title remains with Cede. No new certificates are required.

In re Appraisal of Dell Inc., 2015 WL 4313206, at *1-2 (Del. Ch., Jul. 13, 2015).

application of outdated laws that once made shareholders liable for the debts of certain failed corporations. And far from supporting the notion that trades on the secondary market somehow *alter* shareholder rights and obligations, the Williston treatise follows Delaware law in emphatically stating the opposite: "By substitution, the purchaser or other transferee is vested with the rights of the transferor in the stock; the purchaser holds it on the same conditions and subject to the same liabilities and obligations, and to the same equities as did the seller prior to the transfer." 17 WILLISTON § 51:74, at 849; *see also* DEL. CODE ANN. tit. 6, § 8-302(a).

Neither is there any support for FHFA's argument that the contractual relationship between the corporation and its shareholders is sufficiently "flexible" that this relationship may "evolv[e]" over time to eliminate all shareholder rights. FHFA Br. 9–13. As Class Plaintiffs' rehearing petition demonstrated, Delaware law with respect to the implied covenant of good faith and fair dealing is clear: "the parties' reasonable expectations" must be assessed "at the time of contracting." *Nemec v. Shrader*, 991 A.2d 1120, 1126 (Del. 2010). For purposes of the contract between a corporation and its shareholders, "the time of contracting" is when the corporation issued the shares.

To be sure, Delaware's General Corporation Law forms part of the contractual relationship between a Delaware corporation and its shareholders. *See*

Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 939 (Del. Ch. 2013). But it does not follow that the same is true for the Housing and Economic Recovery Act (HERA)—a federal statute that was enacted *after* the Companies issued Class Plaintiffs' shares and that does not purport to change the fundamental relationship between the Companies and their shareholders. FHFA does not cite any case to support its assumption that such a federal law should be treated the same as the Delaware General Corporation Law for these purposes.

Regardless, this Court held that HERA gives FHFA "permissive, discretionary authority" over the Companies when it acts as conservator, Op. 21, and the implied covenant of good faith and fair dealing specifies how such discretion must be exercised in the context of a contractual relationship. HERA did not preempt the Companies' contractual duty not to "act[] arbitrarily or unreasonably" when exercising their discretion, *Nemec*, 991 A.2d at 1126; *see* Op. 66–67, and Class Plaintiffs must be permitted an opportunity on remand to demonstrate that the Net Worth Sweep violated this duty.

CONCLUSION

Class Plaintiffs' petition for panel rehearing should be granted.

Dated: July 6, 2017

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on July 6, 2017, the foregoing was electronically filed with the Clerk of the Court using the CM/ECF system, which will send a notification to the attorneys of record in this matter who are registered with the Court's CM/ECF system.

DATED: July 6, 2017

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