NO. 17-591

In the Supreme Court of the United States

FAIRHOLME FUNDS, INC., *et al.*,

Petitioners,

v.

THE FEDERAL HOUSING FINANCE AGENCY, *et al.*,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

REPLY BRIEF FOR PETITIONERS

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CORPORATE DISCLOSURE STATEMENT

The disclosure statement in the petition for writ of certiorari remains accurate.

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ARGUMENT

1. In 2008, at the height of the financial crisis, FHFA placed Fannie Mae and Freddie Mac into conservatorship. "A conservatorship," FHFA explained, "is the legal process in which a person or entity is appointed to establish control and oversight of a Company to put it in a sound and solvent condition." Pet.App.232a. Accordingly, FHFA stated that "the powers of the Conservator" were to "take all actions necessary and appropriate to (1) put the Company in a sound and solvent condition and (2) carry on the Company's business and preserve and conserve the assets and property of the Company," and "the conservatorship period [would] end . . . [u]pon the Director's determination that the Conservator's plan to restore the Company to a safe and solvent condition has been completed successfully." Pet.App.233a-234a. FHFA's Director assured Congress that the Companies' "shareholders are still in place," and that "going forward" the shares "may [have] some value." Pet.App.288a, 289a.

FHFA continued to articulate a similar understanding of its conservator role through the early years of the Fannie and Freddie conservatorships. As late as June 20, 2011, FHFA stated that, "as one of the primary objectives of conservatorship of a regulated entity would be restoring that regulated entity to a sound and solvent condition, allowing capital distributions to deplete the entity's conservatorship assets would be inconsistent with the agency's statutory goals, as they would result in removing capital at a time

when the Conservator is charged with rehabilitating the regulated entity." Conservatorship & Receivership, 76 Fed. Reg. 35,724, 35,727 (June 20, 2011).

In August of 2012, however, after the financial crisis had passed and on the heels of Fannie and Freddie announcing financial results showing that they would once again begin building capital, FHFA entered the "Net Worth Sweep," an action that is at war with the agency's previously articulated understanding of what it means to be a conservator. As Treasury explained, the Net Worth Sweep ensures that Fannie and Freddie "will be *wound down* and *will not* be allowed to retain profits, rebuild capital, and return to the market in their prior form." Pet.App.327a (emphases added).

The Net Worth Sweep actively thwarts FHFA's rehabilitative conservatorship mission. By statute, the "maintenance of adequate capital" is essential to the "safe and sound" operation of Fannie and Freddie, 12 U.S.C. § 4513(a)(1)(B)(i), and the Net Worth Sweep prohibits Fannie and Freddie from building capital. In addition, systematically stripping Fannie and Freddie of their capital has effectively nationalized them, subjected Treasury's funding commitment to maximum exposure, enriched the Government by nearly $130 billion, and destroyed the economic interests of Fannie's and Freddie's private shareholders. It is unprecedented in the annals of conservatorship.

In seeking to defend FHFA's startling about-face, its lawyers have offered a "stunningly broad view of [the agency's] power," "insist[ing] its authority is *entirely without limit* and argu[ing] for a complete ouster of federal courts' power to grant injunctive relief to redress *any action* it takes while purporting to serve in the conservator role." Pet.App.90a (Brown, J., dissenting). The D.C. Circuit has gone along with this, "blessing FHFA with unreviewable discretion over any action—short of formal liquidation—it takes towards its wards." Pet.App.99a (Brown, J., dissenting). Indeed, the D.C. Circuit has gone so far as to grant FHFA the authority to shield *other* agencies from judicial scrutiny for acts done in concert with FHFA as conservator, even acts flatly prohibited by law.

The Government is wrong to portray this case as a mundane, one-off dispute about "the renegotiation of an enterprise's financial obligations." Brief of Fed. Respondents in Opposition at 34 (Jan. 17, 2018) ("Opp."). The fundamental question presented is whether Congress has given FHFA unlimited and standardless discretion to do as it pleases when operating the Companies. And the D.C. Circuit's reasoning cannot be limited to the conservatorships of Fannie and Freddie, for the laws that govern conservatorships of the Nation's banks are materially identical. Judge Brown therefore was correct that the D.C. Circuit's decision is "likely to negatively affect the nation's overall financial health," for it "could dramatically affect investor and public confidence in the

fairness and predictability of the government's participation in conservatorship and insolvency proceedings." Pet.App.117a, 119a. The D.C. Circuit's ruling is a clear and present danger to the rule of law and to the Nation's financial health, and it is one that this Court should review and correct.

2. On the merits, the Government, like the D.C. Circuit, centers its case on 12 U.S.C. § 4617(f), an anti-injunction provision that in relevant part reads, "no court may take any action to restrain or affect the exercise of powers or functions of the Agency as a conservator." But this provision is no obstacle to judicial relief when "the agency has acted . . . beyond, or contrary to, its statutorily prescribed . . . powers or functions." Pet.App.22a-23a (quotation marks omitted). *See Coit Indep. Joint Venture v. Federal Sav. & Loan Ins. Corp.*, 489 U.S. 561, 574-75 (1989). And here, FHFA "abandoned the protection of the anti-injunction provision" by taking an action "patently incompatible with any definition of the conservator role." Pet.App.115a, 120a (Brown, J., dissenting).

The Government erroneously interprets FHFA's authorities to be so sweeping that essentially nothing is beyond them. It seizes upon certain general powers that Congress has granted to FHFA as either conservator or receiver, such as the powers to "operate" the Companies and to "transfer or sell any asset or liability" they may have, *id.* (quoting 12 U.S.C. §§ 4617(b)(2)(B)(i), (G)), and posits that the courts have no authority to second-guess whatever FHFA does that can be

described as falling within those powers. This interpretation eviscerates any limit on FHFA's statutory authority. Indeed, even a formal liquidation of assets—expressly designated to be a power of FHFA as receiver, *see* 12 U.S.C. § 4617(b)(2)(E)—would appear to be within the ambit of FHFA's authority as conservator on the Government's reading, because the liquidation would involve "transfer[ring]" Fannie's and Freddie's assets. 12 U.S.C. § 4617(b)(2)(G).

The error of the Government's interpretation is that it requires courts to blind themselves to the ends Congress has authorized FHFA as conservator to pursue. Namely, FHFA "may . . . take such action as may be . . . necessary to put the regulated entity in a **sound and solvent condition**; and . . . appropriate to carry on the business of the regulated entity and **preserve and conserve the assets** . . . of the regulated entity." 12 U.S.C. § 4617(b)(2)(D) (emphases ended). These provisions "mark the bounds of FHFA's conservator . . . powers," Pet.App.96a (Brown, J., dissenting), and FHFA cannot take actions like the Net Worth Sweep that are inconsistent with them.

The Government points to Congress's use of "may" in Section 4617(b)(2)(D) to insist that FHFA is not required to seek to preserve and conserve assets or to restore Fannie and Freddie to soundness and solvency. Opp.21. But Congress's grant of authority to FHFA to advance these ends does not simultaneously authorize FHFA to act in contravention of them. Indeed, the Government's

argument that FHFA's powers as conservator are limited neither by the well-established understanding of conservatorship nor the statutory language reflecting that understanding unconstitutionally rids the statute of any intelligible principle to guide FHFA's actions—a result this Court has avoided in other contexts by interpreting provisions governing conservators in light of established legal understandings. *See Fahey v. Mallonee*, 332 U.S. 245, 250-53 (1947). Tellingly, outside the context of litigation FHFA itself has consistently recognized that Section 4617(b)(2)(D) establishes the "Conservator's *mandate*." *See* Petition for Writ of Certiorari at 30-31 (Oct. 16, 2017). This does not mean that FHFA lacks discretion when pursuing its mandate, or that in any situation there is only one course of action that would be consistent with it. But it does mean that FHFA cannot take an action like the Net Worth Sweep that is fundamentally at odds with it. Congress did not authorize FHFA as "conservator to undermine the interests and destroy the assets of its ward without meaningful limit." Pet.App.96a-97a n.1 (Brown, J., dissenting).

The Government also relies upon an "incidental" provision stating that FHFA "may, as conservator. . . take any action authorized by this section, which the Agency determines is in the best interests of the regulated entity or the agency." 12 U.S.C. § 4617(b)(2)(J). But this provision *limits* FHFA by requiring it to make a "best interests" determination before exercising authority granted elsewhere. And that the provision allows FHFA to consider its own best interests does not help the

Government, for "as conservator" FHFA's interests are those identified in the statute, to preserve and conserve Fannie's and Freddie's assets while seeking to return them to soundness and solvency. Finally, it is highly unlikely that Congress would upend the settled understanding of what it means to be a conservator in such an oblique way, for Congress is not in the habit of hiding "elephants in mouseholes." *Whitman v. American Trucking Ass'ns*, 531 U.S. 457, 468 (2001).

The Government also cites to determinations Treasury was required to make before purchasing Fannie and Freddie stock, such as that the action be "necessary to . . . protect the taxpayer." 12 U.S.C. §§ 1455(*l*)(1)(B)(iii), 1719(g)(1)(B)(iii). But Congress's directive that *Treasury* consider the taxpayer does not alter *FHFA*'s obligations as conservator. And even Treasury was required to consider "the need to maintain the Corporation's status as a private shareholder-owned company" and "the Corporation's plan for the orderly resumption of private market funding," 12 U.S.C. §§ 1455(*l*)(1)(C), 1719(g)(1)(C), belying the notion that Congress intended to authorize any agency to transform the Nation's housing finance system by effectively nationalizing Fannie and Freddie.

The Government finally cites 12 U.S.C. § 4617(a)(2), which provides that FHFA may "be appointed conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity." But like all statutory provisions, this one must be "read in context, with

a view to its place in the overall statutory scheme." *King v. Burwell*, 135 S. Ct. 2480, 2490 (2015) (quotation marks omitted). Read in context, this provision plainly refers to the *collective* purposes for which a conservator or receiver may be appointed; one must read on to discover how these purposes are *allocated* between a conservator and a receiver. Winding up and reorganizing are reserved for a receiver. *See* 12 U.S.C. § 4617(b)(2)(E) (authorizing a receiver to liquidate); 12 U.S.C. § 4617(i) (authorizing a receiver to organize a limited-life regulated entity to succeed Fannie and Freddie). Rehabilitation to soundness and solvency, by contrast, is the defining purpose of a conservator. *See* 12 U.S.C. § 4617(b)(2)(D).

3. Having failed to free FHFA from its conservator mandate, the Government insists that the Net Worth Sweep is consistent with it because FHFA sought to rescue Fannie and Freddie from a "debt spiral" threatened by drawing from Treasury's funding commitment to pay dividends to Treasury. Opp.9; *see also* Opp.22 (defending "prioritizing the preservation of vital, taxpayer-funded capital"). This argument fails on multiple levels.

As an initial matter, under the D.C. Circuit's decision, "allegations of motive are neither here nor there." Pet.App.37a. The D.C. Circuit based its decision on the erroneous conclusion that Congress granted FHFA unbounded discretion to operate Fannie and Freddie however it wishes. Once that conclusion is properly rejected, the Net Worth Sweep must be

declared unlawful regardless of FHFA's motives, because imposing an unyielding, negligible capital cap is incompatible with FHFA's conservator mandate.

Furthermore, to the extent motives were relevant, there would be, "to put it mildly, a dispute of fact regarding the motivations behind FHFA and Treasury's decision to" adopt the Net Worth Sweep that could not properly be resolved at the motion-to-dismiss stage. Pet.App.115a n.7 (Brown, J., dissenting). A multitude of evidence, including internal government emails and sworn testimony, undermines the Government's debt-spiral narrative.

First, "debt spiral" is a misnomer. Treasury's investment in the Companies is equity, not debt, so Fannie and Freddie are not indebted to Treasury.

Second, any threat of a "dividend spiral" was illusory, for the stock agreements with Treasury vested Fannie and Freddie with the "sole discretion" to decide whether to pay dividends in cash at a 10% rate, Pet.App.268a, or "in-kind" by adding to Treasury's liquidation preference at a 12% rate, Pet.App.270a. Thus, as the Congressional Research Service noted shortly before the announcement of the Net Worth Sweep, under their existing contracts Fannie and Freddie could have paid "a 12% annual senior preferred stock dividend indefinitely." N. ERIC WEISS, CONG. RESEARCH SERV., RL34661, FANNIE MAE'S AND FREDDIE MAC'S FINANCIAL PROBLEMS, Summary (2012).

Third, the Net Worth Sweep, far from protecting Treasury's funding commitment, exposes it to maximal threat by stripping Fannie and Freddie of a meaningful capital buffer. But for the Net Worth Sweep, Fannie and Freddie would have nearly $130 billion of additional capital on their books to protect them (and Treasury's commitment) from the vicissitudes of the financial market.

Fourth, the timing of the Net Worth Sweep is inconsistent with the debt-spiral narrative. It was executed in August 2012, mere days after Fannie and Freddie had announced earnings in excess of the 10% dividend that enabled them to begin rebuilding their capital levels even if they opted to continue paying dividends in cash.

Fifth, evidence that the D.C. Circuit added to the record on appeal and considered indicates that FHFA and Treasury entered the Net Worth Sweep because they knew that without it Fannie and Freddie would begin rebuilding their capital levels and thereby threaten the agencies' ability to keep them in perpetual conservatorship. Shortly before the Net Worth Sweep was announced, Fannie presented Treasury with projections showing that the size of Treasury's funding commitment to both Companies would decrease by only $8.7 billion from 2012 through 2022—hardly indicative of a debt spiral. Pet.App.302a. What is more, these projections did not incorporate accounting adjustments that would add tens of billions of dollars to the Companies' balance sheets in 2013 alone, and Fannie's CFO testified that she

told Treasury shortly before the Net Worth Sweep that she expected her Company to make those adjustments in 2013. Pet.App.307a-308a.[1] That same day, an FHFA official reported a "renewed push to move forward" with the Net Worth Sweep, Pet.App.342a, and the day the Net Worth Sweep was announced a senior White House official explained that it would "ensur[e] that [Fannie and Freddie] can't recapitalize" and "escape" conservatorship, Pet.App.378a, 379a.

At any rate, the D.C. Circuit held that the Net Worth Sweep could not be enjoined even if Petitioners' factual account were correct. This exposes the extreme nature of the D.C. Circuit's decision, for if a determination to *thwart* Fannie's and Freddie's rehabilitation is not contrary to FHFA's authority as conservator, nothing is. This Court should grant the petition and reverse the D.C. Circuit's determination to "erase[ ] any outer limit to FHFA's statutory powers" and "foreclose[ ] *any* opportunity for meaningful judicial review of FHFA's actions in conducting its so-called conservatorship." Pet.App.107a (Brown, J., dissenting).

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[1] The Companies were able to recognize substantial "one-time" accounting *earnings*, Opp.9, because after being placed under FHFA's control they were forced to recognize extraordinarily large accounting *losses* that had to be reversed once the Companies' performance improved. Absent these artificial losses, the Companies may have been able to weather the crisis without assistance from Treasury. *See* Br. Amici Curiae of Timothy Howard & the Coalition For Mortg. Sec. in Supp. of Appellants at 17-26, *Perry Capital LLC v. Lew*, No. 14-52423 (D.C. Cir. July 6, 2015).

4. Treasury also exceeded its authority in entering the Net Worth Sweep. After December 31, 2009, Treasury was authorized only "to hold, exercise any rights received in connection with, or sell" the Fannie and Freddie stock it already owned. 12 U.S.C. §§ 1455(*l*)(2)(D), 1719(g)(2)(D). But the Net Worth Sweep changed the nature of Treasury's stock to such an extent that it effectively amounted to the acquisition of new securities. Indeed, the IRS has ruled that preferred stock amended to make its value "equal the net worth of [a] corporation" "constitutes, in substance, . . . new preferred stock." Rev. Rul. 56-564, 1956-2 C.B. 216, 1956 WL 10781. And the Government itself acknowledges that Treasury "exchang[ed] a fixed dividend for a variable one." Opp.9.

The Government insists that the Section 4617(f) anti-injunction provision bars the courts from remedying Treasury's alleged *ultra vires* conduct. Section 4617(f), however, applies only to FHFA, not to Treasury. And enjoining Treasury from violating its own statutory obligations would not "affect the exercise of powers or functions" of FHFA as conservator. 12 U.S.C. § 4617(f). At most, FHFA has the power only to propose a stock transaction to Treasury. It has no power to insist that Treasury agree or to shield Treasury from its own statutory obligations. Therefore, ordering Treasury to abide by those obligations would no more affect FHFA's conservator powers or functions than would Treasury simply declining to enter into the transaction.

The Government's construction of the statute would lead to absurd results that Congress could not possibly have intended. For example, under that construction FHFA could approach Treasury tomorrow and offer to sell, say, $500 billion of brand new stock in the Companies, and the courts would be powerless to enjoin Treasury from accepting despite that action being flatly prohibited by statute. So much for the debt spiral; under the Government's reading of the statute Treasury could continue to fund Fannie and Freddie to any extent deemed necessary. Furthermore, under the Government's construction, Treasury and other agencies acting in concert with FHFA would enjoy even *greater* protection from Section 4617(f) than FHFA itself because, unlike FHFA, they could not be enjoined from taking actions outside of their statutory authority. Congress plainly did not intend these absurd results, and the Court should grant review to correct the D.C. Circuit's decision granting FHFA the authority to allow other agencies to violate statutory limits with impunity.

CONCLUSION

This Court should grant the petition and reverse the judgment below.

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