IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

MICHAEL ROP, STEWART KNOEPP, and ALVIN WILSON, Plaintiffs, v. THE FEDERAL HOUSING FINANCE AGENCY, MELVIN L. WATT, in his official capacity as Director of the Federal Housing Finance Agency, and THE DEPARTMENT OF THE TREASURY, Defendants.	Civil Action No. 1:17-cv-00497 Hon. Paul L. Maloney

THE DEPARTMENT OF THE TREASURY'S REPLY BRIEF IN SUPPORT OF ITS MOTION TO DISMISS

INTRODUCTION

In order to maintain a legal action against a defendant, a plaintiff must allege that the defendant engaged in conduct made actionable under the legal theory that the plaintiff pursues. Absent allegations plausibly suggesting that the defendant's conduct satisfies the elements of a viable legal claim, a plaintiff cannot maintain an action against that defendant. Based on these bedrock principles of federal litigation, Treasury moved to dismiss plaintiffs' claims against it because the Amended Complaint does not contain a single factual allegation suggesting that Treasury is liable under any of plaintiffs' asserted legal theories. Plaintiffs' opposition to that motion, like their Amended Complaint, does not argue that Treasury itself violated the separation of powers, the Appointments Clause, or any nondelegation doctrine, or that Treasury in any respect facilitated FHFA's alleged violations. Plaintiffs identify no basis for any legal claim against Treasury, and their opposition brief does not even attempt to argue otherwise. For that reason alone, their claims against Treasury should be dismissed. In any event, plaintiffs' claims challenging the Third Amendment are precluded by prior shareholder suits attacking the same transaction, and barred by HERA's transfer of shareholder rights provision. As such, the Court should dismiss the Amended Complaint.

I. PLAINTIFFS HAVE CONCEDED THAT THEY HAVE NO CLAIM AGAINST TREASURY

The heart of Treasury's motion to dismiss is that plaintiffs' Amended Complaint does not implicate Treasury or allege that it is liable for any of the five asserted counts. Plaintiffs apparently do not see this fundamental failure as an impediment to their suit against Treasury, devoting only two sentences of their opposition brief to this argument: "But Treasury nowhere suggests that FHFA can immunize itself from otherwise applicable constitutional requirements by contracting with Treasury. Nor does Treasury argue that it was improperly joined as a defendant." Pls.' Br.

in Opp'n to Treasury's Mot. to Dismiss at 24-25, ECF No. 31 ("Pls.' Opp'n"). Neither argument has any bearing on whether plaintiffs have stated a claim against Treasury. That determination is based on an assessment of the Amended Complaint, and whether it alleges that Treasury's conduct violated any legal prohibition and caused concrete legal harm to the plaintiffs. Treasury need not show that FHFA can "immunize itself" from applicable constitutional requirements by contracting with Treasury. It is plaintiffs' pleading burden to allege plausibly that *Treasury's* actions violated those constitutional requirements, and without such allegations plaintiffs cannot state a claim against Treasury (whether or not they would be able to state a claim against FHFA). *See Bishop v. Lucent Techs., Inc.*, 520 F.3d 516, 519 (6th Cir. 2008) (in order to survive a motion to dismiss, a complaint must "contain either direct or inferential allegations respecting all material elements to sustain a recovery under some viable legal theory" (citation omitted)). Moreover, Treasury argued (and continues to argue) that it must be dismissed because plaintiffs have failed to state a claim against it. This argument makes clear that Treasury is not a proper party to the claims asserted in this action and was improperly joined.[1]

In raising only these legally irrelevant arguments, plaintiffs' opposition does not respond to Treasury's argument in favor of dismissal and thus concedes that dismissal is appropriate because the Amended Complaint does not allege any legal claim against Treasury. *See Notredan, LLC v. Old Republic Exch. Facilitator Co.*, 531 F. App'x 567, 569 (6th Cir. 2013) (holding that a plaintiff's failure to respond to an argument in a motion to dismiss amounted to a "forfeiture" of the claim to which that argument was directed).[2]

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[1] In any case, plaintiffs named Treasury as a defendant and alleged, in each count of the Amended Complaint, that Treasury was liable for a violation of the Constitution to the same extent as FHFA. Irrespective of whether Treasury was properly joined, plaintiffs, having attempted to state claims for relief against Treasury, must allege how Treasury is liable or have these claims dismissed.

[2] As addressed more fully in Treasury's motion to dismiss and opposition to plaintiffs' summary judgment motion, plaintiffs' claims should also be dismissed because they challenge actions taken by FHFA as

II. PLAINTIFFS' CLAIMS ARE DERIVATIVE AND BARRED BY HERA'S TRANSFER OF SHAREHOLDER RIGHTS PROVISION

Plaintiffs argue, without further explanation, that their claims are direct as a matter of federal common law because treating them otherwise would "undermine th[e] important federal constitutional policy" underlying plaintiffs' claims. Pls.' Opp'n at 11. But, in the context of shareholder actions, both federal law and applicable Delaware state law have long "distinguish[ed] between derivative and direct actions." *Starr Int'l Co. v. United States*, 856 F.3d 953, 966 (Fed. Cir. 2017). Federal common law – which presumptively incorporates state law on issues, like this one, that "affect[] the allocation of governing power within the corporation," *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 100 (1991) – recognizes that whether a plaintiff's federal claim is direct or derivative turns on the nature of the plaintiff's harm and the relief sought. Thus, if plaintiffs allege that they are only indirectly affected, as a result of harm to the GSEs, by the constitutional violations they complain of, and seek relief that accrues to the GSEs, their claims are derivative. *See Starr Int'l Co.*, 856 F.3d at 966 ("[o]nly 'shareholder[s] with a direct, personal interest in a cause of action,' rather than 'injuries [that] are entirely derivative of their ownership interests' in a corporation, can bring actions directly." (citation omitted)); *Gaff v. FDIC*, 814 F.2d 311, 317 (6th Cir. 1987) (stating the "general rule" that "a shareholder does not have standing to bring a direct cause of action under federal law when the only damage alleged is the diminution in the value of corporate shares"). Plaintiffs' opposition provides no support for setting aside these well-established principles for distinguishing between direct and derivative claims in this case.

Under those principles, as demonstrated in Treasury's motion to dismiss, plaintiffs' claims are derivative because, in attacking the Third Amendment on the basis that it has decreased the

conservator, which involve no exercise of executive power and provide no basis to set aside the Third Amendment on the constitutional grounds plaintiffs allege.

value of their shares, they assert no injury and claim no entitlement to relief that would not accrue to the GSEs in the first instance.[3] In their opposition, plaintiffs try to characterize their claims as direct because the Third Amendment allegedly altered the value of their shares in the GSEs in relation to the value of Treasury's shares. But such claims for equity dilution are generally treated as derivative, *see, e.g.*, *Feldman v. Cutaia*, 956 A.2d 644, 655 (Del. Ch. 2007), and Delaware law only allows a shareholder to bring a direct claim based on the diversion of shareholder value from one shareholder to another in narrowly limited circumstances. That exception exists where: "(1) a stockholder having majority or effective control causes the corporation to issue 'excessive' shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling shareholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders." *El Paso Pipeline GP Co. v. Brinckerhoff*, 152 A.3d 1248, 1263 (Del. 2016) (quoting *Gentile v. Rossette*, 906 A.2d 91, 100 (Del. 2006)). Absent an allegation that a controlling shareholder extracted voting power from minority shareholders, and received an "exclusive benefit of increased equity ownership and voting power," *Feldman*, 956 A.2d at 657, allegations regarding the "expropriation" of "solely economic value" do not constitute direct injury. *El Paso Pipeline*, 152 A.3d at 1264. None of these circumstances are present in this case. Treasury is not a controlling shareholder, the Third Amendment did not involve the issuance of any new shares (much less "excessive" shares), and plaintiffs allege no injury to their voting power. As plaintiffs claim no injury other than dilution of the economic value of their shares, their

[3] Plaintiffs' argument that courts have been more receptive to characterizing claims as direct when they seek "only injunctive or prospective relief" is undermined by their recognition, in the preceding sentence, that "the only way to determine to whom the relief flows is to consider whose injury it remedies," Pls.' Opp'n at 14. Because plaintiffs only assert harm on behalf of the GSEs, the relief they request remedies that harm to the GSEs, and the claims are thus derivative regardless of whether the specific remedy sought is damages or injunctive relief.

claims are derivative. *See Saxton v. FHFA*, 245 F. Supp. 3d 1063, 1072 (N.D. Iowa 2017) (allegations that Third Amendment expropriated the value of shares in the GSEs did not state direct claim "absent additional allegations that [the shareholders'] voting rights had been diluted").[4]

Because plaintiffs' claims are derivative, their contention that their inability to sue "threatens to bar *anyone* from suing to remedy the violations of the separation of powers at issue here," Pls.' Opp'n at 12, misses the mark. By definition, their derivative claims assert harm on behalf of the GSEs rather than any direct, personal injury, and seek recovery that would accrue first to the GSEs. Enforcing traditional limitations on a shareholder's ability to assert such derivative claims in this case does not prevent plaintiffs (or anyone else) from suing to remedy direct, personal harm resulting from the alleged constitutional violations. Indeed, it is fully consistent with the Sixth Circuit's rule that "a shareholder does not have standing to bring a direct cause of action under federal law when the only damage alleged is the diminution in the value of corporate shares." *Gaff*, 814 F.2d at 317. Provided that a party could allege direct and personal harm resulting from FHFA's alleged constitutional violations, as opposed to purely derivative harm from a five-year old transaction that does not even implicate those constitutional theories, that party could bring suit to seek redress. Because plaintiffs cannot demonstrate such harm based on the Third Amendment, their claims are appropriately treated as derivative and dismissed pursuant to HERA's transfer of shareholder rights (or "shareholder succession") provision.[5]

[4] In addition to a footnote in an unpublished, non-controlling Delaware Chancery Court opinion addressing a shareholder's right to compel inspection of corporate books and records, plaintiffs cite a Ninth Circuit decision that ultimately concluded that the plaintiff's claims were for "injury to [the corporation] itself, which ultimately reduced the value of the stock," and thus derivative. *Pareto v. FDIC*, 139 F.3d 696, 699 (9th Cir. 1998). *See* Pls.' Opp'n at 13. Neither case supports plaintiffs' contention that that their claims asserting purely economic injury in diluted share value are direct.

[5] For similar reasons, the Court should reject plaintiffs' argument that the constitutional nature of their claims create a unique impediment to dismissal. As demonstrated in Treasury's opening brief, the shareholder standing rule does not turn on the source of law on which a claim is based and courts have dismissed derivative constitutional claims on that basis. *See* ECF No. 23 at 23-24. Applying the

Finally, plaintiffs' argument that the Court should recognize a conflict-of-interest exception that would allow them to pursue derivative claims lacks merit. HERA's shareholder succession provision by its terms admits of no exceptions, *see Kellmer v. Raines*, 674 F.3d 848, 851 (D.C. Cir. 2012), and, as the D.C. Circuit has recognized, it would be inconsistent with that provision's purpose to create a judicial conflict-of-interest exception. *Perry Capital v. Mnuchin*, 864 F.3d 591, 625 (D.C. Cir. 2017), *petitions for cert. docketed* (Oct. 16, 2017).

The two courts of appeals that have recognized a conflict-of-interest exception to FIRREA's analogous provision did so on the ground that a receiver facing a conflict of interest might be "unable or unwilling to [file suit on a corporation's behalf], despite it being in the best interests of the corporation." *First Hartford Corp. Pension Plan & Trust v. United States*, 194 F.3d 1279, 1295 (Fed. Cir. 1999); *see also Delta Sav. Bank v. United States*, 265 F.3d 1017, 1021–22 (9th Cir. 2001). Derivative actions have been permitted in some circumstances to address such concerns, but Congress, through HERA, has precluded such actions. "[I]t makes little sense to base an exception to the rule against derivative suits in the Succession Clause on the purpose of the derivative suit mechanism." *Perry Capital*, 864 F.3d at 625 (internal citation omitted).[6]

Ultimately, plaintiffs' purported "conflict of interest" is simply that FHFA would have to sue itself to challenge the Third Amendment. But under this logic, every transaction FHFA entered could be challenged by shareholders. Even the two courts that have adopted the conflict-of-interest

shareholder succession provision to bar plaintiffs' derivative claims would not "be tantamount to eliminating any judicial forum in which they could be heard," Pls.' Opp'n at 15, but would merely require the claims to be brought by a party capable of demonstrating direct, personal injury, as opposed to derivative harm to the corporation.

[6] Moreover, plaintiffs' contention that 12 U.S.C. § 4617(a)(5) supports a conflict-of-interest exception is without basis. In § 4617(a)(5), Congress provided the enterprises with a thirty-day window to file a lawsuit challenging FHFA's appointment as conservator or receiver. That Congress expressly granted the enterprises this narrow post-conservatorship right only underscores that the enterprises and their shareholders do not otherwise retain the right to bring suit on behalf of the GSEs during conservatorship.

exception have rejected such a far-reaching rule. *See First Hartford*, 194 F.3d at 1295; *Delta Sav.*, 265 F.3d at 1023 ("We do not suggest that the FDIC-as-receiver is faced with a disqualifying conflict every time a bank-in-receivership is asked to sue another federal agency.").

III. PLAINTIFFS' CLAIMS ARE PRECLUDED BY PRIOR DERIVATIVE ACTIONS ARISING OUT OF THE THIRD AMENDMENT

A. The Rulings In *Saxton* And *Perry Capital* Were On The Merits

HERA contains two statutory bars to suit for derivative claims like the ones plaintiffs assert here: the anti-injunction provision in Section 4617(f), and the shareholder succession provision in Section 4617(b)(2)(A)(i). The prior decisions in *Perry Capital* and *Saxton* resolved the only merits issue that the court in each case could reach – *i.e.*, whether derivative claims challenging the Third Amendment are subject to HERA's substantive bars to suit. Each decision answered that question in the affirmative, requiring dismissal of the claims at issue. The prior decisions are thus rulings on the merits for purposes of res judicata.

Contrary to plaintiffs' assertions, the fact that the court in *Saxton* found that the claims were "jurisdictionally barred" by Section 4617(f), *Saxton*, 245 F. Supp. 3d at 1078, does not change this conclusion. "It has long been the rule that principles of *res judicata* apply to jurisdiction determinations – both subject matter and personal." *Am. Telecom Co. v. Republic of Lebanon*, 501 F.3d 534, 539 n.1 (6th Cir. 2007) (quoting *Ins. Corp. of Ir., Ltd v. Compagnie des Bauxites de Guinee*, 456 U.S. 694, 702 n.9 (1982)). The Sixth Circuit's rationale for holding that, as a general matter, a dismissal for lack of subject matter jurisdiction does not operate as a dismissal on the merits is that "merely because one court does not have jurisdiction over a dispute does not necessarily mean that another court is precluded from properly exercising jurisdiction over the matter." *Wilkins v. Jakeway*, 183 F.3d 528, 533 n.6 (6th Cir. 1999). Here, on the other hand, the *Saxton* court analyzed the substance of the plaintiffs' claims attacking the Third Amendment and determined that because they sought to restrain or affect FHFA's action as conservator, the claims were barred by HERA's anti-injunction provision. Thus, the *Saxton* decision was a merits decision. Plaintiffs are barred by *res judicata* from litigating claims premised on the Third Amendment which could have been, but were not, raised in *Saxton*. *See, e.g.*, *EDP Med. Comp. Sys., Inc. v. United States*, 480 F.3d 621, 624–25 (2d Cir. 2007) ("*Res judicata* is a rule of fundamental repose important for both the litigants and for society," as "[i]t relieve[s] parties of the cost and vexation of multiple lawsuits, conserve[s] judicial resources, and, by preventing inconsistent decisions, encourage[s] reliance on adjudication." (citations omitted)).

Plaintiffs' further argument that *Perry Capital* is not a decision on the merits because it relied on HERA's shareholder succession provision, which attempts to draw an analogy to a dismissal for failure to satisfy a precondition to suit, is similarly unavailing. *Perry Capital* was decided on the basis of a substantive statutory provision foreclosing derivative claims the plaintiffs attempted to bring, not any failure to comply with a technical or procedural requirement of bringing suit. The portion of Wright & Miller on which plaintiffs rely underscores this point, citing preconditions not analogous to the substantive bars at issue here. *See* Wright & Miller, Fed. Prac. & Proc. § 4437 (citing, *inter alia*, cases involving procedural failures to exhaust administrative remedies, provide notice, and fulfill demand requirements).

B. Plaintiffs Are In Privity With The Plaintiffs In *Saxton* And *Perry Capital*

Plaintiffs' arguments regarding privity are in direct conflict with two federal courts of appeals decisions. As plaintiffs acknowledge, Pls.' Opp'n at 20, the First Circuit has held that subsequent shareholders pursuing derivative claims were in privity with earlier shareholder plaintiffs who had pursued derivative claims, notwithstanding that the earlier claims were dismissed because the shareholders could not show that they should "be permitted to bring suit on behalf of the corporation." *In re Sonus Networks, Inc. S'holder Deriv. Litig.*, 499 F.3d 47, 64 (1st Cir. 2007). The Ninth Circuit has similarly rejected a subsequent shareholder's attempt to avoid preclusion by arguing that "he was not in privity with the [earlier shareholder] plaintiffs because they failed to establish derivative standing" and therefore had "fail[ed] to establish their representative capacity." *Arduini v. Hart*, 774 F.3d 622, 633 (9th Cir. 2014). Plaintiffs cite no authority undermining these persuasive arguments, but rather suggest – citing *Smith v. Bayer Corp.*, 564 U.S. 299, 314-18 (2011) – that treating them as in privity with prior GSE shareholders would violate due process. But this argument ignores a critical distinction between class actions—which were at issue in *Smith*—and derivative suits. Unlike a class representative, the derivative shareholder-plaintiff "is not seeking to enforce an individual right," but is instead "suing on behalf of the corporation," which is the real party in interest in both the earlier and any subsequent derivative suits. Wright & Miller, Fed. Prac. & Proc. § 1840; *see also Lewis v. Chiles*, 719 F.2d 1044, 1048 (9th Cir. 1983) (class actions, unlike derivative actions, are "not brought on behalf of the corporation but rather to assert primary individual rights"); *Anwar v. Fairfield Greenwich Ltd.*, 676 F. Supp. 2d 285, 297 (S.D.N.Y. 2009).[7]

Shareholders in the GSEs certainly do not need any added incentive to continue to challenge the Third Amendment in courts across the country. Plaintiffs' argument, which would effectively sanction this practice, is without merit and runs counter to the "policy of repose [which] strongly militates in favor of preclusion." *Sonus*, 499 F.3d at 64.

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[7] Plaintiffs cite a state trial court decision, *In re Wal-Mart Stores, Inc. Del. Deriv. Litig.*, 167 A.3d 513 (Del. Ch. Ct. 2017), which they assert supports their arguments because it criticizes *Sonus*. Pls.' Opp'n at 20-21. But *Wal-Mart's* disagreement with *Sonus* rests on the same incorrect premise "analogiz[ing] stockholder derivative actions to class actions," and is, by the *Wal-Mart* court's own concession, contrary to the "current state of the law" that when "a stockholder files a derivative action, he is deemed in most jurisdictions to be in privity with all other stockholders of the corporation that he purports to represent." 167 A.3d at 524, 528.

C. This Suit Shares Identity With The Causes Of Action Asserted In *Saxton* And *Perry Capital*

Under the governing Sixth Circuit standard, which is based on the Restatement, the third and fourth elements of the claim preclusion test focus on the transaction out of which the claims at issue arise: "If the two claims arose out of the same transaction, they share an 'identity,' and Plaintiff should have raised both in the first suit." *Pram Nguyen ex rel. U.S. v. City of Cleveland*, 534 F. App'x 445, 451 (6th Cir. 2013); *see also J.Z.G. Res., Inc. v. Shelby Ins. Co.*, 84 F.3d 211, 215 (6th Cir. 1996) (claim preclusion extinguishes "all rights of the plaintiff to remedies against the defendant with respect to all or any part of the transaction, or series of connected transactions, out of which the action arose" (quoting Restatement (Second) Judgments § 24 (1982))). In focusing narrowly on discrepancies between the legal claims they now assert and those previously asserted by GSE shareholders, plaintiffs ignore this transactional approach and the proper "level of generality" at which the claim preclusion analysis operates. *Wheeler v. Dayton Police Dep't*, 807 F.3d 764, 767 (6th Cir. 2015) ("We look not at the specific injuries [alleged], but at the underlying *transaction* that gave rise to those injuries."). Regardless of the nature of the claims asserted in two lawsuits, principles of *res judicata* (and the very case plaintiffs themselves cite) make clear that "[w]here two causes of action arise from the same transaction, or series of transactions, the plaintiff should have litigated both causes in the first action and may not litigate the second issue later." *Wilson v. Strickland*, 333 F. App'x 28, 30–31 (6th Cir. 2009) (citations omitted). Plaintiffs' current claims are precluded because they and the derivative claims at issue in *Perry Capital* and *Saxton* arise out of the same transaction (the Third Amendment).

CONCLUSION

For the foregoing reasons, and those stated in Treasury's brief supporting its motion to dismiss, the Court should grant Treasury's motion to dismiss.

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Respectfully submitted,

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