UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

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

Plaintiffs,

v.

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.

Case No. 0:17-cv-02185 (PJS/HB)

PLAINTIFFS' MEMORANDUM OF LAW IN RESPONSE TO DEFENDANTS' MOTIONS TO DISMISS AND IN SUPPORT OF PLAINTIFFS' CROSS-MOTION FOR SUMMARY JUDGMENT

Briggs and Morgan P.A.
Scott G. Knudson (#141987)
Michael M. Sawers(#0392437)
2200 IDS Center
80 South Eighth Street
Minneapolis, Minnesota 55402
(612) 977-8400

ATTORNEYS FOR PLAINTIFFS

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INTRODUCTION

This case presents several alternative routes to a single destination: the Federal Housing Finance Agency ("FHFA") violated the constitutional separation of powers when it entered into a contract with the Treasury Department that effectively nationalized Fannie Mae and Freddie Mac ("the Companies"). If FHFA was acting in a governmental capacity when it took this action, it was exercising either Executive power without the constitutionally required degree of presidential oversight, or a Legislative power in violation of the non-delegation doctrine. If FHFA instead acted as a private entity, it violated the private nondelegation doctrine by exercising statutorily conferred power to bind third parties for the public interest. And however FHFA's actions are categorized, it violated the Appointments Clause by operating for over two years under the direction of an acting principal officer who was never nominated by the President or confirmed by the Senate. Whichever path the Court chooses, the correct conclusion is that FHFA acted unconstitutionally when it imposed the so-called "Net Worth Sweep."

In their motions to dismiss, Defendants trumpet the decisions of other courts dismissing previous challenges to the Net Worth Sweep brought by other plaintiffs. But those suits were dismissed in whole or in part based on 12 U.S.C. § 4617(f)—a limitation on judicial review that Defendants do not even argue is applicable to the constitutional claims at issue here. And while it is true that a single district court has rejected one of the constitutional claims Plaintiffs advance in this case, *see Collins v. FHFA*, 2017 WL 2255564 (S.D. Tex. May 22, 2017), *appeal pending*, No. 17-20364 (5th Cir.), that court ruled as it did only after expressly rejecting the reasoning of a D.C. Circuit decision that

the Department of Justice has endorsed, *see PHH Corp. v. CFPB*, 839 F.3d 1 (D.C. Cir. 2016), *vacated and rehearing en banc granted* (Feb. 16, 2017); Br. of United States as Amicus Curiae, *PHH Corp. v. CFPB*, No. 15-1177 (D.C. Cir. Mar. 17, 2017) ("U.S. *PHH* Br.") (Exhibit 1). To an even greater degree than the identically structured agency deemed unconstitutional by the panel in *PHH*, FHFA operates without meaningful direction or oversight from the President, Congress, or the judiciary. This anomalous arrangement violates the separation of powers, and the Court should enter judgment in favor of Plaintiffs.

BACKGROUND

A. Congress Establishes FHFA as an Independent Agency Headed by a Single Director.

Fannie Mae and Freddie Mac are private, for-profit corporations that insure and securitize mortgages. From 1992 until 2008, the Companies were regulated by the Office of Federal Housing Enterprise Oversight ("OFHEO"). 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); First Amended Complaint ¶¶ 10, 13 (Aug. 4, 2017), Doc. 27 ("FAC").

During the summer of 2008, Congress enacted the Housing and Economic Recovery Act ("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). 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 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, 613 (D.C. Cir. 2017); *see* 12 U.S.C. § 4617(b)(2).

B. FHFA Forces the Companies into Conservatorship and Signs the PSPAs on Their Behalf.

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 and could only be exercised with the Companies' consent. *See* 12 U.S.C. §§ 1455(*l*)(1)(A), 1455(*l*)(4), 1719(g)(1)(A), 1719(g)(4). 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. FAC ¶¶ 32, 41.

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. FAC ¶ 35. The original PSPAs 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%. FAC ¶¶ 36-37. Paying the dividends in kind would not have reduced the amount available under Treasury's funding commitment. *Id.* ¶ 38.

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 upside to taxpayers if the Companies recovered, but this upside would be shared with the Companies' other shareholders. *Id.* ¶ 34. The PSPAs also provided for the Companies to pay Treasury a quarterly market-based periodic commitment fee, but the fee was never charged and could only be set at a market rate with agreement from the Companies. *Id.* ¶ 39.

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

C. 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. FAC ¶ 42. On August 5, 2009, Mr. Lockhart announced that he would resign at the end of the month. FAC ¶ 42; Diana Golobay, *Lockhart to Leave FHFA Soon*, HOUSING WIRE (Aug. 5, 2009) (Exhibit 2).

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. FAC ¶ 43; Presidential Order (Aug. 25, 2009) (Exhibit 3). At the time, Mr. DeMarco was FHFA's Senior Deputy Director for Housing Mission and Goals. *Id.*

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 FAC ¶ 44; 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. FAC ¶ 44; 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. *See* FAC ¶ 49; 159 CONG. REC. S8593 (Dec. 10, 2013). Mr. Watt was sworn into office on January 6, 2014. FAC ¶ 44.

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.* ¶ 46. 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. *See id.* ¶ 47. 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) (Exhibit 4).

D. Unwarranted Accounting Decisions Artificially Increase the Companies' Draws from Treasury, and FHFA Expropriates Plaintiffs' Investments by Imposing the Net Worth Sweep.

Under FHFA's supervision, the Companies were forced to dramatically write down the value of their assets and to incur substantial and unjustified non-cash accounting losses in the form of loan loss reserves and write-offs of deferred tax assets. FAC ¶ 50. As a result of these accounting decisions, the Companies made draws on Treasury's funding

commitment that caused the liquidation preference on Treasury's Government Stock to swell 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. *Id.* ¶¶ 52-54.

On August 17, 2012, 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. FAC ¶ 55. 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. Since the Companies first began paying dividends under the Net Worth Sweep during the first quarter of 2013, they have transferred to Treasury nearly $221 billion in purported dividends—over $130 billion more than Treasury could have received under the original PSPAs. *See* FHFA, TABLE 2: DIVIDENDS ON ENTERPRISE DRAWS FROM TREASURY (Exhibit 5). Altogether, Treasury has recouped over $88 billion more than it disbursed to the Companies. *See id.*; FHFA, TABLE 1: QUARTERLY DRAWS ON TREASURY COMMITMENTS TO FANNIE MAE AND FREDDIE MAC PER PSPA (Exhibit 6). 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. FAC ¶ 69.

Plaintiffs own shares of common and preferred stock in the Companies. Declaration

of Atif F. Bhatti (Exhibit 7); Declaration of Tyler D. Whitney (Exhibit 8); Declaration of Michael F. Carmody (Exhibit 9). They brought this suit to redress injuries they have sustained as a result of FHFA's past and ongoing actions.

LEGAL STANDARD

To survive Defendants' motions to dismiss, Plaintiffs' Complaint "must contain sufficient factual matter, accepted as true, to state a claim for relief that is plausible on its face." *Wilson v. Arkansas Dept. of Human Servs.*, 850 F.3d 368, 371 (8th Cir. 2017) (internal quotation marks omitted). The Court should grant Plaintiffs' cross-motion for summary judgment if it determines that "there is no genuine issue as to any material fact and that [Plaitniffs are] entitled to judgment as a matter of law." *Kassa v. Kerry, Inc.*, 487 F. Supp. 2d 1063, 1065 (D. Minn. 2007).

ARGUMENT

I. The Director's For-Cause Removal Protection Should Be Struck Down and the Net Worth Sweep Should Be Vacated Because FHFA's Leadership Structure Violates the Separation of Powers.

A. Treasury's Approval of the Net Worth Sweep Does Not Defeat Plaintiffs' Standing.

FHFA is mistaken when it argues that Treasury's approval of the Net Worth Sweep deprives Plaintiffs of standing to challenge FHFA's structure. *See* FHFA Br. in Supp. of Mot. to Dismiss at 8 (Sept. 15, 2017), Doc. 32 ("FHFA Br."). It is well settled that a plaintiff's standing in a separation of powers case cannot be defeated by speculation about what decision the government might have reached had it followed the procedures the Constitution requires. *Free Enter. Fund v. PCAOB*, 561 U.S. 477, 512 n.12 (2010) ("We

cannot assume . . . that the Chairman would have made the same appointments acting alone; and petitioners' standing does not require precise proof of what the Board's policies might have been in that counterfactual world."); *Landry v. FDIC*, 204 F.3d 1125, 1131 (D.C. Cir. 2000); *see also Lujan v. Defenders of Wildlife*, 504 U.S. 555, 572 n.7 (1992). This rule should apply with particular force where, as here, the challenged action is the product of negotiations. *Cf. Metropolitan Washington Airports Auth. v. Citizens for Abatement of Aircraft Noise, Inc.*, 501 U.S. 252, 264-65 (1991). FHFA does not address these precedents or cite any authority for its argument to the contrary.

B. The Constitutional Separation of Powers Does Not Permit FHFA To Operate as an Independent Agency Headed by a Single Director.

"Congress's 2008 creation of a single head of the new Federal Housing Finance Agency . . . raises the same question" presented in *PHH*, 839 F.3d at 20, *vacated and reh'g en banc granted* (Feb. 16, 2017). No less than the CFPB, FHFA's status as an independent agency headed by a single Director "represents a gross departure from settled historical practice" and "poses a far greater risk of arbitrary decisionmaking and abuse of power, and a far greater threat to individual liberty, than does a multi-member independent agency." *Id.* at 8. Although *PHH* is being reheard by the D.C. Circuit en banc, the panel's decision was correct, has been endorsed by the Department of Justice, and applies with equal force to FHFA.

The Constitution vests the Executive power in the President, who must "take Care that the Laws be faithfully executed." U.S. CONST. art. II, §§ 1, 3. Restrictions on the President's removal power are presumptively unconstitutional, and the Supreme Court has

recognized only two exceptions: Congress may limit the President's ability to remove (1) a multimember "body of experts," *see Humphrey's Ex'r v. United States*, 295 U.S. 602, 624 (1935), and (2) inferior officers with a narrow scope of powers, *see Morrison v. Olson*, 487 U.S. 654, 671-73, 695-97 (1988).

When a court is asked "to consider a new situation not yet encountered by the [Supreme] Court," there must be special "circumstances" to justify "restrict[ing the President] in his ability to remove" an officer. *Free Enterprise Fund*, 561 U.S. at 483-84. FHFA is precisely such a "new situation." Unlike the Federal Trade Commission, which was at issue in *Humphrey's Executor*, FHFA is headed not by an expert and nonpartisan multimember commission that contains its own internal checks, but by a single Director. *Humphrey's Executor*, 295 U.S. at 624 (citation omitted). Furthermore, the continued viability of *Humphrey's Executor* after *Free Enterprise Fund* has been questioned. *See In re Aiken Cty.*, 645 F.3d 428, 444, 446 (D.C. Cir. 2011) (Kavanaugh, J., concurring). *Humphrey's Executor* should be read narrowly and not extended, and Plaintiffs respectfully preserve the argument that the Supreme Court should overrule it and *Morrison*. *See Morrison*, 487 U.S. at 725-27 (Scalia, J., dissenting).

Neither do the powers of FHFA's Director bear resemblance to those of the independent counsel whose authority the Supreme Court upheld in *Morrison*. The independent counsel was an inferior officer who had only "limited jurisdiction" for defined investigations, 487 U.S. at 691; *see also id.* at 671-72, and "lack[ed] policymaking or significant administrative authority," *id.* at 691. FHFA's Director, in contrast, is a principal officer with broad regulatory power over the Nation's multi-trillion-dollar housing finance

system. *See* 12 U.S.C. § 4526. Indeed, Mr. DeMarco has written that "the entire housing system . . . rel[ies] almost entirely on [FHFA's] decisions," MICHAEL BRIGHT & ED DEMARCO, MILKEN INSTITUTE CENTER FOR FINANCIAL MARKETS, WHY HOUSING REFORM STILL MATTERS 3 (June 2016) (Exhibit 10).

"A long line of Supreme Court precedent tells us that history and tradition are important guides in separation of powers cases," *PHH*, 839 F.3d at 21; *see id.* at 21-25; *Free Enterprise Fund*, 561 U.S. at 505-06, and FHFA's structure finds no support in historical precedent. Plaintiffs are aware of only two instances in which Congress authorized a single individual to head an independent agency before the creation of FHFA: the Office of Special Counsel and the Social Security Administration. The Office of Special Counsel "has a narrow jurisdiction" mainly involving government personnel rules, its current structure was only established in 1978, and the Reagan and Carter Administrations both argued against the current structure on separation of powers grounds. *PHH*, 839 F.3d at 19. The Social Security Administration was headed by a multi-member board until 1994, and when it was restructured, President Clinton issued a signing statement arguing that the change was constitutionally problematic. *PHH*, 839 F.3d at 18-19. Because the structure of both agencies is of recent vintage and has been constitutionally contested by the Executive Branch, they do not demonstrate a "longstanding practice" of independent agencies headed by a single individual. *See NLRB v. Noel Canning*, 134 S. Ct. 2550, 2560 (2014).

FHFA's unusual structure also diminishes the President's constitutional power and responsibility to supervise the agency's decisionmaking and ensure its faithful execution

of laws that give it significant policymaking and administrative responsibility. *See* U.S. *PHH* Br. at 14-16 (making similar point and arguing that CFPB's identical structure is unconstitutional). The terms of most multi-member commissions are staggered, and the President inevitably has the ability to influence the deliberations of such commissions by appointing one or more members. *See PHH*, 839 F.3d at 33. Many statutes establishing independent agencies expressly require bipartisan membership, thus guaranteeing that at least some members will belong to the President's party. *See, e.g.*, 15 U.S.C. § 41 (mandating that no more than three of FTC's five commissioners be members of the same political party). The President has unilateral authority to select the chair of many independent multi-member commissions. *See* HENRY B. HOGUE & MAEVE P. CAREY, CONG. RESEARCH SERV., R44083, APPOINTMENT AND CONFIRMATION OF EXECUTIVE BRANCH LEADERSHIP: AN OVERVIEW 11 (2015), https://goo.gl/aiY2Xq. Multi-member commissions also must deliberate and compromise in ways that reduce the risk that they will adopt extreme policies that are inconsistent with those of the President. Taken together, these features of agencies headed by bipartisan, multi-member commissions establish a floor beneath which presidential influence cannot fall.

FHFA's structure eliminates this floor and makes possible something that could never occur with an agency headed by a bipartisan, multi-member commission: someone opposed to the President's policies exercising exclusive and long-term control over a significant component of the Executive Branch. The Oval Office is today occupied by a Republican, but FHFA is run by a Democratic appointee (Melvin Watt). Acting Director DeMarco, who signed the Third Amendment during the tenure of a Democratic President,

attained his position because he was previously made Deputy Director by Republican-appointed FHFA Director James Lockhart. *See* 12 U.S.C. § 4512(f). In both instances, FHFA's structure reduced the incumbent President's influence to a nadir that could never be reached with a multi-member bipartisan commission. It is no answer to say, as FHFA does, that in some *other* situations the President might prefer that an independent agency be led by a single individual. *See* FHFA Br. 13-14. The President must at all times have at least as much influence over an independent agency as was guaranteed with the bipartisan multi-member commission at issue in *Humphrey's Executor*. FHFA's structure reduces Presidential influence beneath this constitutional minimum.

Furthermore, the *PHH* court correctly concluded that an independent agency headed by a single Director poses a serious threat to the individual liberty that the separation of powers safeguards. As that court explained, "[t]he basic constitutional concern with independent agencies is that the agencies are unchecked by the President, the official who is accountable to the people and who is made responsible by Article II for the exercise of executive power." *PHH*, 839 F.3d at 26. Accordingly, "[i]n the absence of Presidential control, the multi-member structure of independent agencies acts as a critical substitute check on the excesses of any individual independent agency head—a check that helps to prevent arbitrary decisionmaking and abuse of power, and thereby to protect individual liberty." *Id.* Multi-member independent agencies better protect individual liberty because they do not concentrate power in the hands of any one unelected individual, must necessarily account for multiple viewpoints, tend to make decisions that are less extreme, and better resist capture by interest groups. *Id.* at 26-28.

Although FHFA's structure violates the separation of powers without regard to the agency's relative importance in national life, there can be no serious dispute that it, like the CFPB, "wields vast power over the U.S. economy." *Id.* at 8. FHFA is "responsible for the oversight of vital components of the secondary mortgage markets," regulates entities that "provide more than $5.8 trillion in funding for the U.S. mortgage markets and financial institutions," and oversees programs that "have helped millions of Americans remain in their homes." FHFA, *About FHFA: Who We Are & What We Do* (Exhibit 11). It "is charged with directing the largest conservatorships in U.S. history in support of the Nation's multi-trillion dollar mortgage finance system," Declaration of FHFA Director Melvin L. Watt ¶ 7 (May 29, 2014) (Exhibit 12)—a system that underpins the entire housing sector and thus directly affects every American. FHFA exercises broad powers over an industry that is responsible for roughly 15% of the Nation's Gross Domestic Product, *see* David Logan, *Housing Share of GDP Expands*, NAT'L ASS'N OF HOME BUILDERS (June 28, 2016) (Exhibit 13), and there can thus be no doubt that its decisions "have an almost unrivaled effect on a broad swath of the economy," Joe Light, *Fannie-Freddie Regulator Said to Plan to Stay On Under Trump*, BLOOMBERG NEWS (Dec. 15, 2016) (Exhibit 14). The character of the powers FHFA exercises within its domain makes its structure even more constitutionally problematic. FHFA is the regulator of two of the Nation's largest privately owned financial institutions, and in other cases it has asserted that it enjoys "plenary power" over the Companies and the rights of their shareholders during conservatorship. FHFA Motion to Dismiss at 16, *Collins v. Mnuchin*, No. 16-3113 (S.D. Tex. Jan. 9, 2017), ECF No. 24; *see also* 12 U.S.C. §§ 4511 *et seq.* (granting FHFA's Director extensive

regulatory powers over the Companies). When FHFA exercises its powers, it benefits from a variety of statutory restrictions on judicial review. *See* 12 U.S.C. § 4617(f); *id.* § 4617(b)(5)(E); *id.* § 4617(b)(11)(D); *id.* § 4623(d). And unlike every other independent agency headed by a single individual save the CFPB, FHFA is not subject to the congressional appropriations process. *See* 12 U.S.C. § 4516(f)(2).

In the absence of meaningful judicial review or congressional oversight, presidential control is an even more important safeguard against the threat that arbitrary agency decisionmaking poses to individual liberty. *See PHH*, 839 F.3d at 35-36. The separation of powers does not permit a single, unsupervised government official to exercise broadly defined powers with no guidance from Congress, no prospect of review by the courts, and no accountability to the elected President.

C. Mr. DeMarco's Status as an Acting Director Does Not Affect Plaintiffs' Claims.

Defendants argue that Plaintiffs' challenge to FHFA's independence fails because the Net Worth Sweep was signed by Mr. DeMarco, who they contend did not enjoy for-cause removal protection because he was only the agency's *acting* Director. FHFA Br. 7; Treasury Br. in Supp. of Mot. to Dismiss at 12 n.4 (Sept. 15, 2017), Doc. 36 ("Treas. Br."). But HERA says that FHFA is an "independent" agency without any suggestion that its status changes during the tenure of an acting Director. 12 U.S.C. § 4511(a); 44 U.S.C. § 3502(5). Furthermore, "[t]he most reliable factor for drawing an inference regarding the President's power of removal . . . is the nature of the function that Congress vested in" the officer in question. *Wiener v. United States*, 357 U.S. 349, 353 (1958). Given that Congress

vested in the acting Director the very same responsibility for running an independent agency that is otherwise assigned to the Director, the only reasonable inference is that Congress intended for the acting Director to enjoy the Director's removal protections. That Congress did not think it necessary to repeat in 12 U.S.C. § 4512(f) what it had already said in 12 U.S.C. § 4512(b)(2)—that the Director enjoys "for cause" removal protection—does not support a different conclusion. Acting officers are presumed to "succeed[ ] to all the powers of the office" except as otherwise specified. *United States v. Guzek*, 527 F.2d 552, 560 (8th Cir. 1975). The statute's failure to specify a different rule thus indicates that the acting Director enjoys the same protection from removal as the Director.[1]

The Obama Administration understood that HERA insulated Mr. DeMarco from removal by the President. For example, when a senior Obama Administration official was asked about the possibility of firing Mr. DeMarco over a policy disagreement, he told reporters "[t]hat is not authority that the president has." *See* Rob Blackwell, *HUD Chief: Obama Can't Fire FHFA's DeMarco*, NAT'L MORTGAGE NEWS (Aug. 3, 2012) (Exhibit 15). And an internal Treasury document created during Mr. DeMarco's tenure similarly recognized that "Treasury cannot compel FHFA to act" because it is an "independent agenc[y]." Treasury Department, Housing Finance Reform Questions and Answers, at 4 (Exhibit 16); *see also* Joseph Williams, *Housing head at home with criticism*, POLITICO

[1] Indeed, to the extent the text of the statute suggests any variation between the removal protection afforded to an acting Director and a Director, it would be in the direction of *stronger* protection for the acting Director. That is because the statute says that the acting Director "serve[s] . . . until the return of the Director, or the appointment of a [Senate-confirmed] successor," 12 U.S.C. § 4512(f), without any suggestion that he may be removed by the President.

(Oct. 26, 2011) (Exhibit 17) (reporting that Mr. DeMarco "resisted White House and Treasury Department pressure to step down"). The Administration's legal analysis was correct.

In any case, the series of FHFA actions that ultimately resulted in the nullification of Plaintiffs' economic rights were not undertaken exclusively during Mr. DeMarco's tenure. It was FHFA's transitional Director—James Lockhart—who placed the Companies into conservatorship, FAC ¶ 42, and all of the agency's actions as conservator, including the Net Worth Sweep, are infected by that original action undertaken in violation of the separation of powers. Moreover, FHFA's current Senate-confirmed Director has required the Companies to declare dividends under the Net Worth Sweep, blocked shareholder derivative suits seeking to challenge Mr. DeMarco's actions, and vigorously defended the Net Worth Sweep in every court in which it is challenged. *See* FAC ¶ 70. Thus, whether FHFA was an independent agency during Mr. DeMarco's tenure is ultimately of no moment; the Net Worth Sweep was made possible and has been sustained by FHFA Directors who Defendants do not dispute enjoyed for-cause removal protection.

Moreover, even with respect to actions undertaken by Mr. DeMarco, giving the President the power to remove Mr. DeMarco from his post as acting Director without cause would not have cured the constitutional defect in FHFA's leadership structure. If fired, Mr. DeMarco could have only been replaced by one of the agency's other Deputy Directors—individuals selected by Mr. DeMarco or his Republican-appointed predecessor. *See* 12 U.S.C. § 4512(c)-(f). That prevented the President from using any removal power he had to effect a policy change at the agency, thus unconstitutionally insulating the agency from

Presidential control. *See* FAC ¶ 49; Mike Lillis, *Rep. Frank joins calls for top Fannie, Freddie regulator to be replaced*, THE HILL (Mar. 11, 2012) (Exhibit 18) (recounting statement by Representative Barney Frank that President could not force change in policies at FHFA by firing Mr. DeMarco because FHFA's Deputy Directors "support DeMarco's strategies" and "would likely continue the same" policies).

D. FHFA Cannot Evade the Separation of Powers by Labeling Its Actions as Those of a "Conservator."

Defendants are mistaken when they argue that Plaintiffs' separation of powers challenge to FHFA's independence fails because FHFA is not the government when it acts as "conservator." FHFA Br. 9-10; Treas. Br. 11-13. As an initial matter, Plaintiffs were deprived of their economic rights as a result of a series of actions by FHFA, some of which the agency undertook in its *regulatory* capacity. FHFA acted as regulator when it forced the Companies into conservatorship, and that action undertaken in violation of the separation of powers means that its subsequent decisions as conservator—including the decision to enter into the Net Worth Sweep—are likewise invalid. *See* 12 U.S.C. § 4617(a)(1) (stating that "the Director," i.e., FHFA as regulator, "may appoint the Agency as conservator or receiver for a regulated entity"). During conservatorship, the Companies remain subject to oversight by FHFA as regulator. Indeed, FHFA's own regulations say that during conservatorship the Companies cannot pay dividends except with authorization from "[t]he Director," i.e., FHFA as regulator. 12 C.F.R. § 1237.12(a), (b). FHFA is indisputably subject to the separation of powers when it acts as regulator, and Plaintiffs challenge actions FHFA undertook in that capacity.

Defendants' contention that FHFA did not approve the Net Worth Sweep in a governmental capacity is also directly contrary to the position they successfully urged in the D.C. Circuit in *Perry Capital*. There, FHFA argued that "HERA expressly permits the Conservator to consider its own best interests—including, for example to promote the public interest." Brief of Appellees FHFA at 36, *Perry Capital, LLC v. Mnuchin*, No. 14-5243 (D.C. Cir. Mar. 7, 2016). The D.C. Circuit embraced that understanding of the law when it dismissed APA challenges to the Net Worth Sweep, explaining that FHFA did not violate the statute because "Congress, consistent with its concern to protect the public interest, . . . made a deliberate choice in [HERA] to permit FHFA to act in its own best *governmental* interests, which may include the taxpaying public's interest." *Perry Capital*, 864 F.3d at 608 (emphasis added). Having successfully obtained dismissal of another suit by arguing that FHFA as conservator has "governmental" interests that it lawfully advanced when it entered into the Net Worth Sweep, Defendants should be judicially estopped from arguing the opposite here. *See New Hampshire v. Maine*, 532 U.S. 742, 749 (2001); *Hutterville Hutterian Brethren, Inc. v. Sveen*, 776 F.3d 547, 556-57 (8th Cir. 2015).

In all events, Defendants misstate the law when they argue that a federal conservator is not the government under any circumstances. Whether a federal conservator "should be treated as the United States depends on the context," *Auction Co. of America v. FDIC*, 132 F.3d 746, 748 (D.C. Cir. 1997), and the context here is FHFA's decision to expropriate Plaintiffs' investments for the benefit of the federal government. Confronted with similar allegations that as receiver the FDIC had retained a failed bank's liquidation surplus for itself rather than distributing the surplus to shareholders, the Federal Circuit held that the

FDIC could be sued in its receivership capacity for a Fifth Amendment taking. *Slattery v. United States*, 583 F.3d 800, 826-29 (Fed. Cir. 2009). The Federal Circuit observed that "whether the FDIC as receiver is 'the government' depends on the context of the claim" and allowed the constitutional claim to go forward because the facts before it were "unlike the standard receivership situation in which the receiver is enforcing the rights or defending claims and paying the bills of the seized bank." *Id.* at 827-28. The cases cited by Defendants are not to the contrary, for none of them involved a similar expropriation to benefit the public fisc. *See, e.g.*, *United States v. Beszborn*, 21 F.3d 62, 68 (5th Cir. 1994) (federal receiver's suit for civil penalties did not implicate the Double Jeopardy Clause because the penalties collected would "not go to the United States Treasury" but instead "benefit all stockholders and creditors of the bank"); *Herron v. Fannie Mae*, 861 F.3d 160, 167-69 (D.C. Cir. 2017) (declining to apply First Amendment to routine personnel decision by conservator).

Treasury argues that FHFA's imposition of the Net Worth Sweep is not attributable to the federal government in light of the "historical practice" of appointing private conservators, Treas. Br. 12, but Defendants prevailed in *Perry Capital* on the theory that FHFA's conservatorship powers "bear[ ] no resemblance to the type of conservatorship measures that a private common-law conservator would be able to undertake," *Perry Capital*, 864 F.3d at 613. Indeed, the principal difference between FHFA and a common law conservator identified by the court in *Perry Capital*—that FHFA is entitled to promote the public interest—cuts strongly in favor of the conclusion that FHFA was acting as the government when it approved the Net Worth Sweep. In distinguishing between private and

governmental actors under the Appointments Clause, the Office of Legal Counsel ("OLC") has opined that a governmental actor exercises "power lawfully conferred by the Government to bind third parties, or the Government itself, for the public benefit." Officers of the United States Within the Meaning of the Appointments Clause, 2007 WL 1405459, at *11 (O.L.C. Apr. 16, 2007). A private, common law conservator would not satisfy that definition, but FHFA does.

Other aspects of FHFA's decision to enter into the Net Worth Sweep further reinforce the conclusion that it exercised governmental power when it took this action. The D.C. Circuit ruled that by entering into a contract with Treasury, FHFA suspended the application of provisions of the APA and HERA that would have otherwise restricted Treasury's legal authority to invest in the Companies. *Perry Capital*, 864 F.3d at 615-16. Altering the legal duties of a federal agency is not the act of a private entity. Moreover, the Net Worth Sweep would have been a flagrant violation of the duty of loyalty if it had been signed while the Companies were still under private management. *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993). Thus, when FHFA took this action it did not merely exercise powers it inherited from the Companies' private management—those powers did not include giving all of the Companies' assets and future profits to a related entity.

E. FHFA's Unconstitutional Structure Requires Vacatur of the Net Worth Sweep.

If the Court determines that FHFA is unconstitutionally structured, the appropriate remedy is to strike down the Director's for-cause removal protection and vacate the Net

Worth Sweep so that FHFA may reconsider that decision once it is no longer insulated from presidential oversight.

As the Department of Justice recently acknowledged in other litigation, a "second proceeding [is] necessary" when an agency official is "unconstitutionally insulated from presidential control at the time of the initial proceeding." Brief of the SEC at 37, *Laccetti v. SEC*, No. 16-1368 (D.C. Cir. May 5, 2017). That is because when a government official acts on behalf of an agency that is structured in violation of the separation of powers, the official's action is *ultra vires* and must be vacated. Thus, in *NLRB v. Noel Canning*, 134 S. Ct. 2550 (2014), the Supreme Court affirmed a ruling of the D.C. Circuit that an NLRB decision was "void *ab initio*" because the Board "lacked authority to act" due to a violation of the Recess Appointments Clause, *Noel Canning v. NLRB*, 705 F.3d 490, 493 (D.C. Cir. 2013). Numerous other authorities support the same approach in separation of powers cases. *See, e.g.*, *Nguyen v. United States*, 539 U.S. 69, 83 (2003); *Ryder v. United States*, 515 U.S. 177, 182-83 (1995); *IBS, Inc. v. Copyright Royalty Bd.*, 684 F.3d 1332, 1340-42 (D.C. Cir. 2012); *see also Kuretski v. CIR*, 755 F.3d 929, 938 (D.C. Cir. 2014) (case concerning presidential removal power).

Free Enterprise Fund, 561 U.S. at 509, and *John Doe Co. v. CFPB*, 849 F.3d 1129 (D.C. Cir. 2017), are not to the contrary. The plaintiffs in both cases challenged *ongoing* agency investigations, and vacatur was not needed for the constitutionally restructured agencies to decide whether to continue investigating. *See FEC v. Legi-Tech, Inc.*, 75 F.3d 704, 708-09 (D.C. Cir. 1996) (declining to dismiss civil enforcement action first brought by unconstitutionally composed FEC because enforcement action was later ratified by

constitutionally restructured agency). In " 'reject[ing]' the plaintiff's argument that the removal restrictions rendered 'all power and authority exercised by [the PCAOB] in violation of the Constitution,' " FHFA Br. 8 (quoting *Free Enterprise Fund*, 561 U.S. at 508), the Court was saying that the PCAOB would be allowed to continue to function in the future after being restructured—not that there is no remedy for past agency actions undertaken in violation of the separation of powers.

In any event, Plaintiffs seek not only vacatur of the Net Worth Sweep but also an order declaring that FHFA may no longer operate as an independent agency. FHFA suggests that this latter form of relief would be inappropriate because all of Plaintiffs' injuries "stem from the historical adoption of the Third Amendment," FHFA Br. 9, but that is not correct. As the Companies' conservator, FHFA succeeded to most of Plaintiffs' rights as shareholders, *see* 12 U.S.C. § 4617(b)(2)(A), and the agency's ongoing policy is to exercise those rights to promote the interests of the federal government without regard to what is best for shareholders, *see* C-SPAN, Newsmakers with Mel Watt at minute 9:00-9:27 (May 16, 2014), http://goo.gl/s3XWqi (statement by Director Watt that he does not "lay awake at night worrying about what's fair to the shareholders" but rather focuses on "what is responsible for the taxpayers").

Treasury argues that vacating the Net Worth Sweep while leaving the original PSPAs in place would improperly allow Plaintiffs to "benefit from conservator action they now insist is unlawful." Treas. Br. 13. But Plaintiffs did not benefit from the original PSPAs, which greatly diluted the value of their shares in return for a funding commitment from Treasury that the Companies did not need. *See* FAC ¶¶ 25-26, 34-35. 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 cannot be faulted for focusing their constitutional suit on the actions by FHFA that have been most harmful to them.

II. FHFA Violated the Nondelegation Doctrine When It Imposed the Net Worth Sweep.

To the extent that the Court agrees with Defendants that FHFA "step[ped] into the shoes" of the Companies and acted as a private entity when it imposed the Net Worth Sweep, FHFA Br. 10, that will only establish a different constitutional basis for vacating the Net Worth Sweep. As FHFA concedes, "[u]nder the private nondelegation doctrine, Congress generally cannot delegate sovereign legislative or executive power to a private entity." *Id.* at 23 (citing *Pittston Co. v. United States*, 368 F.3d 385, 394-95 (4th Cir. 2004)); *see Department of Transp. v. Association of American R.R.*, 135 S. Ct. 1225, 1252-53 (2015) (Thomas, J., concurring).

Despite FHFA's arguments to the contrary, several aspects of its decision to impose the Net Worth Sweep show that this was an exercise of governmental powers. First, in imposing the Net Worth Sweep, FHFA exercised authority under a federal statute to alter the legal rights and obligations of third parties—the Companies and their shareholders—and promote what it deemed to be in the public interest. Such actions are by definition an exercise of "a portion of the sovereign powers of the federal Government." Officers of the United States Within the Meaning of the Appointments Clause, 2007 WL 1405459, at *4. Second, the D.C. Circuit ruled that by entering into a contract with Treasury, FHFA had

the power under 12 U.S.C. § 4617(f) to suspend the application of provisions of the APA and HERA that would have otherwise restricted Treasury's legal authority to invest in the Companies. *Perry Capital*, 864 F.3d at 615-16. Whether denominated as legislative or executive, the power to alter the legal responsibilities of a federal agency is essentially governmental. Third, the most basic principles of corporation law did not give the Companies' private management the power to enter into a contract like the Net Worth Sweep, *see Cede & Co.*, 634 A.2d at 361, so FHFA's actions cannot be treated as an exercise of powers it merely inherited from the Companies.

Furthermore, to the extent FHFA acted as the government when it imposed the Net Worth Sweep, FHFA is wrong when it argues that Congress gave it an intelligible principle to guide its exercise of discretion. In *Perry Capital*, the D.C. Circuit said that as conservator FHFA has "permissive, discretionary authority." *Perry Capital*, 864 F.3d at 607. Under this interpretation, neither FHFA's power to "carry on the business of the [Companies]" pursuant to their charters nor its power to pursue the Companies' "best interests" provides the necessary intelligible principle because these are powers that FHFA "may" but is not required to exercise. *See* 12 U.S.C. § 4617(b)(2)(D), (b)(2)(J). The D.C. Circuit thus "eras[ed] any outer limit to FHFA's statutory powers." *Perry Capital*, 864 F.3d at 642 (Brown, J., dissenting). The nondelegation doctrine requires more, especially when an agency's exercise of discretion is largely immunized from judicial review. *See Whitman v. American Trucking Ass'n*, 531 U.S. 457, 472 (2001); *United States v. Garfinkel*, 29 F.3d 451, 459 (8th Cir. 1994).

III. FHFA Was Constituted in Violation of the Appointments Clause When It Approved the Net Worth Sweep.

A. Mr. DeMarco's Tenure as Acting Director Violated the Appointments Clause.

1. The Appointments Clause provides an independent reason for vacating the Net Worth Sweep. It provides that the President "shall nominate, and by and with the Advice and Consent of the Senate, shall appoint" all officers of the United States. U.S. CONST. art. II, § 2, cl. 2. The Constitution permits only two exceptions to this rule: First, Congress may "vest the Appointment of such *inferior* Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments." *Id.* (emphasis added). Second, the President "shall have Power to fill up all vacancies that may happen during the recess of the Senate, by granting commissions which shall expire at the end of their next session." U.S. CONST. art. II, § 2, cl. 3.

FHFA does not dispute that its Director is a *principal* officer of the United States, who must therefore either be nominated by the President and confirmed by the Senate or receive a temporary presidential commission during the recess of the Senate. Neither does it dispute that Mr. DeMarco had not been confirmed by the Senate, nor received a temporary commission during the recess of the Senate, at the time he approved the Net Worth Sweep.

FHFA nevertheless contends that Mr. DeMarco had authority to exercise powers ordinarily reserved to principal officers by virtue of 12 U.S.C. § 4512(f), which empowers the President, upon the resignation of the Director of FHFA, to designate one of three Deputy Directors to serve as "acting Director until . . . the appointment of a successor."

President Obama exercised his statutory power to designate then-Deputy Director DeMarco as acting Director after Mr. Lockhart resigned from his transitional post in August 2009. Given the absence of an "acting director" exception to the Appointments Clause in the Constitution, the question arises how Mr. DeMarco could constitutionally exercise the powers of the Director.

The United States Supreme Court has provided some guidance on that question in the context of another group of officers that require Senate confirmation: consuls. In *United States v. Eaton*, 169 U.S. 331 (1898), the Court held that a "vice consul" could "be charged with the duty of temporarily performing the functions of the consular office" for ten months. *Id.* at 343. Allowing that Article II requires consuls to be nominated by the President and confirmed by the Senate, the Court concluded that "the word 'consul' therein does not embrace a subordinate and temporary officer like that of vice consul." *Id.* "Because the subordinate officer is charged with the performance of the duty of the superior *for a limited time*, and under special *and temporary conditions*," he remained an "inferior Officer." *Id.* (emphases added).[2]

The Supreme Court reaffirmed this temporal dimension to the Appointments Clause in *Morrison v. Olson*, 487 U.S. 654 (1988), in which it identified several factors that distinguish inferior from principal officers. *Id.* at 671-72. They were: the degree to which

[2] Furthermore, the Constitution does not permit the President to *appoint* an acting principal officer. *See NLRB v. SW Gen., Inc.*, 137 S. Ct. 929, 945-49 (2017) (Thomas, J. concurring). FHFA dismisses this argument because it is inconsistent with longstanding practice, FHFA Br. 22, but the Constitution's text is clear: except during a recess of the Senate, the President may not appoint principal officers without the advice and consent of the Senate.

the officer is subject to supervision by another officer; the scope and nature of the duties assigned to the officer; the scope and nature of the officer's jurisdiction; and the limitations on the officer's tenure. *Id*.

Under *Morrison*, an acting Director can claim classification as an "inferior" officer, if at all, under only one circumstance: if he serves "for a limited time" and under "temporary conditions." *Eaton*, 169 U.S. at 343. As with many "acting" positions, including the position of vice consul in *Eaton*, the degree of supervision and the scope and nature of the officer's duties and jurisdiction do not distinguish the position of the acting Director from that of the principal officer whose shoes the acting Director fills. It follows *a fortiori* that an "acting" position may not be occupied *indefinitely* by a person who has not been appointed to that office "by and with the Advice and Consent of the Senate;" instead, his or her tenure must be "temporary" and "limited." *Id.*

The structure of the Constitution reinforces this conclusion. Article II provides a reticulated scheme for selecting officers of the United States: one that balances pragmatic considerations like exigency and efficiency with institutional ones like accountability and deliberation. *See Noel Canning*, 134 S. Ct. at 2558-59; *see also Edmond v. United States*, 520 U.S. 651, 663 (1997). It requires the President to solicit and receive the Senate's approval for the most important appointments, but permits Congress to authorize unilateral action in the selection of officers who exercise less power by virtue of the subordinate, limited, or temporary nature of their responsibilities. *See Edmond*, 520 U.S. at 660. It also permits the President to meet public need by filling vacancies while the Senate is in recess,

but it once again reinforces the importance of Senate input by placing strict time limits on these "recess appointments."

It would be strange for this densely woven fabric to include a loophole through which the President might introduce permanent, unilateral appointments to the most powerful offices in the Executive Branch. Yet that is precisely what FHFA suggests: that the President may designate acting principal officers to serve indefinitely, thereby frustrating the Senate's constitutional role. Indeed, FHFA's interpretation would permit the President as well as the Senate to be cut out of the appointments process for certain independent agencies, by permitting the independent head of a federal agency to select his own acting successor to serve indefinitely, so long as the Senate refused to confirm any presidential nominee. *See* 12 U.S.C. § 4512(c)-(e) (authorizing the Director of FHFA to choose the three deputy directors from which the President selects the Director's successor). Merely labeling an officer as an "acting officer," while permitting him to serve indefinitely, does not render him "inferior." "[T]he structural protections of the Appointments Clause can[not] be avoided based on such trivial distinctions." *SW General*, 137 S. Ct. at 946 n.1 (Thomas, J., concurring).

2. Having established that acting appointments must be temporary, the question remains: how long is too long? The answer is that in all circumstances an acting principal's tenure must be less than two years. This constitutional ceiling derives from the Recess Appointments Clause, which provides that even when necessitated by the most exigent of circumstances—a recess of the Senate that necessarily prevents appointment "by and with the Advice and Consent of the Senate"—a unilateral appointment by the President may not

exceed the length of the period from the start of the recess until the end of the Senate's next session. U.S. CONST. art. II, § 2.[3] During the first nearly 150 years of this Republic, the maximum period for which someone could hold a recess appointment was usually shorter than one year. *Noel Canning*, 134 S. Ct. at 2579-83 (app'x A). Today, by virtue of the Twentieth Amendment, that period must be less than two years. U.S. CONST. amend. XX, § 2. Because Mr. DeMarco had served for more than two years at the time FHFA approved the Net Worth Sweep, he held his office in violation of the Appointments Clause, and the Net Worth Sweep is therefore void.

Even in the absence of a fixed constitutional ceiling, however, Mr. DeMarco's tenure would violate the Appointments Clause. OLC has opined that someone may serve as an acting principal officer without Senate confirmation only for "as long as is reasonable under the circumstances." Designation of Acting Director of OMB, 2003 WL 24151770, at *1 n.2 (June 12, 2003). *See also Status of the Acting Director, Office of Management and Budget*, 1 Op. O.L.C. 287, 287 (1977). In determining how long a tenure is "reasonable under the circumstances," OLC identified the following considerations as "pertinent": "the specific functions being performed by the [acting officer]; the manner in which the vacancy

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[3] FHFA dismisses the Recess Appointments Clause as irrelevant because Mr. DeMarco was not serving as a recess appointee. FHFA Br. 21. But the Recess Appointments Clause reflects a constitutional judgment that, even under circumstances that make unilateral action by the President *most reasonable*—that is, when a vacancy for a critical office arises during a recess of the Senate—officers commissioned without Senate confirmation ought to serve just long enough to give the President a full session of the Senate in which to attempt to secure confirmation for a regular appointment. *See Noel Canning*, 134 S. Ct. at 2565. It follows that a *longer* tenure would be unreasonable under any circumstances.

was created (death, long-planned resignation, etc.); the time when the vacancy was created (*e.g.*, whether near the beginning or the end of a session of the Senate); whether the President has sent a nomination to the Senate; and particular factors affecting the President's choice (*e.g.*, a desire to appraise the work of an Acting Director) or the President's ability to devote attention to the matter." *Id.* at 290. It is also relevant whether there is a statutory time limit on the tenure of the principal officer whose position is being filled on a temporary basis. *SW General*, 137 S. Ct. at 946 n.1 (Thomas, J.).

Every single "pertinent consideration" militates in favor of the conclusion that Mr. DeMarco's tenure was, by the fall of 2012, unreasonable under the circumstances: *First*, Mr. DeMarco exercised the full powers of the Director of FHFA, 12 U.S.C. § 4512(f), the head of an independent federal agency, without *anyone's* supervision—even the President's—from August 2009 until January 2014.

Second, the vacancy Mr. DeMarco filled was created by Mr. Lockhart's voluntary resignation after holding the post for thirteen months under a transitional provision of HERA that made the outgoing Director of OFHEO the head of the agency until a permanent Director could be nominated and confirmed. 12 U.S.C. § 4512(b)(5).

Third, President Obama did not send a nomination for Director of FHFA to the Senate until November 2010, and when he did, the Senate refused to act on it. By the time the Net Worth Sweep was approved, that nomination had been withdrawn and shelved for nearly two years.

Fourth, whatever factors might have influenced President Obama's choice when he appointed Mr. DeMarco—such as the need for quick action in response to an ongoing

crisis—those factors no longer held by the time Mr. DeMarco approved the Net Worth Sweep three years later. The crisis had passed and Fannie's and Freddie's performance was improving.

Fifth, there appears to be no claim that, in the three years between Mr. DeMarco's appointment and the approval of the Net Worth Sweep, President Obama did not have the time or attention to devote to the question who should serve as Director of one of the most powerful (and independent) agencies in the country.

Sixth, Mr. DeMarco served four years and four months in an office limited by statute to a 5-year term. "There was thus nothing 'special and temporary' about [his] appointment." *SW General*, 137 S. Ct. at 946 n.1 (Thomas, J.) (quoting *Eaton*, 169 U.S. at 343).

FHFA does not analyze these considerations individually. Instead, it points out that during Mr. DeMarco's tenure, the country was "reeling from recession" and "FHFA's future role w[as] uncertain." FHFA Br. 20 (speculation unsupported by the Complaint). But a recession and uncertainty do not suspend the Constitution. And leaving aside that these factors would seem to militate in favor of putting a Senate-confirmed Director at the helm, it was simply not the case that the crisis continued four years after HERA was enacted. To the contrary, both the housing market and Fannie and Freddie had recovered prior to the approval of the Net Worth Sweep. FAC ¶¶ 52-54.

In addition, FHFA cites President Obama's own opposition to Mr. DeMarco as evidence that keeping him in office was reasonable under the circumstances. FHFA Br. 20. But the "reasonable under the circumstances" inquiry is not about assigning blame:

whether it is the President's or the Senate's fault that Mr. DeMarco's successor was such a long time coming, the fact is that the duration of Mr. DeMarco's tenure rendered him a principal officer who could not act unless nominated by the President *and* confirmed by the Senate. Indeed, given that the appointment power is vested jointly in the President and the Senate, the fact that Mr. DeMarco enjoyed the support of *neither* the President *nor* the Senate reinforces rather than undermines the conclusion that his protracted tenure violated the Appointments Clause.

FHFA finally seeks to take refuge in modern practice. FHFA Br. 21 n.5. The handful of very recent examples—all of the tenures FHFA identifies lasting longer than one year date to 1990 or later—should be given little to no weight in the face of the textual, structural, and longstanding doctrinal support for the proposition that acting principal officers may serve only for a limited time. *See INS v. Chadha*, 462 U.S. 919, 944 (1983) ("[O]ur inquiry is sharpened rather than blunted by the fact that [the challenged practice was] appearing with increasing frequency . . . ."); *see, e.g.*, *Noel Canning*, 134 S. Ct. at 2567 (considering and rejecting anomalous historical examples of recess appointments made during recesses of fewer than ten days).

3. While Mr. DeMarco's appointment was constitutionally invalid for the reasons just discussed, the Court can avoid this issue and still rule for Plaintiffs. *See Ashwander v. TVA*, 297 U.S. 288, 347 (1936) (Brandeis, J., concurring); *National Advert. Co. v. City of Rolling Meadows*, 789 F.2d 571, 574 (7th Cir. 1986). That is because Mr. DeMarco's purported appointment as an "inferior officer" did not even comply with 12 U.S.C. § 4512(f). Congress has authorized the President to designate an acting Director "[i]n the

event of the death, resignation, sickness, or absence of *the Director*." 12 U.S.C. § 4512(f) (emphasis added). But none of these events preceded Mr. DeMarco's designation as acting Director. Instead, President Obama designated him upon the resignation of former OFHEO Director Lockhart, who was merely authorized to "act" as FHFA Director until one was appointed. 12 U.S.C. § 4512(b)(5). No "Director" whose departure from office could trigger the President's powers under Section 4512(f) had yet even been appointed by the President pursuant to Section 4512(b)(1), much less left office. *Cf. Doolin Sec. Sav. Bank, FSB v. OTS*, 139 F.3d 203, 207-08 (D.C. Cir. 1998) (holding that the President's powers under the Vacancies Act cannot be triggered by the resignation of a mere acting official), *superseded by statute*, Federal Vacancies Reform Act of 1998, Pub. L. No. 105-277, 112 Stat. 2681 (1998). Because no "Director" resigned, the President was not vested with the power to appoint an acting Director, and Mr. DeMarco's appointment violated 12 U.S.C. § 4512.

B. The Constitutionality of Mr. DeMarco's Tenure Is Justiciable.

FHFA further argues that the question whether an acting officer's tenure is "reasonable under the circumstances" is a non-justiciable political question. FHFA Br. 19-20. The Court need not reach that question in this case because Mr. DeMarco's tenure had exceeded the two-year ceiling set by the Recess Appointments Clause when he approved the Net Worth Sweep.

In any event, courts are fully capable of deciding whether the length of an acting principal officer's tenure violates the Appointment Clause. Courts have long adjudicated similar challenges under the Appointments Clause. Indeed, FHFA's own defense of Mr.

DeMarco's exercise of the Director's powers—that he acted as an inferior officer, FHFA Br. 17—invokes a constitutional line that is "far from clear." *Morrison*, 487 U.S. at 671. Yet courts have repeatedly decided whether an officer is inferior, including by taking into account the duration of the officer's tenure. *See, e.g.*, *id.*; *Edmond*, 520 U.S. at 666; *Eaton*, 169 U.S. at 343. FHFA offers no compelling reason why the temporal factor for determining an officer's constitutional status defies adjudication here.

Indeed, the Supreme Court recently rejected an argument that is materially indistinguishable from FHFA's: that courts are incapable of determining how short a "recess" is too short to permit a recess appointment. In *NLRB v. Noel Canning*, the Court held that a recess of "less than 10 days is presumptively too short to fall within the Clause." 134 S. Ct. at 2567. Not only was the Court willing to draw a line in the absence of an express numerical threshold in the Constitution, but it also allowed that courts might have to adjudicate whether "unusual circumstance[s]," including "a national catastrophe . . . that renders the Senate unavailable but calls for an urgent response," would permit an exception to this presumptive rule. *Id.* And as though speaking directly to FHFA's justification for Mr. DeMarco's all-but-unprecedented tenure as an acting officer, the Court observed that "[i]t should go without saying . . . that political opposition in the Senate would not qualify as an unusual circumstance." *Id.* The types of judgments this precedent makes or invites courts to make are indistinguishable from the judgment whether an acting principal officer's appointment is "reasonable under the circumstances."

To be clear: that is the *only* judgment this Court must make here. The Court need not decide whether the President waited too long to nominate a successor or whether the

Senate was unreasonable in rejecting his first nomination. FHFA's argument to the contrary begins with the flawed premise that "an acting official is needed for however long a vacancy persists." FHFA Br. 19. FHFA cites no authority for that proposition, nor could it, for the simple reason that a vacancy may remain vacant. A practical consequence of Article II is that certain offices may remain vacant or inoperative when the constitutional requirements for an appointment cannot be satisfied. A desire to avoid those consequences cannot relieve a court of its responsibility to give effect to those constitutional requirements when the case before it requires it to do so. *See Olympic Fed. Sav. and Loan Ass'n v. Director, OTS*, 732 F. Supp. 1183, 1196 (D.D.C. 1990). The political question doctrine does not permit courts to "avoid their responsibility merely because the issues have political implications." *Zivotofsky ex rel. Zivotofsky v. Clinton*, 566 U.S. 189, 196 (2012) (quotation marks omitted).

C. The De Facto Office Doctrine Cannot Salvage the Net Worth Sweep.

Finally, FHFA argues that Plaintiffs' challenge to the Net Worth Sweep based on Mr. DeMarco's tenure is precluded by the disfavored de facto officer doctrine. *See United States v. Gantt*, 194 F.3d 987, 998 (9th Cir. 1999), *overruled on other grounds*, *United States v. Grace*, 526 F.3d 499, 506 (9th Cir. 2008) (en banc); *see* FHFA Br. 23-25. Because Plaintiffs challenge Mr. DeMarco's *constitutional* authority to impose the Net Worth Sweep, the de facto officer doctrine has no application here.

The de facto officer doctrine operates only where the challenge is based on a "merely technical" defect in the incumbent's title to the office. *Nguyen v. United States*, 539 US. 69,77. (2003). In *Glidden Co. v. Zdanok*, 370 U.S. 530 (1962), for example, the

Court rejected the argument that a party could not raise an Article III challenge to the judge who decided its case for the first time on appeal. Writing for a plurality, Justice Harlan noted first that the de facto officer doctrine did not apply "when the statute claimed to restrict authority is not merely technical but embodies a strong policy concerning the proper administration of judicial business," *id.* at 535-36, and held that "[a] fortiori is this so when the challenge is based upon nonfrivolous constitutional grounds." *Id.* at 536.

Contrary to FHFA's argument based on non-binding D.C. Circuit decisions, the rule enunciated in *Glidden* and *Nguyen* is not limited to timely challenges. To the contrary, non-technical, and especially constitutional, violations are not protected by the de facto officer doctrine "even though the defect was not raised in a timely manner." *Nguyen*, 539 U.S. at 78; *accord Wrenn v. District of Columbia*, 808 F.3d 81, 84 (D.C. Cir. 2015) (refusing to apply the de facto officer doctrine where district judge sitting by designation exceeded his authority to hear specific cases even though "no party challenged the judge's authority until after the decision issued"); *see United States v. Wrigley*, 520 F.2d 362, 366 n.8 (8th Cir. 1975). Regardless, Plaintiffs filed suit within the six-year statute of limitations, *see* 28 U.S.C. § 2401, and no more should be required for Plaintiffs' nonfrivolous constitutional claim to be deemed "timely."[4]

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[4] Although the constitutional nature of Plaintiffs' challenge makes it unnecessary for them to satisfy *either* prong of the D.C. Circuit's exception to the de facto officer doctrine, it is also the case that FHFA "had reasonable notice under all circumstances of the claimed defect in the official's title to office." *See* Complaint ¶¶ 46-52, *Ohio Pub. Emps. Retirement Sys. v. FHFA*, No. 11-1543 (D.D.C. Aug. 26, 2011) (complaint filed full year before Net Worth Sweep alleging that Mr. DeMarco's lengthy tenure violated the Appointments Clause).

IV. 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). 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* Treas. Br. 17-20, 23-24. 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 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 law.

Even if FHFA agreed 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—a troubling result given that "[t]he structural principles secured by the separation of powers protect the individual." *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 support in the Supreme Court's relaxation of prudential third-party standing rules in cases in which there is a "close relationship" between the plaintiff and a third party facing "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' status as shareholders gives them a close relationship with the Companies that makes them the appropriate parties to assert the claims at issue here.

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." *Deephaven Risk Arb Trading Ltd. v. UnitedGlobalCom, Inc.*, 2005 WL 1713067, at *8 n.41 (Del. Ch. July 13, 2005); *cf. 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. 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 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, Treas. Br. 19, 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). 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 Woody v. United States Bureau of Prisons*, 2016 WL 7757523, at *3 (D. Minn. Nov. 22, 2016) (plaintiff could press constitutional claim because statute did not "explicitly remove constitutional claims from the ambit of judicial review"). 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), 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). 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.

Even apart from the constitutional concerns that make this case different from *Perry Capital*, the D.C. Circuit in that case erred in declining to follow the 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 the

Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("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. 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.

V. Claim Preclusion Does Not Bar Plaintiffs' Suit.

As Treasury acknowledges, 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. United States Dep't of Health & Human Servs.*, 533 F.3d 634, 639 (8th Cir. 2008). Neither of the prior suits Treasury identifies as providing a basis for claim preclusion were decided on the merits, Plaintiffs were not parties or in privity with parties in those cases, and this case is based on a distinct cause of action. Accordingly, this suit cannot be dismissed on claim preclusion grounds.

A. Dismissals of Claims Under HERA's Succession Clause Are Not Judgments "On the Merits."

Without reaching the substance of the claims that were before them, the *Perry Capital* and *Saxton* courts dismissed claims they deemed to be derivative on the ground that only FHFA may assert derivative claims during conservatorship. *Perry Capital*, 864 F.3d at 625-26; *Saxton v. FHFA*, 245 F. Supp. 3d 1063, 1078-79 (N.D. Iowa 2017). 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); *see Kulinski v. Medtronic Bio-Medicus, Inc.*, 112 F.3d 368, 373 (8th Cir. 1997). As explained above,

even if the *Perry Capital* and *Saxton* courts were correct to dismiss common law and statutory derivative claims 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 suits, 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.[5]

B. Plaintiffs Are Not in Privity with the Plaintiffs from *Perry Capital* and *Saxton*.

Plaintiffs were not parties in *Perry Capital* or *Saxton*. Treasury's contention that there is nevertheless privity depends entirely on its argument that Plaintiffs' claims are derivative and thus subject to the general rule that in derivative cases parties and their privies include the corporation and nonparty shareholders. Treas. Br. 15-16. 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*

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[5] The dismissal in *Saxton* was not "on the merits" for an additional reason: the court in that case held in the alternative that "each of [the plaintiffs'] claims [is] jurisdictionally barred by HERA's anti-injunction provision." 245 F. Supp. 3d at 1078. A dismissal for lack of subject matter jurisdiction does not preclude a second suit on the same claim. *Kulinski*, 112 F.3d at 373; *see Pizlo v. Bethlehem Steel Corp.*, 884 F.2d 116, 119 (4th Cir. 1989) ("When a dismissal is based on two determinations, one of which would not render the judgment a bar to another action on the same claim, the dismissal should not operate as a bar.").

to sue on behalf of the Companies due to HERA's Succession Clause. The rationale for finding privity between shareholder derivative plaintiffs in separate suits is that the corporation is "the true plaintiff in interest" in all such suits. *See Cottrell v. Duke*, 737 F.3d 1238, 1242 (8th Cir. 2013). 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, FEDERAL PRACTICE & PROCEDURE § 1840. To be sure, the First Circuit has taken a different view with respect to issue preclusion in the demand futility context. *Sonus*, 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 before 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 that implicate similar due process concerns. *See Wal-Mart Stores*, 2017 WL 3138201, at *10-*14. 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.

C. This Suit Is Not Based on the Same Cause of Action Asserted in *Perry Capital* and *Saxton*.

To determine whether two suits are based on the same cause of action the Court must look to "whether or not proof of the same facts will support both actions, or to whether the wrong for which redress is sought is the same in both actions." *Dixon v. Deutsche Bank Nat'l Trust Co.*, 2008 WL 4151835, at *8 (D. Minn. Sept. 3, 2008) (quoting *Poe v. John Deere Co.*, 695 F.2d 1103, 1106 (8th Cir. 1982)). 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* Fannie D.D.C. Derivative Compl. ¶¶ 110-16 (Dec. 3, 2013) (Exhibit 19); Freddie D.D.C. Derivative Compl. ¶¶ 53-64 (July 30, 2014) (Exhibit

20). The plaintiffs in *Saxton* pressed APA claims that were similarly premised on allegations that FHFA had failed to preserve and conserve the Companies' assets and that Treasury had exceeded its statutory authority to purchase the Companies' securities and acted arbitrarily and capriciously. *See* Plaintiffs' Amended Complaint ¶¶ 135-62, *Saxton v. FHFA*, No. 15-47 (N.D. Iowa Feb. 9, 2016), ECF No. 61 (Exhibit 21). 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* and *Saxton* plaintiffs' 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 claims in *Perry Capital* and *Saxton*: 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. There is at most only modest overlap between the key facts in this case and those relevant to the claims in *Perry Capital* and *Saxton*. *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.") (citing 46 Am. Jur. 2d Judgments § 569 (1994)).

Treasury emphasizes that Plaintiffs ask the Court to vacate the Net Worth Sweep—a contract amendment that the *Perry Capital* and *Saxton* plaintiffs asked the courts in those cases 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. 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.[6]

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. It is well settled that claim preclusion cannot bar claims based on events arising after the first suit was filed. *Lundquist v. Rice Mem'l Hosp.*, 238 F.3d 975, 977 (8th Cir. 2001); *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 complaints in *Perry Capital* and *Saxton*—including continuing payments of "dividends" to Treasury and FHFA's policy of exercising shareholder rights to benefit the federal government.

CONCLUSION

For the foregoing reasons, the Court should deny Defendants' motions to dismiss and grant Plaintiffs' cross-motion for summary judgment.

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[6] 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. Treas. Br. 7-11. But Treasury cites no authority for the proposition that FHFA can immunize itself from otherwise applicable constitutional requirements by contracting with another federal agency. Nor does Treasury argue that it was improperly joined as a defendant.

Respectfully submitted,

Dated: October 16, 2017

BRIGGS AND MORGAN, P.A.

By *s/Scott G. Knudson*
Scott G. Knudson(#141987)
Michael M. Sawers(#0392437)
2200 IDS Center
80 South Eighth Street
Minneapolis, Minnesota 55402
(612) 977-8400

ATTORNEYS FOR PLAINTIFFS ATIF F. BHATTI, TYLER D. WHITNEY, AND MICHAEL F. CARMODY

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

Case No. 17-cv-02185 (PJS/HB)

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

Plaintiffs,

-vs-

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.

WORD COUNT COMPLIANCE CERTIFICATE

I, Scott G. Knudson, certify that Plaintiff's Memorandum in Support of its Motion for Summary Judgment and in Opposition to Defendants' Motions to Dismiss consists of 14,446 words total.

Plaintiffs' Memorandum has been prepared in size 13 font using Microsoft Word 2010.

I relied on the word count tool in Microsoft Word 2010, applied specifically to include all text, including headings, footnotes and quotations, to determine the number of words contained in Plaintiffs' Memorandum.

Dated: October 16, 2017.

BRIGGS AND MORGAN, P.A.

By *s/Scott G. Knudson*
Scott G. Knudson (#0141987)
Michael M. Sawers (#0392437)
2200 IDS Center
80 South Eighth Street
Minneapolis, Minnesota 55402
(612) 977-8400

ATTORNEYS FOR PLAINTIFFS