UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

MICHAEL ROP; STEWART KNOEPP; and ALVIN WILSON,

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 TREASURY,

Defendants.

Case No. 1:17-cv-00497

Hon. Paul L. Maloney

PLAINTIFFS' BRIEF IN OPPOSITION TO DEFENDANT DEPARTMENT OF THE TREASURY'S MOTION TO DISMISS

ORAL ARGUMENT REQUESTED

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES ii

INTRODUCTION 1

BACKGROUND 2

Congress establishes FHFA as an independent agency headed by a single director 2

FHFA forces the companies into conservatorship and signs the PSPAs on their behalf..........3

Mr. DeMarco serves as FHFA's acting director for over four years 5

Unwarranted accounting decisions artificially increase the companies' draws from Treasury, and the companies return to sustained profitability 7

FHFA imposes the net worth sweep, thereby expropriating Plaintiffs' investments in the companies 9

ARGUMENT 10

I. Legal standard. 10

II. HERA's succession clause does not immunize FHFA from claims that it is operating the companies in violation of the separation of powers..........10

A. Plaintiffs' claims are direct under principles of both federal and state law. 11

B. HERA's succession clause does not prevent shareholders from asserting derivative constitutional claims against FHFA..........14

III. Claim preclusion does not bar Plaintiffs' suit..........17

A. The *Perry Capital* court's dismissal of derivative claims under HERA's succession clause was not a judgment "on the merits." 18

B. Plaintiffs are not in privity with the plaintiffs from *Perry Capital*..........20

C. This suit is not based on the same cause of action asserted in *Perry Capital*..........21

IV. Treasury's remaining arguments for dismissal are without merit. 24

CONCLUSION 25

TABLE OF AUTHORITIES

Page(s)

Cases

Bartlett v. Bowen,
816 F.2d 695 (D.C. Cir. 1987)....................15

Battaglia v. General Motors Corp.,
169 F.2d 254 (2d Cir. 1948)....................15

Beard Research, Inc. v. Kates,
8 A.3d 573 (Del. Ch. 2010)....................22

Bergeron v. Mackie,
2016 WL 6122601 (W.D. Mich. Oct. 20, 2016)....................18

Bond v. United States,
564 U.S. 211 (2011)....................12

Bowsher v. Synar,
478 U.S. 714 (1986)....................11

Bragdon v. Abbott,
524 U.S. 624 (1998)....................16

Branch v. FDIC,
825 F. Supp. 384 (D. Mass. 1993)....................16

Brehm v. Eisner,
746 A.2d 244 (Del. 2000)....................14

Costello v. United States,
365 U.S. 265 (1961)....................19, 20

Cruz v. Don Pancho Market, LLC,
167 F. Supp. 3d 902 (W.D. Mich. 2016)....................10

Deephaven Risk Arb Trading Ltd. v. UnitedGlobalCom, Inc.,
2005 WL 1713067 (Del. Ch. July 13, 2005)....................13

Delta Savings Bank v. United States,
265 F.3d 1017 (9th Cir. 2001)....................15, 16, 17

First Hartford Corp. Pension Plan & Trust v. United States,
194 F.3d 1279 (Fed. Cir. 1999)....................15, 16

Page(s)

Franklin Savings Corp. v. United States,
970 F. Supp. 855 (D. Kan. 1997) 16

Gatz v. Ponsoldt,
2004 WL 3029868 (Del. Ch. Nov. 5, 2004) 14

Grayson v. Imagination Station, Inc.,
2010 WL 3221951 (Del. Ch. Aug. 16, 2010) 14

Grimes v. Donald,
673 A.2d 1207 (Del. 1996) 14

Hansberry v. Lee,
311 U.S. 32 (1940) 21

Herendeen v. Champion International Corp.,
525 F.2d 130 (2d Cir. 1975) 23

In re Sonus Networks, Inc., Shareholder Derivative Litigation,
499 F.3d 47 (1st Cir. 2007) 19, 20

In re Wal-Mart Stores, Inc. Del. Derivative Litigation,
2017 WL 3138201 (Del. Ch. July 25, 2017) 21

Joelson v. United States,
86 F.3d 1413 (6th Cir. 1996) 15

Kamen v. Kemper Financial Services, Inc.,
500 U.S. 90 (1991) 11

Kowalski v. Tesmer,
543 U.S. 125 (2004) 12, 17

Lawlor v. National Screen Service Corp.,
349 U.S. 322 (1955) 23

Levin v. Miller,
763 F.3d 667 (7th Cir. 2014) 11

Lucas v. JBS Plainwell, Inc.,
2012 WL 12854880 (W.D. Mich. Mar. 8, 2012) 22

Mertens v. Black,
948 F.2d 1105 (9th Cir. 1991) 18

Page(s)

Nathan v. Rowan,
651 F.2d 1223 (6th Cir. 1981) 20, 21

Pagan v. Calderon,
448 F.3d 16 (1st Cir. 2006) 12

Pareto v. FDIC,
139 F.3d 696 (9th Cir. 1998) 13

Perry Capital, LLC v. Mnuchin,
864 F.3d 591 (D.C. Cir. 2017) 3, 14, 16, 18

Phillips Petroleum Co. v. Shutts,
472 U.S. 797 (1985) 15

Pittston Co. v. United States,
199 F.3d 694 (4th Cir. 1999) 23

Rawe v. Liberty Mutual Fire Insurance Co.,
462 F.3d 521 (6th Cir. 2006) 23

Remus Joint Venture v. McAnally,
116 F.3d 180 (6th Cir. 1997) 17

Richards v. Jefferson County,
517 U.S. 793 (1996) 15

Ross v. Bernhard,
396 U.S. 531 (1970) 21

San Antonio Fire & Police Pension Fund v. Bradbury,
2010 WL 4273171 (Del. Ch. Oct. 28, 2010) 14

Saxton v. FHFA,
2017 WL 1148279 (N.D. Iowa Mar. 27, 2017) 17

SEC v. Federal Labor Relations Authority,
568 F.3d 990 (D.C. Cir. 2009) 12

Smith v. Bayer Corp.,
564 U.S. 299 (2011) 21

Starr International Co. v. United States,
856 F.3d 953 (Fed. Cir. 2017) 11

Page(s)

Suess v. United States,
33 Fed. Cl. 89 (1995) 16

Tackett v. M&G Polymers, USA, LLC,
561 F.3d 478 (6th Cir. 2009) 17

Tooley v. Donaldson, Lufkin & Jenrette, Inc.,
845 A.2d 1031 (Del. 2004) 13, 14

Tumey v. Ohio,
273 U.S. 510 (1927) 15

United States v. ICC,
337 U.S. 426 (1949) 12

United States v. Tohono O'Odham Nation,
563 U.S. 307 (2011) 23

Ward v. Village of Monroeville,
409 U.S. 57 (1972) 15

Webster v. Doe,
486 U.S. 592 (1988) 15

Weinfeld v. Minor,
2016 WL 951352 (D. Nev. Mar. 9, 2016) 18

Wilson v. Strickland,
333 F. App'x 28 (6th Cir. 2009) 21

Winget v. JP Morgan Chase Bank, N.A.,
537 F.3d 565 (6th Cir. 2008) 18

Wood v. Georgia,
450 U.S. 261 (1981) 15

Youngstown Sheet & Tube Co. v. Sawyer,
343 U.S. 579 (1952) 11

Statutes

12 U.S.C. § 1455 3

12 U.S.C. § 1719 3

12 U.S.C. § 1821 16

Page(s)

12 U.S.C. § 4511 2

12 U.S.C. § 4512 .... 2, 5, 6

12 U.S.C. § 4516 2

12 U.S.C. § 4617 .... passim

44 U.S.C. § 3502 2

Other Authorities

106 Stat. 3672 (Oct. 28, 1992) 2

156 CONG. REC. S11071 (Dec. 22, 2010) 6

156 CONG. REC. S7911 (Nov. 15, 2010) 6

159 CONG. REC. S8593 (Dec. 10, 2013) 6

Charles Alan Wright & Arthur R. Miller, Federal Practice & Procedure § 4437 (2d ed. 2017) 19, 20

George Blum et al., 46 Am. Jur. 2d Judgments § 463 23

INTRODUCTION

The Federal Housing Finance Agency ("FHFA") exists wholly outside the system of limited and divided government established by the Constitution, and for years it operated under the direction of a single acting Director who had been neither nominated to that post by the President nor confirmed to it by the Senate. The FHFA regulatory and conservatorship actions at issue in this case violated the separation of powers, and none of Treasury's arguments provides a proper basis for dismissing this suit without reaching the merits of Plaintiffs' claims. Treasury's reliance on 12 U.S.C. § 4617(b)(2)(A)—the "Succession Clause" of the Housing and Economic Recovery Act ("HERA")—is misplaced because this provision does not bar direct claims or derivative constitutional claims against FHFA. Plaintiffs' constitutional claims are direct as a matter of both federal and state law, and in any event the Succession Clause would be unconstitutional if it required the Companies to accept FHFA as their exclusive representative to assert claims that FHFA has violated the Constitution. Claim preclusion also does not bar this suit for multiple reasons: suits dismissed under HERA's Succession Clause are not decided "on the merits," Plaintiffs are not in privity with any of the plaintiffs who have previously challenged the Net Worth Sweep in other cases, and Plaintiffs in this case seek to advance a cause of action that is different from those that have been brought in the past. Treasury's arguments for declining to treat FHFA as the federal government when it acts as conservator or withholding any remedy for Plaintiffs' injuries are likewise without merit. Therefore, the Court should deny Treasury's motion to dismiss.

BACKGROUND

Congress establishes FHFA as an independent agency headed by a single director

Fannie Mae and Freddie Mac ("the Companies") are private, for-profit corporations that purchase, insure, and securitize mortgages. From 1992 until 2008, the Companies were regulated by the Office of Federal Housing Enterprise Oversight ("OFHEO")—an office within the Department of Housing and Urban Development. OFHEO was not an independent agency; its Director could be removed from office by the President for any reason. *See* Housing and Community Development Act of 1992 §§ 1311, 1312, 106 Stat. 3672 (Oct. 28, 1992). To fund OFHEO's operations, Congress permitted the office to impose annual assessments on the Companies "to the extent provided in appropriation Acts." *Id.* § 1316(a). By statute, OFHEO's annual spending plans had to be included in the President's budget. *Id.* § 1316(g)(3).

During the summer of 2008, Congress passed and President Bush signed HERA, which established FHFA as the successor to OFHEO. Unlike its predecessor, FHFA is an "independent" agency, 12 U.S.C. § 4511(a); 44 U.S.C. § 3502(5), and it is headed by a Director who is only removable "for cause by the President," 12 U.S.C. § 4512(b)(2). To further insulate FHFA from presidential influence, HERA also provides that when FHFA acts as conservator it "shall not be subject to the direction or supervision of any other agency of the United States." *Id.* § 4617(a)(7). Also unlike OFHEO, FHFA is funded through assessments that are "not . . . construed to be Government or public funds or appropriated money." *Id.* § 4516(f)(2). As a result, FHFA is neither subject to presidential control nor constrained by the congressional appropriations process.

In addition to giving FHFA supervisory regulatory powers over the Companies, HERA also empowered FHFA to appoint itself as the Companies' conservator under specified

circumstances. *See* 12 U.S.C. § 4617(a). When it acts as conservator, FHFA has successfully argued that its powers are "extraordinarily broad" and that it may disregard the interests of the Companies and their investors in order to pursue its own interests, including "public and governmental interests." *Perry Capital, LLC v. Mnuchin*, 864 F.3d 591, 606, 613 (D.C. Cir. 2017); *see* 12 U.S.C. § 4617(b)(2). Indeed, FHFA has consistently taken the position that as conservator it has "plenary operational authority," (Ex. A, FHFA Appellees Br. at 11, *Perry Capital LLC v. Mnuchin*, No. 14-5243 (D.C. Cir. Mar. 7, 2016)), and may "operate Fannie and Freddie as it sees fit," Ex. B, FHFA Mem. in Supp. of Mot. to Dismiss at 15, *Collins v. FHFA*, No. 16-cv-3113 (S.D. Tex. Jan. 9, 2017) (quotation marks omitted). (*See* R.17, Am. Compl. ¶¶ 27-31, Pg.ID 206-09.)

FHFA forces the companies into conservatorship and signs the PSPAs on their behalf

The Companies were in a relatively strong financial position throughout the financial crisis and generated sufficient income to cover their expenses and retained billions of dollars of capital that could be used to cover any future losses. (*Id.* ¶¶ 33-34, Pg.ID 209-10.) Nevertheless, on September 6, 2008, FHFA exercised its power to place the Companies into conservatorship.

In addition to establishing FHFA, HERA also gave Treasury temporary authority to invest in the Companies' securities. This authority expired at the end of 2009, 12 U.S.C. §§ 1455(*l*)(4), 1719(g)(4), could only be exercised with the Companies' consent, 12 U.S.C. §§ 1455(*l*)(1)(A), 1719(g)(1)(A), and depended on Treasury first considering "[t]he need to maintain [the Companies'] status as private shareholder-owned" entities, 12 U.S.C. §§ 1455(*l*)(1)(C)(v), 1719(g)(1)(C)(v). Concurrent with FHFA's imposition of conservatorship, Treasury exercised this authority by entering agreements with FHFA to purchase equity in the Companies ("Preferred Stock Purchase Agreements" or "PSPAs"). The PSPAs allowed the Companies to

draw up to $100 billion each from Treasury as needed to avoid a negative net worth—an amount that was subsequently increased to allow the Companies to draw unlimited sums from Treasury until the end of 2012, and thereafter capped at the amount drawn from 2010 through 2012, plus $200 billion per Company. (R.17, Am. Compl. ¶¶ 43, 54, Pg.ID 213, 218.)

In return for Treasury's funding commitment, FHFA agreed that the Companies would provide several forms of consideration. First, the PSPAs created a new class of securities with very favorable terms to Treasury, known as Senior Preferred Stock ("Government Stock"). For each Company, the Government Stock had an initial liquidation preference of $1 billion, an amount that would increase by one dollar for every dollar drawn on Treasury's funding commitment.[1] The original PSPAs also required the Companies to pay quarterly dividends on the Government Stock's liquidation preference. These dividends could be paid in cash, at an annual rate of 10%, or in kind, by increasing the liquidation preference by an annual amount of 12%. (*Id.* ¶¶ 46-47, Pg.ID 214-15.) FHFA repeatedly acknowledged the payment in kind option, (*id.* ¶ 48, Pg.ID 215), and paying the dividends in kind would not have reduced the amount available under Treasury's funding commitment.

Second, FHFA agreed that the Companies would issue warrants entitling Treasury to buy 79.9% of their common stock at a nominal price. The warrants were designed to provide future upside to taxpayers once the Companies recovered, but this upside would be shared with the Companies' other preferred and common shareholders. (*Id.* ¶ 45, Pg.ID 213-14.)

Third, the PSPAs provided for the Companies to pay Treasury a quarterly market-based periodic commitment fee beginning in 2010. (*Id.* ¶ 52, Pg.ID 217.) Prior to the Net Worth

[1] If the Companies liquidate, Treasury's liquidation preference entitles it to receive the sum specified before more junior preferred and common shareholders receive anything.

Sweep, Treasury consistently waived this fee, and it could only be set with the agreement of the Companies at a market rate. Freddie forecasted its "sensitivity" to imposition of the periodic commitment fee beginning in 2013 at $0.4 billion per year, (*id.* ¶ 92, Pg.ID 237-38)—a modest sum for a company that during 2013 reported comprehensive income of $51.6 billion, *see* Federal Home Loan Mortgage Corporation, Form 10-K at 1 (April 9, 2013).

The original PSPAs thus diluted, but did not eliminate, the economic interests of the Companies' private shareholders.

Mr. DeMarco serves as FHFA's acting director for over four years

As the Director of OFHEO when HERA became law, James Lockhart automatically became vested with the authority to "act" as FHFA's independent Director until a permanent Director could be appointed. *See* 12 U.S.C. § 4512(b)(5). Mr. Lockhart forced the Companies into conservatorship and signed the original PSPAs on their behalf in September 2008. On August 5, 2009, Mr. Lockhart publicly announced that he would resign at the end of the month. (R.17, Am. Compl. ¶ 55, Pg.ID 218.)

HERA provides that "[i]n the event of the . . . resignation . . . of the Director, the President shall designate" one of FHFA's three Deputy Directors "to serve as acting Director until . . . the appointment of a successor" who is nominated by the President and confirmed by the Senate. 12 U.S.C. § 4512(f). Each of FHFA's Deputy Directors is appointed by FHFA's Director. *Id.* § 4512(c)-(e). In accordance with HERA, on August 25, 2009, President Obama designated Edward DeMarco to serve as FHFA's acting Director. (R.17, Am. Compl. ¶ 56, Pg.ID 218.) At the time, Mr. DeMarco was FHFA's Senior Deputy Director for Housing Mission and Goals. (*Id.*) Mr. DeMarco had previously been appointed to that post by Mr. Lockhart. *See* 12 U.S.C. § 4512(e)(1).

Acting agency heads normally serve only temporarily, during the time necessary for the President to nominate and the Senate to confirm someone to permanently fill the position. But it was not until 15 months after Director Lockhart's resignation, on November 12, 2010, when President Obama nominated Joseph A. Smith, Jr. to be FHFA's Director. *See* 156 CONG. REC. S7911 (Nov. 15, 2010). The Senate failed to confirm Mr. Smith, and on December 22, 2010, the nomination was returned to the President. *See* 156 CONG. REC. S11071 (Dec. 22, 2010). President Obama did not again nominate someone to fill the vacancy created by Mr. Lockhart's resignation until May 2013, when he nominated Congressman Melvin L. Watt. After more than seven months, the Senate confirmed Mr. Watt on December 10, 2013. 159 CONG. REC. S8593 (Dec. 10, 2013). Mr. Watt was sworn into office on January 6, 2014. *See* FHFA, Melvin L. Watt, https://goo.gl/wvyLtS.

From August 2009 until January 2014, Mr. DeMarco led FHFA as the independent agency's acting Director. Mr. DeMarco's 52-month tenure was only eight months shy of the full five-year term that a Senate-confirmed FHFA Director would have served. *See* 12 U.S.C. § 4512(b)(2). And during the great majority of the time Mr. DeMarco was acting Director, there was no pending nomination from the President to fill the important post that Mr. DeMarco occupied. The fact that FHFA did not have a Senate-confirmed Director for over four years, during much of the time when the Nation's housing market was recovering from the 2008 financial crisis, is extraordinary.

During his time as acting Director, Mr. DeMarco was responsible for an important shift in FHFA's overall approach to operating the Companies as their conservator. Whereas Mr. Lockhart publicly stated that his goal was to help the Companies rebuild capital and return to private control, (*see* R.17, Am. Compl. ¶¶ 34, 38-40, Pg.ID 210, 211-12), Mr. DeMarco

undertook a policy aimed at winding down the Companies and doing so in a manner that guaranteed their private shareholders would lose all the value of their investments. (*See id.* ¶ 24, 59, Pg.ID 205, 219-20.)

Despite Mr. DeMarco's commitment to operate the Companies for the exclusive financial benefit of the federal government, he resisted some of the Obama Administration's most significant housing finance policies. Most notably, Mr. DeMarco refused to approve the Administration's proposal that the Companies reduce the principal on certain mortgages in an effort to jumpstart the recovery in housing prices. *See* Letter from Timothy F. Geithner, Secretary, Treasury, to Edward DeMarco, Acting Dir., FHFA (July 31, 2012), http://goo.gl/BGbWJR. Internal Treasury documents concerning negotiations over the Net Worth Sweep reveal that Treasury officials viewed those negotiations in the context of the Administration's broader dispute with Mr. DeMarco and that they sought to leverage the negotiations to "keep estrangement" "to a minimum." (R.17, Am. Compl. ¶ 61, Pg.ID 221.)

Unwarranted accounting decisions artificially increase the companies' draws from Treasury, and the companies return to sustained profitability

Under FHFA's supervision, the Companies were forced to dramatically write down the value of their assets and to incur substantial non-cash accounting losses in the form of loan loss reserves and write-offs of deferred tax assets.[2] Tens of billions of dollars of these accounting adjustments were based on wildly pessimistic assumptions about potential future losses and were wholly unwarranted. (*See id.* ¶¶ 65-70, Pg.ID 223-27.) By June 2012, FHFA had forced Fannie and Freddie to draw $161 billion from Treasury to make up for the paper losses caused by these

[2] Loan loss reserves reduce reported net worth to reflect anticipated future losses. Deferred tax assets are used to reduce taxable income on future earnings. The book value of a tax asset depends on the likelihood that the corporation will earn sufficient income to use the tax asset.

erroneous accounting decisions, even though there was no indication that the Companies' actual cash expenses could not be met by their cash receipts. The Companies drew $26 billion more to pay dividends to Treasury. Because (i) the Companies were forced to draw funds from Treasury that were not needed to continue operations, (ii) the PSPAs did not permit the Companies to redeem the Government Stock or pay down the liquidation preference, and (iii) the PSPAs tied the Companies' dividend obligations to the size of the outstanding liquidation preference, the dividends owed to Treasury were artificially—and permanently—inflated with each additional unnecessary draw.

As a result of these transactions, Treasury's liquidation preference swelled to $189 billion. But based on the Companies' performance in the second quarter of 2012, it was apparent that the Companies' private shares still had value. Mr. DeMarco explicitly recognized this fact during a June 24, 2012 meeting with Treasury Secretary Geithner, stating that because the Companies "will be generating large revenues over the coming years, thereby enabling them to pay the 10% annual dividend well into the future," he "no longer [saw] the urgency of amending the PSPAs." (R.17, Am. Compl. ¶ 89, Pg.ID 235.) Minutes of a July 2012 Fannie management meeting circulated broadly within FHFA confirmed this assessment, indicating that Fannie was entering a period of "golden years" of earnings, (*id.* ¶ 79, Pg.ID 230), and projections attached to those minutes showed that Fannie expected its cumulative dividend payments to Treasury to exceed its total draws by 2020 and that over $115 billion of Treasury's commitment would remain available after 2022 (*id.*).

FHFA also knew that the Companies were about to reverse many of the erroneous paper losses previously imposed upon them. Susan McFarland, Fannie's Chief Financial Officer at the time of the Net Worth Sweep, testified that in July 2012, she highlighted the potential release of

the deferred tax asset valuation allowance at a meeting attended by at least one FHFA official. (*Id.* ¶ 80, Pg.ID 231.) FHFA was also on notice that nine days before the Net Worth Sweep was announced Ms. McFarland told senior Treasury officials that she expected Fannie to report roughly $50 billion in profits within the next year thanks to the recognition of deferred tax assets. (*See id.*)

FHFA imposes the net worth sweep, thereby expropriating Plaintiffs' investments in the companies

Plaintiffs own shares of common and preferred stock in the Companies. (R.17, Am. Compl. ¶¶ 9-11, Pg.ID 200.) On August 17, 2012, just days after the Companies announced robust second quarter earnings indicating that they had earned more than enough to pay Treasury's dividends in cash without making a draw from the funding commitment (*see id.* ¶ 84, Pg. ID 233); Press Release, Fannie Mae, Fannie Mae Reports Net Income of $5.1 Billion for Second Quarter 2012 (Aug. 8, 2012), https://goo.gl/TfJHrv, FHFA and Treasury amended the PSPAs to impose the Net Worth Sweep. The Net Worth Sweep replaces the PSPAs' prior dividend structure with one that requires Fannie and Freddie to pay Treasury their entire net worth on a quarterly basis, minus a small capital buffer that started at $3 billion and steadily decreases until it reaches $0 at the end of 2017.[3] FHFA thus agreed to nationalize the Companies and expropriated not just their future earnings but also their retained capital, thereby depriving the Companies' private shareholders of all of their economic rights.

As FHFA expected, the Net Worth Sweep has resulted in massive and unprecedented payments to the government. From the fourth quarter of 2012, the first fiscal quarter subject to

[3] The Net Worth Sweep agreement also suspended operation of the periodic commitment fee, but, as explained above, the fee had consistently been waived and was projected to be a relatively modest amount.

the Net Worth Sweep, through the second quarter of 2017, the Companies generated over $219 billion in comprehensive income. But rather than using that income to prudently build capital reserves and prepare to exit conservatorship, the Companies have instead been forced to pay substantially all of it as "dividends" to Treasury—approximately $130 billion more than Treasury would have received under the original PSPAs if the Companies had elected to pay cash dividends. *See* FHFA, TABLE 2: DIVIDENDS ON ENTERPRISE DRAWS FROM TREASURY, https://goo.gl/vHl8V0. Altogether, Treasury has recouped over $88 billion more than it disbursed to the Companies. Yet FHFA insists that the outstanding liquidation preference remains firmly fixed at $189 billion and that the federal government has the right to all of the Companies' net worth in perpetuity. (*Cf.* R.23-3, Treas. Br. Ex. C, Pg.ID 367-74.)

ARGUMENT

I. Legal standard.

The Court may grant Treasury's motion to dismiss only if Plaintiffs' complaint fails to provide "sufficient factual allegations that, if accepted as true, are sufficient to raise a right to relief above the speculative level." *Cruz v. Don Pancho Market, LLC*, 167 F. Supp. 3d 902, 904 (W.D. Mich. 2016). For purposes of a motion to dismiss, the Court "must accept as true all factual allegations" in the Complaint.

II. HERA's succession clause does not immunize FHFA from claims that it is operating the companies in violation of the separation of powers.

HERA's Succession Clause provides that as conservator FHFA "immediately succeed[s] to . . . all rights, titles, powers, and privileges . . . of any stockholder." 12 U.S.C. § 4617(b)(2)(A). At least when a conservator does not face a conflict of interest, this provision

and the materially identical provision of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") have been interpreted as generally transferring to the conservator shareholders' right to bring derivative but not direct claims. *See Levin v. Miller*, 763 F.3d 667, 672 (7th Cir. 2014). Treasury's argument that the Succession Clause bars this suit rests on two premises: (1) that Plaintiffs' separation of powers claims are derivative; and (2) that the Succession Clause prohibits derivative constitutional claims against FHFA during conservatorship. (*See* R.23, Treas. Br. 17-20, 23-24, Pg.ID 310-13, 316-17.) Treasury is mistaken on both points.

A. Plaintiffs' claims are direct under principles of both federal and state law.

1. The direct or derivative nature of Plaintiffs' federal constitutional claims is ultimately a question of federal common law. *Starr Int'l Co. v. United States*, 856 F.3d 953, 965-66 (Fed. Cir. 2017). And while federal courts often look to state law principles when distinguishing between direct and derivative claims, they will not do so when the application of state law "would be inconsistent with the federal policy underlying the cause of action." *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 99 (1991). The federal policy underlying Plaintiffs' causes of action is clear: "The declared purpose of separating and dividing the powers of government . . . was to 'diffus[e] power the better to secure liberty.' " *Bowsher v. Synar*, 478 U.S. 714, 721 (1986) (quoting *Youngstown Sheet & Tube Co. v. Sawyer*, 343 U.S. 579, 635 (1952) (Jackson, J., concurring)). Because treating Plaintiffs' claims as derivative would badly undermine this important federal constitutional policy, Plaintiffs' claims are direct as a matter of federal common law.

Even if FHFA were otherwise inclined to agree with Plaintiffs' separation of powers arguments, Article III's case or controversy requirement would not permit the agency to raise

these arguments by suing itself. *See United States v. ICC*, 337 U.S. 426, 430 (1949) (recognizing the "general principle that no person may sue himself"); *SEC v. Federal Labor Relations Auth.*, 568 F.3d 990, 997 (D.C. Cir. 2009) (Kavanaugh, J., concurring). Treasury's contention that Plaintiffs' claims are derivative and therefore belong to FHFA thus threatens to bar *anyone* from suing to remedy the violations of the separation of powers at issue here. That result might not offend federal policy if "the dynamic between and among the branches [were] the only object of the Constitution's concern," but "[t]he structural principles secured by the separation of powers protect the individual as well." *Bond v. United States*, 564 U.S. 211, 222 (2011). Accordingly, at least where there is no more directly injured party with the capacity to sue, an individual who has suffered "injury that is concrete, particular, and redressable" "has a direct interest in objecting to laws that upset the constitutional balance" among the branches of the federal government and need not sue derivatively. *Id.*

This analysis finds strong support in the Supreme Court's willingness to relax prudential third-party standing rules in cases in which there is a "close relationship" between the plaintiff and a third party who faces "a 'hindrance' to [his] ability to protect his own interests." *Kowalski v. Tesmer*, 543 U.S. 125, 130 (2004). With FHFA incapable of suing on behalf of the Companies to vindicate the important constitutional principles at stake in this case, Plaintiffs' close relationship to the Companies makes them the appropriate parties to assert the claims at issue here. *See Pagan v. Calderon*, 448 F.3d 16, 28 (1st Cir. 2006) (observing that "the rule that a shareholder cannot sue in his own name for an injury sustained by the corporation is not ironclad" and recognizing possible exception "if it is absolutely inconceivable that the corporation itself would pursue a claim for the misconduct").

2. Plaintiffs' claims are also direct under governing principles of state law. "Causes of action for the misallocation of shares among competing stockholders or for discrimination against specific stockholders have often been found to be direct and not derivative in nature."[4] *Deephaven Risk Arb Trading Ltd. v. UnitedGlobalCom, Inc.*, 2005 WL 1713067, at *8 n.41 (Del. Ch. July 13, 2005); *see Pareto v. FDIC*, 139 F.3d 696, 699-700 (9th Cir. 1998) (observing that under California law minority shareholders may sue directly to challenge "a majority stockholders' breach of a fiduciary duty to minority stockholders, which resulted in the majority stockholders retaining a disproportionate share of the corporation's ongoing value"). That is because rearranging a corporation's capital structure to shift part of the corporation's ongoing value from one shareholder to another does not necessarily injure the corporation. In such cases, the disadvantaged shareholder directly suffers the "alleged harm" and receives "the benefit of any recovery." *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004).

The Net Worth Sweep rearranged the Companies' capital structure so that dividends that would have been shared with Plaintiffs are now instead paid exclusively to Treasury. For example, during the second quarter of 2013, Fannie's board declared a shareholder dividend of $59.4 billion, all of which was paid to Treasury as the owner of Fannie's senior preferred stock. Had Fannie declared the same dividend before the Net Worth Sweep, only the first $2.9 billion of this amount would have been paid on Treasury's senior preferred stock, with the remaining $56.5 billion being distributed to Fannie's junior preferred and common shareholders. *See* FHFA, TABLE 2: DIVIDENDS ON ENTERPRISE DRAWS FROM TREASURY, https://goo.gl/o2uk9K. Treasury's argument that this change to the Companies' capital structure harms Plaintiffs only derivatively is not correct; the fact that Treasury now receives dividends that would have

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[4] This issue does not appear to have been addressed by courts applying Michigan law.

otherwise been paid to Plaintiffs harms Plaintiffs, not the Companies. Accordingly, Plaintiffs "can prevail without showing an injury to the corporation." *Tooley*, 845 A.2d at 1039. Indeed, even if Defendants were correct that the Net Worth Sweep benefitted the Companies, Plaintiffs would be no less injured by having their economic rights transferred to Treasury.

Treasury also argues that vacatur of the Net Worth Sweep would only benefit Plaintiffs indirectly, (R.23, Treas. Br. 19, Pg.ID 312), but when a plaintiff seeks injunctive or declaratory relief rather than damages the only way to determine to whom the relief flows is to consider whose injury it remedies. Accordingly, "courts have been more prepared to permit the plaintiff to characterize the action as direct when the plaintiff is seeking only injunctive or prospective relief," as is the case here. *Grimes v. Donald*, 673 A.2d 1207, 1213 (Del. 1996), *overruled on other grounds*, *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000); *see also Tooley*, 845 A.2d at 1038 (citing *Grimes* with approval). For example, the Delaware Court of Chancery held in *Gatz v. Ponsoldt* that a shareholder's claim was direct where the plaintiff asked the court to unwind a transaction entered into by the corporation to the advantage of certain shareholders at the expense of others. 2004 WL 3029868, at *7-*8 (Del. Ch. Nov. 5, 2004); *see also San Antonio Fire & Police Pension Fund v. Bradbury*, 2010 WL 4273171, at *9 (Del. Ch. Oct. 28, 2010); *Grayson v. Imagination Station, Inc.*, 2010 WL 3221951, at *6 (Del. Ch. Aug. 16, 2010). Because Plaintiffs seek similar relief, their claims are direct.

B. HERA's succession clause does not prevent shareholders from asserting derivative constitutional claims against FHFA.

When the D.C. Circuit dismissed derivative fiduciary duty claims against FHFA in *Perry Capital*, it created a circuit split on the question whether such shareholder derivative claims may go forward during conservatorship or receivership. *Compare Perry Capital, LLC v. Mnuchin*, 864 F.3d 591, 623 (D.C. Cir. 2017), *with First Hartford Corp. Pension Plan & Tr. v. United*

States, 194 F.3d 1279, 1283 (Fed. Cir. 1999); *Delta Sav. Bank v. United States*, 265 F.3d 1017, 1024 (9th Cir. 2001). But even if the Court concludes that Plaintiffs' claims are derivative, there is an important difference between this case and *Perry Capital* that makes it unnecessary to decide whether the D.C. Circuit was correct: unlike the plaintiffs in *Perry Capital*, Plaintiffs here assert constitutional claims.

Because both practical and Article III impediments would prevent FHFA from suing on the constitutional claims Plaintiffs seek to advance, interpreting HERA's Succession Clause to vest in FHFA the exclusive authority to press these claims would be tantamount to eliminating any judicial forum in which they could be heard. The Supreme Court has repeatedly strained to read statutes "to avoid the 'serious constitutional question' that would arise if a federal statute were construed to deny any judicial forum for a colorable constitutional claim." *Webster v. Doe*, 486 U.S. 592, 603 (1988); *see Joelson v. United States*, 86 F.3d 1413, 1420 (6th Cir. 1996). Plaintiffs submit that the Succession Clause would violate due process if it had this effect. *See Bartlett v. Bowen*, 816 F.2d 695, 705 (D.C. Cir. 1987); *Battaglia v. General Motors Corp.*, 169 F.2d 254, 257 (2d Cir. 1948). The Due Process Clause would not permit Congress to pass a law requiring a litigant to accept the decisions of a conflicted class representative, *Richards v. Jefferson Cty.*, 517 U.S. 793, 801 (1996); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 812 (1985), criminal defense lawyer, *Wood v. Georgia*, 450 U.S. 261, 271-72 (1981), or judge, *Ward v. Village of Monroeville*, 409 U.S. 57, 61-62 (1972); *Tumey v. Ohio*, 273 U.S. 510, 523 (1927). Neither may a federal statute require the Companies to accept FHFA as their exclusive representative in a lawsuit alleging that FHFA itself has violated the Constitution.

The canon of constitutional avoidance thus provides a powerful reason to follow the Federal and Ninth Circuits in allowing shareholder derivative claims against a federal

conservator or receiver—at least when the plaintiff seeks to advance a colorable constitutional claim. But even apart from the unique constitutional concerns presented here, the *Perry Capital* court erred in declining to follow the well-reasoned and congressionally ratified decisions of its sister circuits.

Before Congress enacted HERA, both the Federal and Ninth Circuits had interpreted 12 U.S.C. § 1821(d)(2)(A)(i), the provision of FIRREA on which HERA's Succession Clause was modeled, as allowing shareholders to maintain a derivative suit when the conservator or receiver has a manifest conflict of interest. *See First Hartford*, 194 F.3d at 1283; *Delta Sav. Bank*, 265 F.3d at 1024; *see also Franklin Sav. Corp. v. United States*, 970 F. Supp. 855, 862 (D. Kan. 1997); *Suess v. United States*, 33 Fed. Cl. 89, 94-96 (1995); *Branch v. FDIC*, 825 F. Supp. 384, 405 (D. Mass. 1993). When Congress reenacted substantially the same language in HERA, it must be presumed to have adopted these consistent judicial constructions. *See Bragdon v. Abbott*, 524 U.S. 624, 645 (1998). Indeed, given the importance of financial markets' "settled expectations" in this sensitive area and Congress's manifest intent to reassure investors by including in HERA conservatorship provisions modeled on the familiar provisions of FIRREA, *see Perry Capital*, 864 F.3d at 647 (Brown, J., dissenting), prior judicial constructions of FIRREA deserve particular weight.

First Hartford and *Delta Savings Bank* also reflect the best reading of the statute's text. Another provision of HERA explicitly contemplates that during conservatorship a "regulated entity" may sue "for an order requiring the Agency to remove itself as conservator." 12 U.S.C. § 4617(a)(5). Since FHFA controls the Companies during conservatorship and FHFA could not sue itself, this provision would be meaningless if shareholders could not sue the conservator derivatively on behalf of the Companies. HERA's Succession Clause, moreover, does not

purport to *eliminate* any shareholder rights but only provides that FHFA temporarily "succeed[s]" to them. For this reason as well, HERA should not be read as making FHFA the "successor" to rights it cannot exercise. *See Delta Sav. Bank*, 265 F.3d at 1024; *cf. Kowalski*, 543 U.S. at 129-30 (there are "circumstances where it is necessary to grant a third party standing to assert the rights of another" due to inability of third party to vindicate its own rights).

III. Claim preclusion does not bar Plaintiffs' suit.

Most of the previous Net Worth Sweep cases that Treasury says bar this suit as a matter of claim preclusion can be disposed of with dispatch. The court in *Saxton v. FHFA*, held that "each of [the plaintiffs'] claims are jurisdictionally barred by HERA's anti-injunction provision," 2017 WL 1148279, at *11 (N.D. Iowa Mar. 27, 2017), and it is "well settled" that "dismissal for lack of subject-matter jurisdiction does not preclude a second action on the same claim," *Tackett v. M&G Polymers, USA, LLC*, 561 F.3d 478, 486-87 (6th Cir. 2009). It makes no difference that the court in *Saxton* held in the alternative that the claims before it were derivative and therefore also barred by HERA's Succession Clause; "when a district court's ruling rests on alternative grounds, at least one of which is based on the inability of the court to reach the merits, the judgment should not act as a bar in a future action." *Remus Joint Venture v. McAnally*, 116 F.3d 180, 184 n.5 (6th Cir. 1997).

In a footnote, Treasury suggests that several other Net Worth Sweep-related cases preclude Plaintiffs' claims. (*See* R.23, Treas. Br. 20 n.10, Pg.ID 313.) But the plaintiffs in each of those cases contended that all of their claims were direct, and none of the courts addressed Treasury's arguments to the contrary. Because the earlier actions were "pursued only on [the plaintiffs'] own behalf" and the courts "did not treat the claim[s] as . . . derivative shareholder claim[s]," they cannot bar subsequent shareholder derivative suits much less other shareholders'

direct suits. *Weinfeld v. Minor*, 2016 WL 951352, at *4 (D. Nev. Mar. 9, 2016); *Mertens v. Black*, 948 F.2d 1105, 1106 (9th Cir. 1991) (prior judgment not binding on ERISA plan where plaintiffs in previous suit "did not purport to represent the Plan as a whole" but only themselves). Treasury cites no authority to support its proposal that the Court peer behind the plaintiffs' characterization of their own claims in each of these prior cases and decide in the first instance whether the claims were direct or derivative. In any event, Treasury has not attempted to provide the Court with the information it would need for such an undertaking, and Treasury bears the burden of proof to establish the applicability of claim preclusion. *Winget v. JP Morgan Chase Bank, N.A.*, 537 F.3d 565, 572 (6th Cir. 2008).

The only remaining Net Worth Sweep case is *Perry Capital, LLC v. Mnuchin*, 864 F.3d 591, 625-28 (D.C. Cir. 2017), in which some of the plaintiffs asserted derivative breach of fiduciary duty claims that the D.C. Circuit dismissed on the threshold ground that they could not go forward during conservatorship due to HERA's Succession Clause. For that ruling to foreclose this suit as a matter of claim preclusion, "the court must find that (1) the previous lawsuit ended in a final judgment on the merits; (2) the previous lawsuit was between the same parties or their privies; and (3) the previous lawsuit involved the same claim or cause of action as the present case." *Bergeron v. Mackie*, 2016 WL 6122601, at *3 (W.D. Mich. Oct. 20, 2016). As explained below, Treasury has failed to establish any of these elements.

A. The *Perry Capital* court's dismissal of derivative claims under HERA's succession clause was not a judgment "on the merits."

Without reaching the substance of the derivative fiduciary duty claims that were before it, the D.C. Circuit dismissed those claims on the ground that only FHFA could assert them during conservatorship. It has long been settled that dismissal for failure to satisfy a precondition to suit is not a decision on the merits that bars subsequent suits after the precondition is cured, *Costello*

v. United States, 365 U.S. 265, 285-88 (1961), and this rule applies when "a new substantive theory can be advanced that is not subject to the same precondition," CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE & PROCEDURE § 4437 (2d ed. 2017). As explained above, even if the *Perry Capital* court correctly dismissed the derivative claims in that case under HERA's Succession Clause, this suit may still proceed because Plaintiffs allege violations of the Constitution. With Plaintiffs having thus identified claims that are not subject to the precondition that justified dismissal of the earlier suit, claim preclusion does not apply.

Plaintiffs are not aware of a case in which a court decided whether dismissal of a shareholder derivative suit under HERA's Succession Clause constitutes a judgment "on the merits" for claim preclusion purposes, but the First Circuit's decision in *In re Sonus Networks, Inc., Shareholder Derivative Litig.*, 499 F.3d 47, 58-62 (1st Cir. 2007), is instructive. An earlier shareholder derivative suit had been dismissed for failure to adequately plead demand futility, and the First Circuit ruled that the prior judgment was "on the merits" for purposes of issue preclusion *but not* claim preclusion. Explaining that "some determinations may reach the 'merits' of a particular issue, but bar only relitigation of that particular issue, rather than the whole claim," the court "reject[ed] the defendants' argument that the . . . dismissal was 'on the merits' in the sense that no further suit could be brought on the same claim." *Id.* at 58, 62. The same logic applies with equal force to dismissals based on HERA's Succession Clause.

Furthermore, treating dismissals under the Succession Clause as judgments "on the merits" would lead to troubling and incongruous results, as the following hypothetical illustrates. Suppose that a shareholder attempted to derivatively sue the Companies' auditors for various alleged accounting errors that occurred before the Companies were placed into conservatorship. With the plaintiffs unable the identify a conflict of interest that FHFA would face when deciding

whether to pursue the claims, the derivative suit would be dismissed under HERA's Succession Clause. If FHFA later decided to pursue the claims itself on behalf of the Companies, could the auditors avoid liability by pointing to the prior judgment as a basis for claim preclusion? The correct answer is that they could not. "[T]here must be at least one decision on a right between the parties . . . before a judgment can avail as a bar to a subsequent suit," *Costello*, 365 U.S. at 285, and dismissals under the Succession Clause do not determine any rights between the Companies and the defendants.

B. Plaintiffs are not in privity with the plaintiffs from *Perry Capital*.

Plaintiffs were not parties in *Perry Capital*. Treasury's contention that there is nevertheless privity depends entirely on its argument that Plaintiffs' claims are derivative and thus subject to the rule that in derivative cases "parties and their privies include the corporation and all nonparty shareholders." *Nathan v. Rowan*, 651 F.2d 1223, 1226 (6th Cir. 1981). Because Plaintiffs' claims are direct, Treasury's privity argument fails.

But even if the Court determines that Plaintiffs' claims are derivative, Plaintiffs still would not be in privity with plaintiffs who the D.C. Circuit determined *lacked the capacity* to sue on behalf of the Companies due to HERA's Succession Clause. As Treasury explains, the rationale for finding privity between shareholder derivative plaintiffs in separate suits is that the true plaintiff in interest in all such suits is the corporation. (R.23, Treas. Br. 16, Pg.ID 309.) That rationale does not apply when a putative shareholder derivative suit is dismissed because the plaintiff lacks "capacity to bring the suit," and in such cases the dismissal "will not bar other stockholders from bringing a derivative action." WRIGHT & MILLER, FED. PRACTICE & PROCEDURE § 1840. To be sure, the First Circuit has taken a different view with respect to issue preclusion in the demand futility context. *In re Sonus Networks*, 499 F.3d at 64. But this aspect

of the *Sonus* court's issue preclusion analysis has been criticized, *see generally In re Wal-Mart Stores, Inc. Del. Derivative Litig.*, 2017 WL 3138201 (Del. Ch. July 25, 2017), and as discussed in the preceding section the *Sonus* court's claim preclusion holding would in any event foreclose the defense that Treasury raises here.

The conclusion that Plaintiffs are not in privity with the *Perry Capital* plaintiffs is further supported by the Supreme Court's unanimous ruling that where a putative class action is dismissed prior to certification, issue preclusion does not bar absent class members from relitigating the same issues in a subsequent suit. *Smith v. Bayer Corp.*, 564 U.S. 299, 314-18 (2011). Class actions and shareholder derivative suits are closely related procedural mechanisms by which a plaintiff may sue to vindicate the rights of another, *see Ross v. Bernhard*, 396 U.S. 531, 541 (1970), and these procedural mechanisms implicate many of the same due process concerns, *see Nathan*, 651 F.2d at 1227 (looking to class action precedents to determine "the constitutional requirements of due process" when assessing claim preclusion argument in shareholder derivative suit). Just as due process would not permit absent class members to be bound by a judgment obtained by an inadequate class representative, *Hansberry v. Lee*, 311 U.S. 32, 42-43 (1940), the Companies cannot as a matter of logic or constitutional law be bound by a judgment dismissing claims on the ground that the plaintiffs lacked the capacity to represent the Companies, *see Wal-Mart Stores*, 2017 WL 3138201, at *10-*14.

C. This suit is not based on the same cause of action asserted in *Perry Capital*.

For claim preclusion to apply "there must be an identity of the causes of action, that is, an identity of the facts creating the right of action and of the evidence necessary to sustain each action." *Wilson v. Strickland*, 333 F. App'x 28, 30 (6th Cir. 2009) (brackets omitted). Treasury argues that this requirement is satisfied because, at a high level of generality, both this case and

Perry Capital involve challenges to the Net Worth Sweep. But a more nuanced comparison of operative facts is required before concluding that two cases concern the same cause of action, and there is at most only modest overlap between the evidence and issues relevant to this case and the derivative claims that were dismissed in *Perry Capital*.

The only derivative claims at issue in *Perry Capital* alleged that FHFA and Treasury breached their fiduciary duties to the Companies by entering into the Net Worth Sweep. To prevail on these claims, the *Perry Capital* derivative plaintiffs were required to show that the defendant agencies owed fiduciary duties to the Companies and breached those duties. *See Beard Research, Inc. v. Kates*, 8 A.3d 573, 601 (Del. Ch. 2010). The essence of these claims was that the agencies had acted unreasonably and out of self-interest when they imposed the Net Worth Sweep. (*See* Ex. C, Fannie D.D.C. Derivative Compl. ¶¶ 110-16 (Dec. 3, 2013); Ex. D, Freddie D.D.C. Derivative Compl. ¶¶ 53-64 (July 30, 2014).) This case, in contrast, asks the Court to decide whether FHFA is operating the Companies in violation of several separation of powers doctrines, and establishing the facts that were essential to the *Perry Capital* plaintiffs' fiduciary duty claims would do little to advance the claims at issue here. Instead, Plaintiffs' claims in this case are based on a number of facts that were wholly irrelevant to the derivative fiduciary duty claims in *Perry Capital*: that FHFA is headed by a single Director who operates without presidential oversight, that Mr. DeMarco had been serving as FHFA's acting Director for over two years when he approved the Net Worth Sweep, and that FHFA exercises its conservatorship powers over the Companies without the benefit of an intelligible principle from Congress. "[I]t is the difference in factual evidence that drives the res judicata analysis" when determining whether two cases involve the same cause of action, *Lucas v. JBS Plainwell, Inc.*, 2012 WL 12854880, at *8 (W.D. Mich. Mar. 8, 2012) (Maloney, J.), and there is at most only very modest overlap

between the key facts in this case and those relevant to the derivative fiduciary duty claims in *Perry Capital*. *Cf. Pittston Co. v. United States*, 199 F.3d 694, 705 (4th Cir. 1999) ("[W]hen the constitutionality of a statute is merely assumed in an earlier action, the resulting judgment is not res judicata on the constitutionality issue in a subsequent suit between the same parties on a different cause of action.").

Rather than addressing the specific operative facts and evidence relevant to this case and in *Perry Capital*, Treasury emphasizes that Plaintiffs ask the Court to vacate the Net Worth Sweep—a contract amendment that the *Perry Capital* plaintiffs asked the court in that case to rescind. But "[t]he mere fact that the same relief is sought in two actions does not make the causes of action identical within the meaning of the doctrine of res judicata." GEORGE BLUM ET AL., 46 AM. JUR. 2D JUDGMENTS § 463; *see Herendeen v. Champion Int'l. Corp.*, 525 F.2d 130, 134 (2d Cir. 1975) (claim preclusion did not apply because "[w]hile the same alleged right . . . is involved in both suits, the wrongful acts of defendants alleged in the two complaints are quite different"). Whether two suits are based on the same cause of action "depends on factual overlap," *United States v. Tohono O'Odham Nation*, 563 U.S. 307, 316 (2011), not the remedies sought.

Finally, Plaintiffs' complaint challenges not only the original Net Worth Sweep but also FHFA's quarterly decision to declare and pay cash dividends to Treasury and its ongoing exercise of shareholder rights. (*See* R.17, Am. Compl. ¶¶ 125, 128-33, Pg.ID 252, 253-57.) It is well settled that claim preclusion cannot bar claims based on events arising after the first suit was filed. *Rawe v. Liberty Mut. Fire Ins. Co.*, 462 F.3d 521, 529 (6th Cir. 2006); *accord Lawlor v. National Screen Serv. Corp.*, 349 U.S. 322, 327-28 (1955) (permitting second suit where violations of antitrust laws alleged in first suit continued after first suit ended in settlement). At a

minimum, Plaintiffs are entitled to proceed with this suit with respect to FHFA conduct that occurred after the filing of the operative derivate complaints in *Perry Capital*.

IV. Treasury's remaining arguments for dismissal are without merit.

Echoing an argument advanced by FHFA, Treasury contends that Plaintiffs' constitutional claims fail because FHFA steps into the shoes of the Companies and is not subject to constitutional constraints when it acts as conservator. (R.23, Treas. Br. 12-14, Pg.ID 305-07.) Plaintiffs respond to this argument at length in their opposition to FHFA's motions to dismiss, and the same flaws in FHFA's argument also apply with equal force here. In short, FHFA exercised sovereign, governmental powers when it expropriated Plaintiffs' property, immunized Treasury of liability under HERA and the APA, and entered into a self-dealing transaction that private management could never have undertaken.

Treasury also argues that vacating the Net Worth Sweep while leaving the original PSPAs in place would improperly allow Plaintiffs to "benefit from agency action they now insist is unlawful." (R.23, Treas. Br. 14, Pg.ID 307.) But Plaintiffs did not benefit from the original PSPAs, which greatly diluted the value of Plaintiffs' shares in return for a funding commitment from Treasury that the Companies did not need. (*See* R.17, Am. Compl. ¶¶ 33-37, 65-70, Pg.ID 209-11, 223-27.) To the extent the Court deems it appropriate, Plaintiffs have no objection to vacatur of the PSPAs in their entirety. Furthermore, even if the Court accepts Treasury's premise that the original PSPAs did not injure Plaintiffs, Plaintiffs can hardly be faulted for focusing their constitutional suit on the actions by FHFA that have been most harmful to them.

Finally, Treasury devotes several pages of its brief to arguing that *it* did not violate the separation of powers when it entered into the Net Worth Sweep even if FHFA did. (R.23, Treas. Br. 8-12, Pg.ID 301-05.) But Treasury nowhere suggests that FHFA can immunize itself from

otherwise applicable constitutional requirements by contracting with Treasury. Nor does Treasury argue that it was improperly joined as a defendant.

CONCLUSION

For all the foregoing reasons, the Court should deny Treasury's motion to dismiss.

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