IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MINNESOTA
Civil No. 17-cv-02185 (PJS/HB)

ATIF F. BHATTI, TYLER D. WHITNEY, and MICHAEL F. CARMODY,

Plaintiffs,

v.

THE FEDERAL HOUSING FINANCE AGENCY, MELVIN L. WATT, in his official capacity as Director of the Federal Housing Finance Agency, and THE DEPARTMENT OF THE TREASURY,

Defendants.

MEMORANDUM IN SUPPORT OF THE DEPARTMENT OF THE TREASURY'S MOTON TO DISMISS

INTRODUCTION

During and after the financial crisis, the Department of the Treasury ("Treasury") committed hundreds of billions of dollars to ensure the solvency of the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") (collectively, "the GSEs" or "the enterprises"). That commitment eventually became capital infusions of $187.5 billion, with an additional pledged commitment of $258 billion. "That $200 billion-plus lifeline is what saved the [GSEs] – none of the institutional stockholders were willing to infuse that kind of capital during desperate economic times." *Perry Capital LLC v. Mnuchin*, 864 F.3d 591, 613 (D.C. Cir. 2017).

Nevertheless, plaintiffs, shareholders in the enterprises, have filed suit to overturn the Third Amendment to the Preferred Stock Purchase Agreements (the "Third

Amendment") between Treasury and the Federal Housing Finance Agency ("FHFA"), the conservator of the GSEs. *See* Pls.' First Am. Compl. for Declaratory and Injunctive Relief, ECF No. 27 ("Complaint" or "Compl."). That agreement changed the dividend formula on the preferred stock held by Treasury, replacing a fixed dividend with a variable dividend tied to the enterprises' net worth. *See Perry Capital*, 864 F.3d at 612. Plaintiffs seek injunctive relief reversing the agreement based on their belief that without it the price of their shares in the enterprises would be higher. They do so, however, not by alleging that the Third Amendment is illegal on its own terms (as many of the suits that precede this one have argued and lost), but instead by alleging that FHFA is unconstitutionally structured and was led by an improperly serving acting director at the time the Third Amendment was executed, and that the Housing and Economic Recovery Act ("HERA") is an unconstitutional delegation of legislative or executive power.

Despite presenting pages of allegations questioning the motives underlying the Third Amendment – allegations that numerous courts have found insufficient to sustain suits against either FHFA or Treasury[1] – plaintiffs identify no legal basis for any claim against Treasury. Fundamentally, plaintiffs fail to connect the legal claims they assert,

[1] *See Perry Capital*, 864 F.3d at 598–99 (*affirming in pertinent part Perry Capital v. Lew*, 70 F. Supp. 3d 208, 246 (D.D.C. 2014)); *Collins v. FHFA*, --- F. Supp. 3d ---, 2017 WL 2255564, at 3–4 (S.D. Tex. May 22, 2017), *appeal docketed*, No. 17-20364 (5th Cir. May 30, 2017); *Saxton v. FHFA*, --- F. Supp. 3d ---, 2017 WL 1148279, at *10 (N.D. Iowa Mar. 27, 2017), *appeal docketed*, No. 17-1727 (8th Cir. Apr. 4, 2017); *Roberts v. FHFA*, --- F. Supp. 3d ---, 2017 WL 1049841, at *2 (N.D. Ill. Mar. 20, 2017), *appeal docketed*, No. 17-1880 (7th Cir. Apr. 27, 2017); *Robinson v. FHFA*, 223 F. Supp. 3d 659, at *665-671 (E.D. Ky. 2016), *appeal argued*, No. 16-6680 (6th Cir. July 27, 2017); *Cont'l W. Ins. Co. v. FHFA*, 83 F. Supp. 3d 828, 840 n.6 (S.D. Iowa 2015).

which attack aspects of FHFA's structure and legal authority, with any actionable conduct by Treasury. These allegations provide no basis upon which to invalidate the Third Amendment because FHFA executed that agreement in its capacity as conservator of the enterprises. And plaintiffs do not even allege any illegal conduct on the part of Treasury; in presenting Counts I-V, the Complaint does not even mention Treasury, let alone explain how its conduct is implicated by those counts. In any event, plaintiffs' claims are precluded because they could have been asserted in earlier shareholder suits challenging the Third Amendment; principles of res judicata foreclose this stream of piecemeal litigation, arising out of the same transaction between the same parties in interest. Further, because plaintiffs' claims are derivative, they are barred by HERA's transfer of shareholder rights provision. The Court should dismiss this suit in its entirety.

BACKGROUND

I. FANNIE MAE AND FREDDIE MAC

Fannie Mae and Freddie Mac are government-sponsored enterprises, chartered by Congress, that provide liquidity to the mortgage market by purchasing residential loans from banks and other lenders, thereby facilitating the ability of lenders to make additional loans. *See* Compl. ¶ 10. These entities, which own or guarantee trillions of dollars of residential mortgages and mortgage-backed securities, have played a key role in housing finance and the United States economy. *Perry Capital*, 864 F.3d at 599.

"[I]n 2008, the United States economy fell into a severe recession, in large part due to a sharp decline in the national housing market. Fannie Mae and Freddie Mac suffered a precipitous drop in the value of their mortgage portfolios, pushing the Companies to the

brink of default." *Id.* In response to the developing financial crisis, in July 2008, Congress passed HERA, Pub. L. No. 110-289, 122 Stat. 2654. Compl. ¶ 14. HERA created FHFA, an independent federal agency, to supervise and regulate Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. 12 U.S.C. § 4501 *et seq.*; Compl. ¶ 14. HERA granted the Director of FHFA discretionary authority to appoint FHFA "conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity." 12 U.S.C. § 4617(a)(2). The statute provides that, upon its appointment as the conservator or receiver, FHFA would "immediately succeed to … 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." *Id.* § 4617(b)(2)(A). The conservator has the power to "operate" and "conduct all business" of the enterprises, *id.* § 4617(b)(2)(B), including the power to take such action as may be "appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity," *id.* § 4617(b)(2)(D), and to "transfer or sell" any of the enterprises' assets or liabilities, *id.* § 4617(b)(2)(G).

HERA also amended the statutory charters of the enterprises to grant the Secretary of the Treasury the authority to purchase "any obligations and other securities" issued by the enterprises "on such terms and conditions as the Secretary may determine and in such amounts as the Secretary may determine," provided that Treasury and the enterprises reached a "mutual agreement" for such a purchase. *See* 12 U.S.C. § 1719(g)(1)(A) (Fannie Mae); *id.* § 1455(*l*)(1)(A) (Freddie Mac). Treasury was required to determine, prior to exercising this purchase authority, that the purchase was necessary to "provide stability to

the financial markets," "prevent disruptions" in mortgage financing, and "protect the taxpayer." *Id.* § 1719(g)(1)(B) (Fannie Mae); *id.* § 1455(*l*)(1)(B) (Freddie Mac).

II. THE CONSERVATORSHIP OF THE GSES AND TREASURY'S SENIOR PREFERRED STOCK PURCHASE AGREEMENTS WITH THE ENTERPRISES

In 2008, the Director of FHFA placed Fannie Mae and Freddie Mac into conservatorships. Compl. ¶ 28. Treasury used its authority "to promptly invest billions of dollars in Fannie and Freddie to keep them from defaulting. Fannie and Freddie had been 'unable to access [private] capital markets' to shore up their financial condition, 'and the only way they could [raise capital] was with Treasury support.'" *Perry Capital*, 864 F.3d at 601 (citation omitted). Treasury entered into Senior Preferred Stock Purchase Agreements (the "PSPAs") with each enterprise, through FHFA. Treasury committed to advance funds to each enterprise for each calendar quarter in which the enterprise's liabilities exceeded its assets, in accordance with generally accepted accounting principles, so as to maintain the solvency (*i.e.*, positive net worth) of the enterprise. If a draw was needed, Treasury would provide funds sufficient to eliminate any net worth deficit. *See* Ex. A[2], Fannie Mae PSPA §§ 2.1, 2.2; Freddie Mac PSPA §§ 2.1, 2.2 (cited in, *e.g.*, Compl. ¶¶ 31-36). Both enterprises enter mandatory receivership, and their assets must be liquidated, if they maintain a negative net worth for 60 days. *See* 12 U.S.C. § 4617(a)(4)(A). As of August 2012, Fannie Mae had drawn $116.15 billion and Freddie Mac had drawn $71.34 billion from Treasury. *See* Compl. ¶ 68.

[2] Exhibits referenced herein are attached to the Declaration of R. Charlie Merritt.

In exchange, Treasury received senior preferred stock with a liquidation preference, warrants to purchase 79.9 percent of each enterprise's common stock, and commitment fees. Compl. ¶¶ 34-35, 39; Fannie Mae PSPA §§ 3.1–3.4; Freddie Mac PSPA §§ 3.1–3.4. The face value of the liquidation preference on Treasury's senior preferred stock was $1 billion from each enterprise, and it increased dollar-for-dollar as Fannie Mae or Freddie Mac drew on its PSPA funding capacity. Fannie Mae PSPA § 3.3; Freddie Mac PSPA § 3.3. Currently, Treasury has a combined liquidation preference of $189.5 billion for the two enterprises. (This reflects approximately $187.5 billion in draws, plus the initial $2 billion in liquidation preference.) *See* Compl. ¶¶ 35, 68.

Treasury also received quarterly dividends on the liquidation preference of its senior preferred stock. *Id.* ¶ 36. Prior to the Third Amendment, the GSEs paid dividends at an annual rate of ten percent of their respective liquidation preferences. Ex. B, Fannie Mae Senior Preferred Stock Certificate § 5; Freddie Mac Senior Preferred Stock Certificate § 5 (cited in Compl. ¶¶ 35-36). Treasury provided funds to the enterprises to cure both enterprises' negative net worth, which was caused in part by the payment of dividends to Treasury. *See* Compl. ¶ 51.

The original PSPAs further required the enterprises to pay a periodic commitment fee to Treasury beginning on March 31, 2010. Fannie Mae PSPA §§ 3.1, 3.2; Freddie Mac PSPA §§ 3.1, 3.2. This fee "is intended to fully compensate [Treasury] for the support provided by the ongoing Commitment following December 31, 2009." *Id.* The amount was to be "determined with reference to the market value of the Commitment as then in effect," as mutually agreed between Treasury and the enterprises, in consultation with the

Chair of the Federal Reserve. *Id.* Treasury's rights under the PSPAs reflected the significant commitment taxpayers had made to the enterprises.

In August 2012, Treasury and FHFA, acting as conservator for the GSEs, entered into the Third Amendment to the PSPAs. Compl. ¶ 55. The amendment eliminated the 10 percent fixed annual dividend and suspended the periodic commitment fee in favor of a quarterly variable dividend in the amount (if any) of the GSEs' positive net worth, minus a capital reserve. Ex. C, Third Amendment to Amended and Restated Fannie Mae PSPA, § 3 (Aug. 17, 2012); Third Amendment to Amended and Restated Freddie Mac PSPA, § 3 (Aug. 17, 2012)) (cited in Compl. ¶ 55). If the GSEs have a negative net worth, they pay no dividend. *Id.* Since the execution of the Third Amendment, the enterprises have not drawn funds from Treasury to pay dividends to Treasury.

LEGAL STANDARD

To withstand a motion to dismiss, "a complaint must contain either direct or inferential allegations respecting all material elements necessary to sustain recovery under some viable legal theory." *Carter v. Hassell*, 316 F. App'x 525, 526 (8th Cir. 200) (citing *Bell Atl. Corp. v. Twombly*, 550 U.S. 554, 562 (2007)). The court must take the well-pleaded facts as true but is "not bound to accept as true a legal conclusion couched as a factual allegation." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (citation omitted).

ARGUMENT

I. PLAINTIFFS DO NOT STATE A CLAIM TO RELIEF AGAINST TREASURY

A. The Complaint Does Not Allege That Treasury Has Engaged In Any Actionable Conduct

Plaintiffs' claims should be dismissed because they have not pled facts supporting an inference that Treasury is liable under any of plaintiffs' asserted claims. To be sure, the Complaint is replete with allegations that the Third Amendment harmed their financial interests as GSE shareholders. *See, e.g.*, Compl. ¶ 60 (Net Worth Sweep "furthered FHFA's goal of enriching the federal government at private shareholders' expense."); ¶ 73 (citing FHFA's "ongoing policy of seeking to eliminate the investments of the Companies' private shareholders while winding down the Companies and preventing them from rebuilding capital"). The substantive claims, however, focus entirely on FHFA's structure and legal authority. Plaintiffs do not challenge any aspect of *Treasury*'s structure or authority, or otherwise allege that Treasury's conduct caused them any legal harm.

Tellingly, none of plaintiffs' counts even mention Treasury in the operative paragraphs. (This despite the fact that each claim is captioned as supposedly being "against . . . Treasury," *see, e.g.*, Compl. at 29, Claims for Relief, Count I.)

- The first count alleges that, "[b]y making FHFA's head a single Director rather than a multi-member board and eliminating the President's power to remove the Director at will, HERA violates the President's constitutional removal authority." *Id.* ¶ 76. This count does not challenge any action or legal authority applicable to Treasury, which is, in any event, an Executive Branch department headed by a Secretary who serves at the pleasure of the President. 31 U.S.C. § 301(b); *see also* Compl. ¶ 9 (characterizing Treasury as an "executive agency.").
- Count II alleges that HERA violates the separation of powers because FHFA

allegedly operates "without any supervision by the President," Compl. ¶ 85, "has no meaningful direction or supervision from Congress," *id.*, and, because of HERA's limitations on judicial review, courts "are powerless to ensure that FHFA exercises its authorities in a lawful manner," *id.* ¶ 86. Again, this count relates to supervision of FHFA, not Treasury. Treasury is subject to presidential supervision as an Executive Branch agency, s*ee* 31 U.S.C. § 301; *see also* Compl. ¶ 9, and its budget is established by annual Congressional appropriations. *See, e.g.*, Consolidated Appropriations Act, 2017, Pub. L. 115-31, 131 Stat. 135, Div. E., Title I.

- Count III alleges that Edward DeMarco's service as acting director of FHFA was unreasonable in duration and in violation of the Appointments Clause. Compl. ¶¶ 89-96. This count also does not mention Treasury or explain how Treasury is implicated in the challenged conduct. Further, the Complaint pleads that Treasury could not direct or control Mr. DeMarco's actions. *See id*. ¶ 47.
- Count IV alleges that HERA violates the non-delegation doctrine because it does not provide an "intelligible principle to guide FHFA's exercise of discretion" as conservator, or as the successor to the GSEs' directors, officers, and shareholders. *Id*. ¶¶ 99-100. This count concerns FHFA's authority as conservator under Section 4617 of HERA; it does not cite, or otherwise discuss, Treasury's authority under HERA, codified at 12 U.S.C. §§ 1455(l) and 1719(g), to invest in securities and other obligations of the

GSEs, let alone plausibly allege that Treasury's authority violates the non-delegation doctrine.

- Count V, which alleges HERA has unconstitutionally delegated executive power to a private entity because FHFA, as conservator of the GSEs, is not a governmental actor for constitutional purposes, Compl. ¶¶ 104-110, similarly does not implicate Treasury's authority under HERA. Nor could it; Treasury is indisputably a government actor for constitutional purposes.

Only one allegation conceivably bears on the central question of whether, in agreeing to the Third Amendment, Treasury engaged in any conduct that satisfies the elements of any legal claim and caused concrete legal harm to plaintiffs. Paragraph 72 alleges that "FHFA's approval of the Net Worth Sweep also authorized" Treasury "to engage in conduct that would have otherwise violated HERA and the Administrative Procedure Act," ("APA") because Treasury "acted arbitrarily and capriciously" in agreeing to the Third Amendment, and "it violated HERA, which does not permit Treasury to purchase the Companies' securities after 2009." Compl. ¶ 72. But the Complaint does not present any APA claim, or any claim related to this alleged violation of HERA. In any event, every court to have considered the merits of such a claim has concluded that the Third Amendment was not a purchase of securities and was consistent with Treasury's authority under HERA. *See Perry Capital LLC v. Lew*, 70 F. Supp. 3d 208, 223 (D.D.C. 2014); *see also Roberts*, 2017 WL 1049841, at *8; *Robinson*, 223 F. Supp. 3d at 666–67.

Plaintiffs have thus not established any legal claim against Treasury. The five counts of their Complaint are focused on conduct by FHFA, and the Complaint pleads that

Treasury and FHFA operate independently of one another, and that Treasury cannot compel action by FHFA. *See* Compl. ¶ 47. Nothing in the Complaint purports to establish that Treasury is either itself liable or liable for the alleged misconduct of FHFA under any of the five counts set forth.

Plaintiffs are clear only with respect to their requested relief: Vacating the Third Amendment. *See, e.g.*, *id.* ¶¶ 82, 88, 96, 103, 110. For the reasons explained below, plaintiffs are not entitled to that relief.

B. Plaintiffs' Separation of Powers and Appointments Clause Claims Provide No Basis for Invaliding the Third Amendment

The Third Amendment does not implicate either the separation of powers or the Appointments Clause because the FHFA, as conservator for the GSEs, did not exercise Executive power in agreeing to it.[3]

In agreeing to the Third Amendment, FHFA undertook the "quintessential conservatorship tasks" of "[r]enegotiating dividend agreements, managing heavy debt and other financial obligations, and ensuring ongoing access to vital yet hard-to-come-by capital." *Perry Capital*, 864 F.3d at 607. Such tasks are the hallmarks of a private financial manager. They bear no resemblance to the regulatory activities and enforcement actions that characterize the exercise of Executive power. *See Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 508 (2010); *Collins*, 2017 WL 2255564, at *5

[3] "The nondelegation doctrine is rooted in the principle of separation of powers that underlies our tripartite system of Government." *Mistretta v. United States*, 488 U.S. 361, 371 (1989). Plaintiffs' non-delegation claims are thus appropriately categorized as separation of powers claims.

(finding that the Third Amendment "was adopted by the FHFA in its capacity as conservator of Fannie Mae and Freddie Mac, not as an executive enforcing the laws of the United States"). When FHFA "stepped into the[ ] shoes" of the GSEs to act as conservator, it "shed[ ] its government character and . . . [became] a private party." *Herron v. Fannie Mae*, 861 F.3d 160, 169 (D.C. Cir. 2017) (quoting *Meridian Invs., Inc. v. Fed. Home Loan Mortg. Corp.*, 855 F.3d 573, 579 (4th Cir. 2017)); *see also United States v. Beszborn*, 21 F.3d 62, 68 (5th Cir. 1994) (when the Resolution Trust Corporation acts as a receiver, it "stands in the shoes" of an insolvent financial institution and any actions it takes are "private, non-governmental" in character).

Moreover, viewing FHFA's actions as conservator as non-governmental in nature is in keeping with historical practice. Federal regulators appointed private entities to be conservators and receivers of troubled financial institutions until the advent of the FDIC, and may continue to appoint private entities as receivers for banks that are not insured by FDIC. *See* 12 U.S.C. § 191; 12 C.F.R. § 51.2; *see also* FDIC, *Managing the Crisis: The FDIC and RTC Experience* 212-13 (1998). Similarly, state law generally authorizes the appointment of private entities to serve as receivers for failed banks chartered under state authority. *Id*. at 213-15.

The actions FHFA takes as conservator are not governmental actions. Thus, the President's inability to remove the conservator's top manager except for cause, the fact that the conservator's director served in an acting role[4] at the time of the Third Amendment,

[4] Indeed, plaintiffs' arguments that HERA unconstitutionally constrains the President's removal power are undermined by the fact that at the time of the Third Amendment, FHFA

and any asserted improper delegation of government authority to FHFA as conservator do not sufficiently impinge on "the functioning of the Executive Branch," *Morrison v. Olson*, 487 U.S. 654, 691 (1988), to run afoul of the Constitution in the ways plaintiffs assert.

Plaintiffs' constitutional claim suffers from an additional infirmity. As a remedy for the alleged separation of powers violation, plaintiffs seek an order vacating the Third Amendment and requiring Treasury to return the dividends it received under the Third Amendment. Compl. Prayer for Relief. But under plaintiffs' theory, all actions taken by FHFA as conservator would be unlawful, including its agreement to the original Purchase Agreements and the First and Second Amendments. As the D.C. Circuit recognized in *Perry Capital*, the original Purchase Agreements and subsequent amendments rescued the GSEs and continue to provide capital that is essential to their ongoing operation. 864 F.3d at 613. In asking that only the Third Amendment be set aside and unwound, leaving the Purchase Agreements and first two amendments in place, plaintiffs seek to benefit from conservator action they now insist is unlawful. Principles of equity do not permit such a remedy. *See Lemon v. Kurtzman*, 411 U.S. 192, 200 (1973) ("[I]n constitutional adjudication as elsewhere, equitable remedies are a special blend of what is necessary, what is fair, and what is workable.").

II. CLAIM PRECLUSION BARS ALL COUNTS ASSERTED IN THE COMPLAINT

was headed by an Acting Director whose designation as an acting officer was revocable at will by the President. *See* Compl. ¶ 45 (noting that Edward DeMarco served as Acting Director from August 2009 until January 2014); 12 U.S.C. § 4512(f). The for-cause removal restriction that plaintiffs challenge here, 12 U.S.C. § 4512(b)(2), applies by its plain terms only to FHFA's permanent Director, who is "appointed by the President, by and with the advice and consent of the Senate." No such for-cause removal limitation exists with respect to an Acting Director of the agency.

As noted above, plaintiffs are not the first GSE shareholders to bring a lawsuit seeking to set aside the Third Amendment based on the harm it allegedly inflicts on the GSEs. Because the claims they assert are derivative in nature and could have been asserted in prior derivative suits challenging the Third Amendment, plaintiffs are barred by claim preclusion from presenting them here.

Federal law governs the res judicata effect of a federal court judgment based on federal law.[5] *Poe v. John Deere Co.*, 695 F.2d 1103, 1105 (8th Cir. 1982). Under the federal doctrine of res judicata, "also known as claim preclusion," *Costner v. URS Consultants, Inc.*, 153 F.3d 667, 673 (8th Cir. 1998), "a final judgment on the merits of an action precludes the parties or their privies from relitigating issues that were or could have been raised in that action." *Carlisle Power Transmission Prods., Inc. v United Steel, Local Union No. 662*, 725 F.3d 864, 867 (8th Cir. 2013) (quoting *Allen v. McCurry*, 449 U.S. 90, 94 (1980)). Specifically, claim preclusion requires that: "(1) the first suit resulted in a final judgment on the merits; (2) the first suit was based on proper jurisdiction; (3) both suits involve the same parties (or those in privity with them); and (4) both suits are based upon the same claims or causes of action." *Yankton Sioux Tribe v. U.S. Dep't of Health and*

[5] As discussed below, plaintiffs' claims are precluded by final judgments entered in two prior derivative actions by GSE shareholders. *See Perry Capital LLC v. Lew*, 70 F. Supp. 3d 208 (D.D.C. 2014), *aff'd*, 864 F.3d 591 (D.C. Cir. 2017); *Saxton v. FHFA*, --- F. Supp. 3d ----, 2017 WL 1148279 (N.D. Iowa 2017), *appeal docketed*, No. 17-1727 (8th Cir. Apr. 4, 2017). In each case, a federal court dismissed the claims at issue based on application of either HERA's anti-injunction provision, 12 U.S.C. § 4617(f), or HERA's transfer of shareholder rights provision, 12 U.S.C. § 4617(b)(2)(A). *See Perry Capital*, 864 F.3d at 598–99; *Saxton*, 2017 WL 1148279 at *9–12. As these decisions were based on federal law, the federal law of res judicata governs their preclusive effect.

Human Servs., 533 F.3d 634, 639 (8th Cir. 2008) (citation omitted).

Each element is satisfied here. GSE shareholders already have brought prior, unsuccessful derivative actions in federal court seeking to vacate the Third Amendment. Although this suit purports to be brought by different shareholders asserting different causes of action from the prior suits, it likewise asserts derivative claims challenging the same underlying transaction—the Third Amendment; indeed the primary remedy sought—vacating the Third Amendment—is the same. As set forth below, claim preclusion bars plaintiffs' attempts to assert new claims arising from the Third Amendment.

A. Prior Third Amendment Actions Resulted in Final Decisions on the Merits by Courts with Proper Jurisdiction

In two prior cases, federal courts rejected shareholder derivative claims seeking to undo the Third Amendment through injunctive relief. *See Perry Capital LLC v. Lew*, 70 F. Supp. 3d 208, 228–29 (D.D.C. 2014), *aff'd*, 864 F.3d 591 (D.C. Cir. 2017); *Saxton*, 2017 WL 1148279 at *6-7, *11.[6] *Perry Capital* and *Saxton* represent final decisions on the merits by courts of competent jurisdiction rejecting derivative claims by enterprise shareholders. The first two elements of claim preclusion are satisfied.

B. This Action Involves Privies of the Parties to the Prior Actions

In general, a judgment rendered in a shareholder derivative suit precludes

[6] In *Perry Capital*, the shareholder plaintiffs expressly framed their claims as derivative. 70 F. Supp. 3d at 229. In *Saxton*, while the shareholder plaintiffs took the position their claims were not derivative, the court analyzed them and found them to be derivative. 2017 WL 1148279 at *6-7. The pending appeal in *Saxton* does not lessen its preclusive effect. *See, e.g., In re Ewing*, 852 F.2d 1057, 1060 (8th Cir. 1988) ("It is well established in the federal courts that the pendency of an appeal does not diminish the *res judicata* effect of a judgment rendered by a federal court." (citation omitted)).

subsequent litigation by both the corporation and its shareholders. *See, e.g.*, *Cottrell v. Duke*, 737 F.3d 1238, 1242–43 (8th Cir. 2013); *In re Sonus Networks, Inc. S'holder Derivative Litig.*, 499 F.3d 47, 64 (1st Cir. 2007) ("[I]f the shareholder can sue on the corporation's behalf, it follows that the corporation is bound by the result of the suit in subsequent litigation, even if different shareholders prosecute the suits."); *Akin v. PAFEC Ltd.*, 991 F.2d 1550, 1560–61 (11th Cir. 1993) (because "there is . . . an identity of parties between [initial and subsequent shareholder plaintiffs]" where "the[] claims are derivative in nature," the subsequent shareholder plaintiff is "barred from raising any claim on [the corporation's] behalf logically related to . . . the subject matter of the prior [shareholder] suit"). Although plaintiffs here were not named parties to the prior Third Amendment cases, they are in privity with their fellow enterprise shareholders because their claims — like those in *Perry Capital* and *Saxton*—are entirely derivative.

"A basic tenet of American corporate law is that the corporation and its shareholders are distinct entities." *Dole Food Co. v. Patrickson*, 538 U.S. 468, 474 (2003). Thus, legal harms committed against a corporation give rise to claims belonging to the corporation itself, and shareholder suits seeking to enforce those claims are derivative. This principle is reflected in the shareholder standing rule, also known as the derivative injury rule, which prevents shareholders from suing over injuries to the corporation. *Franchise Tax Bd. of Cal. v. Alcan Aluminum Ltd.*, 493 U.S. 331, 336 (1990) (shareholder standing rule "is a longstanding equitable restriction that generally prohibits shareholders from initiating actions to enforce the rights of the corporation unless the corporation's management has refused to pursue the same action for reasons other than good-faith business judgment.");

see also In re Kaplan, 143 F.3d 807, 811-12 (3d Cir. 1998) (Alito, J.) ("The derivative injury rule holds that a shareholder . . . may not sue for personal injuries that result directly from injuries to the corporation.").

The Eighth Circuit has consistently held that "[a]ctions to enforce corporate rights or redress injuries to the corporation cannot be maintained by a stockholder in his own name." *Potthoff v. Morin*, 245 F.3d 710, 716 (8th Cir. 2001) (quoting *Brictson v. Woodrough*, 164 F.2d 107, 109 (8th Cir. 1947)). This result holds "even though in an economic sense real harm may well be sustained as the impact of such wrongful acts bring about reduced earnings, lower salaries, bonuses, injury to general business reputation, or diminution in the value of ownership." *Schaffer v. Universal Rundle Corp.*, 397 F.2d 893, 896 (5th Cir. 1968) (citation omitted). Indeed, courts do not regard a decline in the value of stock as a personal injury suffered by the holder of stock. *Potthoff*, 245 F.3d at 716 (noting that shareholder standing rule bars suit by individual shareholder "even though the injury to the corporation may incidentally result in the depreciation or destruction of the value of the stock" (quoting *Brictson*, 164 F.2d at 109)).

The determination whether a federal-law claim is direct or derivative is governed by federal law. *See* 7C Charles Alan Wright & Arthur R. Miller, *Federal Practice and Procedure* § 1821 (3d ed.); *cf. Rifkin v. Bear Stearns & Co.*, 248 F.3d 628, 631 (7th Cir. 2001) ("[S]tanding to bring a federal claim in federal court is exclusively a question of federal law."). Where standing turns on the "allocation of governing power within [a] corporation," however, federal law often looks to state-law principles. *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 99 (1991); *Starr Int'l Co. v. United States*, 856 F.3d 953,

965–66 (Fed. Cir. 2017) ("federal law dictates" whether a plaintiff has standing to assert federal law claims, but state law "also plays a role").[7]

The principles for distinguishing direct from derivative claims are well-established and consistent across federal and state law. The analysis is governed by two questions: "(1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004) (en banc). A claim is "direct" when "the duty breached was owed to the stockholder" and the stockholder "can prevail without showing an injury to the corporation." *Id*. 845 at 1039. A claim is "derivative" if the harm to the shareholder is the byproduct of some injury to the corporate body as a whole. *Id*.

With respect to Treasury, plaintiffs ask that the Third Amendment be declared invalid and enjoined, so that future increases in net worth are retained by the GSEs, and also requests that dividends Treasury has received be returned to the GSEs. Compl. Prayer for Relief (3). Such an order would not benefit plaintiffs directly. The relief sought would

[7] "Fannie Mae is governed by its federal charter and federal law. *See* 12 U.S.C. § 1716 *et seq.*; *id.* at § 1451 *et. seq.*; 12 C.F.R. § 1710.10(a). For issues not addressed by the charter or federal law, Fannie Mae may follow applicable corporate law of Delaware so long as that law is not inconsistent with federal law. 12 C.F.R. § 1710.10(b)." *Edwards v. Deloitte & Touche, LLP*, No. 16-21221-CIV, 2017 WL 1291994, at *6 (S.D. Fla. Jan. 18, 2017), *appeal docketed*, No. 17-12852 (11th Cir. June 22, 2017). Freddie Mac, similarly, is governed by its federal charter and federal law, *see* 12 U.S.C. § 1451 *et seq.*, but may follow Virginia corporate law so long as it is not inconsistent with federal law. Virginia has not adopted the *Tooley* test for direct and derivative claims, but also distinguishes between direct injuries to the shareholder and injuries to the corporation. *See Remora Invs., LLC v. Orr*, 277 Va. 316, 324, 673 S.E.2d 845, 848 (2009).

flow to the GSEs and supposedly make plaintiffs' stock in the GSEs more valuable. Similarly, the harm that plaintiffs allege – the assertedly improper transfer of the GSEs' net worth to Treasury – was suffered by the GSEs. *See, e.g.*, Compl. ¶¶ 60, 66, 73. That the Third Amendment will allegedly cause plaintiffs indirect harm as shareholders, such as a decline in the value of their shares or a reduced likelihood of future dividends or liquidation payouts, does not transform those claims into direct claims. *See, e.g.*, *Potthoff*, 245 F.3d at 716 ("[D]epreciation or destruction of the value of the [shareholder's] stock" is a derivative injury.); *Tooley*, 845 A.2d at 1037 (a claim is derivative where "the *indirect* injury to the stockholders arising out of the harm to the corporation comes about solely by virtue of their stockholdings").

With respect to FHFA, plaintiffs also seek various forms of injunctive or declaratory relief to rectify the agency's allegedly unconstitutional conduct. *See* Compl. ¶¶ 82, 88, 96, 103, 110. Again, however, such relief would not benefit plaintiffs directly. This relief would affect plaintiffs, if at all, only insofar as it affects the GSEs in which they own stock. Nothing in plaintiffs' Complaint suggests that FHFA, either as regulator or as conservator of the GSEs, has taken any action specific to them; their argument, rather, is that FHFA has mismanaged the conservatorships of the GSEs, and that this has affected them as investors. *Id.* ¶ 81 ("Plaintiffs are suffering ongoing injuries as a result of FHFA's expropriation of the Companies' resources and private shareholders' rights . . . ."). Plaintiffs' claims are derivative and thus brought on behalf of the GSEs. *See Edwards*, 2017 WL 1291994, at *7 (holding claims challenging the Third Amendment to be derivative); *Saxton*, 2017 WL 1148279, at *6 (same).

Thus, plaintiffs are in privity with the GSE shareholders that pursued derivative suits in *Perry Capital* and *Saxton*. Further, to the extent plaintiffs disclaim the derivative nature of their suit, they would lack Article III standing. *See, e.g., Defs. of Wildlife, Friends of Animals and Their Env't v. Hodel*, 851 F.2d 1035, 1040 (8th Cir. 1988) ("[A]n asserted right to have the Government act in accordance with law is not sufficient, standing alone, to confer jurisdiction on a federal court" (citation omitted)).

C. The Claims in this Case Should Have Been Litigated in the Prior Actions, And There is Identity of the Causes of Action

With respect to the fourth element of the claim preclusion test, the Eighth Circuit has stated that "whether a second lawsuit is precluded turns on whether its claims arise out of the 'same nucleus of operative facts as the prior claim.'" *Costner*, 153 F.3d at 673 (quoting *United States v. Gurley*, 43 F.3d 1188, 1195 (8th Cir. 1994)). In conducting this analysis, federal circuit courts—including the Eighth Circuit—follow the approach set forth in the Restatement (Second) of Judgments, pursuant to which res judicata extinguishes "all rights of the plaintiff to remedies against the defendant with respect to all or any part of the transaction, or series of connected transactions, out of which the action arose." *Poe*, 695 F.2d at 1106 (quoting Restatement (Second) of Judgments § 24(1) (1982)).

Here, the relevant transaction is the Third Amendment—its execution unquestionably is the gravamen of the complaints filed to date. Regardless of the label applied to the various claims, all seek precisely the same remedy—the vacating of the Third Amendment. Compl. ¶¶ 82, 88, 96, 103, 110. The only other relief sought relates to

FHFA's structure as an independent agency. But merely seeking additional relief is insufficient. *See Harnett v. Billman*, 800 F.2d 1308, 1314 (4th Cir. 1986) ("Claims may arise out of the same transaction or series of transactions even if they involve different harms or different theories or measures of relief." (citing Restatement (Second) of Judgments § 24(2) (1982), comment c)).[8]

The Complaint simply asserts new legal theories to challenge the same underlying transaction, but "when applying the transactional approach to claim preclusion," courts "focus on the core of operative facts for the plaintiff's claims and causes of actions, not the legal labels attached to them." *Serna v. Holder*, 559 F. App'x 234, 237 (4th Cir. 2014) (unpublished) (citation omitted); *see also Costner*, 153 F.3d at 674 ("[t]he legal theories of the two claims are relatively insignificant because a litigant cannot attempt to relitigate the same claim under a different legal theory of recovery" (citations omitted)).

The causes of action asserted in the Complaint could and should have been presented by the shareholder plaintiffs in the prior derivative actions. Nothing of substance has changed since that time, aside from the fact that other federal courts have now considered and rejected shareholder derivative claims challenging the Third Amendment. "At some point," however, "litigation must come to an end." *Consol. Television Cable Serv., Inc. v. City of Frankfort*, 857 F.2d 354, 358 (6th Cir. 1988). The doctrine of claim preclusion is designed "to prevent the sort of dribbling of claims from earlier lawsuits to

[8] Plaintiffs' prayer for relief underscores this point. Putting aside the type of boilerplate requests that are included at the end of every complaint, three of the four listed requests focus on rescinding the Third Amendment. *See* Compl. Prayer for Relief (1)-(3).

later ones that occurred here." *Serna*, 559 F. App'x at 238-39. Rather than permitting shareholders to attack the same core action in multiple suits under varying legal theories, this Court should apply the doctrine of claim preclusion to dismiss plaintiffs' Complaint.

III. PLAINTIFFS' CLAIMS ARE BARRED BY HERA'S TRANSFER OF SHAREHOLDER-RIGHTS PROVISION

That plaintiffs' claims are derivative provides another basis to dismiss the Complaint: FHFA as conservator has succeeded to plaintiffs' rights to assert them here. HERA's transfer of shareholder rights provision, 12 U.S.C. § 4617(b)(2)(A)(i), provides that FHFA "shall, as conservator or receiver, and by operation of law, immediately succeed to . . . 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." The provision "plainly transfers [to FHFA the] shareholders' ability to bring derivative suits." *Perry Capital*, 864 F.3d at 623 (quoting *Kellmer v. Raines*, 674 F.3d 848, 850 (D.C. Cir. 2012)). As discussed above, *supra* Sec. II.B, plaintiffs' claims are derivative, and thus barred.

That plaintiffs are pursuing constitutional claims makes no difference. Whether a claim is direct or derivative turns on the nature of the plaintiffs' injury and the relief sought; it does not depend on the source of law on which a shareholder plaintiff relies. *See, e.g.*, *Sinclair v. Hawke*, 314 F.3d 934, 939 (8th Cir. 2003) (applying shareholder standing rule to dismiss First and Fifth Amendment claims, as well as federal statutory civil rights claims (citing *Potthoff*, 245 F.3d at 716)); *Pagan v. Calderon*, 448 F.3d 16, 28–29 (1st Cir. 2006) (shareholders lacked standing to pursue substantive due process and equal protection

claims because they had failed to allege that they "sustained a particularized, nonderivative injury" separate from any injury to the corporation); *Duran v. City of Corpus Christi*, 240 F. App'x 639, 642–43 (5th Cir. 2007) (concluding that "only the corporation [had] standing to seek redress" for an alleged First Amendment violation). Here, plaintiffs' claims are constitutional in name only, and they do not allege injury or request relief that is personal to them. Instead, they allege injury based on harm to the GSEs and seek relief that will accrue, if at all, first to the GSEs before any individual shareholder; their claims are thus derivative and barred by the shareholder succession provision.

CONCLUSION

For the reasons stated in the foregoing brief, the Court should dismiss the Complaint.

Dated: September 15, 2017

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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MINNESOTA
Civil No. 17-cv-02185 (PJS/HB)

ATIF F. BHATTI, TYLER D. WHITNEY, and MICHAEL F. CARMODY,

Plaintiffs,

v.

THE FEDERAL HOUSING FINANCE AGENCY, MELVIN L. WATT, in his official capacity as Director of the Federal Housing Finance Agency, and THE DEPARTMENT OF THE TREASURY,

Defendants.

CERTIFICATE OF COMPLIANCE

The undersigned attorney for the United States certifies this memorandum complies with the type-volume limitation of D. Minn. LR 7.1(f) and the type size limitation of D. Minn. LR 7.1(h). The memorandum has 6,476 words of type, font size 13. The memorandum was prepared using Microsoft Word 2013, which includes all text, including headings, footnotes and quotations in the word count.

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