Redacted Version

UNITED STATES COURT OF FEDERAL CLAIMS

LOUISE RAFTER, JOSEPHINE RATTIEN, STEPHEN RATTIEN, PERSHING SQUARE CAPITAL MANAGEMENT, L.P., on behalf of Pershing Square, L.P., Pershing Square II, L.P., Pershing Square Holdings, Ltd., and Pershing Square International, Ltd., PERSHING SQUARE, L.P., PERSHING SQUARE II, L.P., PERSHING SQUARE HOLDINGS, LTD., and PERSHING SQUARE INTERNATIONAL, LTD., Plaintiffs, v. THE UNITED STATES OF AMERICA, Defendant, FEDERAL NATIONAL MORTGAGE ASSOCIATION, Nominal Defendant.	Case No. 14-740C Judge Margaret M. Sweeney **REDACTED VERSION PREPARED IN ACCORDANCE WITH PROTECTIVE ORDER**

SECOND AMENDED VERIFIED COMPLAINT

TABLE OF CONTENTS

Plaintiffs Louise Rafter, Josephine Rattien, Stephen Rattien, Pershing Square Capital Management, L.P., Pershing Square, L.P., Pershing Square II, L.P., Pershing Square Holdings, Ltd., and Pershing Square International, Ltd. (collectively, "**Plaintiffs**"), bring their claims against the Department of Treasury ("**Treasury**") and the Federal Housing Finance Agency ("**FHFA**"), and their agents acting at their direction (collectively, the "**Government**").[1] By and through their undersigned attorneys, Plaintiffs allege on personal knowledge as to themselves and their own conduct and on information and belief as to all other matters as follows:

I.
NATURE OF THIS ACTION

1. This suit arises from the Government's appropriation of hundreds of billions of dollars in cash payments and property amounting to the entire net worth of the Federal National Mortgage Association ("**Fannie Mae**") and the Federal Home Loan Mortgage Corporation ("**Freddie Mac**") (the "**Companies**" or the "**GSEs**"), entities created by Congress to foster liquidity in the residential mortgage market. Fannie Mae and Freddie Mac have operated for almost half a century as federally chartered for-profit corporations whose stock is widely held by private investors. The Government's conduct threatens to eliminate any viable independent future for Fannie Mae and Freddie Mac other than liquidation, any possible return on the common stock Plaintiffs hold, and all of the Companies' residual value.

2. The Government conduct at issue originated in measures undertaken during the 2008 financial crisis with the aim of stabilizing—not decimating—Fannie Mae and Freddie Mac. During that downturn in financial and housing markets, the Companies suffered their first losses

[1] Pursuant to Rule of the Court of Federal Claims 15(a)(2), Plaintiffs file this Second Amended Verified Complaint with the consent of the Government, which was provided in writing on February 26, 2018, and pursuant to the Court's Order dated January 12, 2018 (ECF No. 22).

in decades. In response, the Government affirmed that its "primary focus" was "supporting Fannie Mae and Freddie Mac in their current form," and it intended "to work with the [C]ompanies as they take the steps necessary to allow them to continue to perform their important public mission." Press Release, U.S. Dep't of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Fannie Mae and Freddie Mac (July 11, 2008). Congress enacted the Housing and Economic Recovery Act of 2008 ("**HERA**"), which Treasury described as "legislation that will help promote confidence in these companies." *Id.*

3. HERA established FHFA and endowed it with authority to act either as the Companies' "conservator" or their "receiver." 12 U.S.C. §4617(a). Notwithstanding the conclusions of regulators, including Treasury, that the Companies were "adequately capitalized," in September 2008, FHFA placed the Companies under its conservatorship. *See, e.g.*, Press Release, James B. Lockhart III, Dir., Office of Fed. Hous. Enters. Oversight (July 10, 2008). FHFA repeatedly stressed that the creation of conservatorships was a temporary, restorative measure—"a statutory process designed to stabilize a troubled institution with the objective of maintaining normal business operations and restoring its safety and soundness." James B. Lockhart III, Dir., FHFA, Statement Before the Senate Committee on Banking, Housing, and Urban Affairs on the Appointment of FHFA as Conservator for Fannie Mae and Freddie Mac (Sept. 23, 2008).

4. The day after FHFA placed the Companies into conservatorship, Treasury used its HERA authority to augment the Companies' liquidity by signing Senior Preferred Stock Purchase Agreements ("**PSPAs**") pursuant to which the Government purchased senior preferred stock ("**Government Preferred Stock**") newly issued by each Company. In exchange for the stock, Treasury committed to provide each Company with funds as needed to maintain that Company's

positive net worth. The Government Preferred Stock earned an annual dividend, payable quarterly, equal to 10% of its liquidation preference if paid in cash, or 12% if paid in kind. That liquidation preference was $1 billion, plus the amount of all draws against the Treasury's funding commitment, and all unpaid dividends.

5. Like FHFA, Treasury characterized its efforts as remedial and forward-looking: the "Senior Preferred Stock Purchase Agreement with each GSE … ensures that each enterprise maintains a positive net worth[, …] adds to market stability by providing additional security to GSE debt holders[, …] adds to mortgage affordability by providing additional confidence to investors in GSE mortgage-backed securities[, and …] eliminates any mandatory triggering of receivership." Press Release, U.S. Dep't of Treasury Office of Pub. Affairs, Fact Sheet: Treasury Senior Preferred Stock Purchase Agreement (Sept. 7, 2008). Secretary Paulson stressed that "[g]iven the combination of actions we are taking, including the Preferred Share Purchase Agreements, <u>we expect the GSEs to be in a stronger position to fund their regular business activities in the capital markets</u>." Press Release, U.S. Dep't of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008) (emphasis added).

6. Four years later, in August 2012, the Companies remained in conservatorship—as they do to this day—and had drawn $187.5 billion from Treasury's commitment. Most of the draws were precipitated by non-cash losses in the value of deferred tax assets that FHFA forced the Companies to declare, even as they continued to generate enough cash to cover their expenses, as they had done throughout their long histories. The Companies' combined quarterly dividend on the Government Preferred Stock had grown to $4.7 billion. Despite these, and other, burdens of conservatorship, the Companies had generated net operating revenues in excess of their net

operating expenses for every year during the conservatorships except 2010, and, by 2012, the Companies had also regained profitability. At the end of 2012, they reported a combined $28.2 billion in net income. Both Companies had positive net worth even after paying the Treasury dividend with cash, and could begin to foresee eventual redemption of the Government Preferred Stock and emergence from conservatorship.

7. Yet when it became clear in 2012 that Fannie Mae and Freddie Mac had been rehabilitated and would generate sizeable profits again, Treasury effected a plan to nationalize the Companies, keep them permanently shackled, and remove any prospect of their generating economic value for shareholders, while simultaneously sweeping their imminent and significant profits into the federal coffers. Although the Companies' corporate charters, issued by the federal government (12 U.S.C. §1451, *et seq.* ("**Freddie Mac's Charter**"); 12 U.S.C. §1716, *et seq.* ("**Fannie Mac's Charter**") (together, the "**Charter Acts**")), clearly provided that the Companies should operate as private, for-profit enterprises, the Government sought to nationalize the Companies by executive fiat through a radical reinterpretation of FHFA's powers as conservator. Instead of *conserving* the Companies' assets, Treasury and FHFA, acting at Treasury's behest, entered into a third amendment to the PSPAs (the "**Third Amendment**"), which reassigned all of the Companies' future profits to the Government. The Third Amendment radically altered the Government Preferred Stock by replacing fixed dividends with a dividend equal to the Company's entire net worth, less a dwindling cash reserve (the "**Net Worth Sweeps**"). Unlike the first and second amendments—which were executed in 2009 to increase the capital available to the Companies—the Third Amendment gave Treasury *all* of the privately owned Companies' future earnings and virtually all of their net worth. Under the Third Amendment, the Companies were required to hand over their net worth to Treasury every fiscal quarter, in perpetuity, no matter how

many times over they have repaid their debts to the Government, with no reduction in the principal amount of the debt.

8. The Third Amendment obliterated the economic rights of the private shareholders and made the federal government the effective owner of Fannie Mae and Freddie Mac in everything but name. The Third Amendment allowed the Government to reap all the profits the Companies will ever earn, without permitting the Companies to recapitalize, and kept the Companies on the brink of insolvency, with recourse solely to draws on Treasury's commitment to fill any operating deficit. As a consequence of the Third Amendment, the Government owns all of the upside and all of the downside of the Companies' operations.

9. Under the Third Amendment, the Companies cannot return to private ownership, as Congress intended. Rather, the Government deliberately implemented the Net Worth Sweeps "to ensure existing common equity holders will not have access to any positive earnings from the [Companies] in the future," to seize the profits from the Companies for the Government, and to wind down the Companies. Treasury decided to carry out this plan even though it acknowledged internally that "the path laid out under HERA" required that the Companies "becom[e] adequately capitalized" and "exit conservatorship as private companies." Information Memorandum for Secretary Geithner from Jeffrey A. Goldstein, Undersecretary for Domestic Fin., Dep't. of the Treasury (Jan. 4, 2011).

10. Although FHFA has repeatedly acknowledged its duty, as a conservator under HERA, to "[c]onserve and preserve" the Companies' assets, FHFA acquiesced in Treasury's plan, agreeing to act as an *anti*-conservator by giving Treasury all of the Companies' assets. FHFA has joined Treasury in calling on Congress to pass legislation to reform the Companies, claiming that the conservatorships after the Third Amendment are "not sustainable."

11. The enormity of the Government's actions in using the Third Amendment to take over the Companies is heightened by consideration of the Government's pretext for the Third Amendment. The Government has attempted before this Court to portray the Net Worth Sweeps as an effort to save Fannie Mae and Freddie Mac from a "death spiral" of debt, but the historical facts belie that narrative. There was *no risk* that the Companies would have to draw on Treasury's commitment to pay cash dividends due on the original PSPAs because the PSPAs also gave the Companies an option to pay the dividends "in kind."

12. Moreover, the Government knew *ex ante* as it considered the Third Amendment in mid-2012 that the Companies were in no danger of a debt spiral. The national real estate market generally was recovering, bolstering the Companies' portfolios of loan exposures. And despite the shackles of conservatorship since 2008, an internal July 2012 FHFA email heralded "the GSEs return to profitability" and based on "[c]urrent projections" and predicted that "the next 8 years" would likely be "the golden years of [the Companies'] earnings." The Government was also well-aware—by August 2012—that the Companies were on the verge of recognizing tens of billions in profits, due in large part to a decrease in excessive loan loss reserves that FHFA forced the Companies to take early in the conservatorships, and would soon be able to rebuild their capital and emerge from conservatorship as Congress had intended. The Government did not adopt the Third Amendment because the Companies would need to borrow money from Treasury; it did so *because the Companies were so profitable that they would no longer need to do so*. The Government's clear goal, in the private words of one senior White House official, was to "eliminat[e] [the Companies'] ability to pay down principal (so they can't repay their debt and escape as it were)."

13. The Government also knew *ex ante* that the Net Worth Sweeps heightened the very risk they were supposed to redress. [redacted] FHFA Director Melvin Watt has since admitted to Congress that forcing the Companies to operate without a sufficient capital reserve was "especially irresponsible." FHFA Dir. Watt, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs on the Status of the Housing Finance System After Nine Years of Conservatorship (May 11, 2017). Director Watt's warnings have come to pass. A fourth amendment to the PSPAs executed on December 21, 2017 (the "**Fourth Amendment**") conceded, but did not rectify, the folly of the Third Amendment by permitting the Companies to maintain $3 billion of their own capital as a reserve, subject to a corresponding increase in Treasury's liquidation preference. And in February 2018, the Companies announced that—*despite* earning net income in 2017 after years of consistent profits, and despite anticipating continuing profits—each had a net worth deficit that required it to draw on Treasury's commitment because they had suffered paper losses as a result of tax reform legislation passed in December 2017 and the Net Worth Sweeps forced them to operate without adequate capital reserves to absorb such losses. The Fourth Amendment does nothing to prevent the Net Worth Sweeps' ongoing and uncompensated appropriation of the Companies' assets in perpetuity.

14. The Net Worth Sweeps have nothing to do with conserving the assets or property of Fannie Mae and Freddie Mac, and everything to do with nationalizing the Companies and channeling their profits into the Government's own coffers. As a senior White House official has confirmed, the

Net Worth Sweeps were consciously designed to "ensur[e] that [the Companies] can't recapitalize," and to "close[ ] off [the] possibility that they ever go (pretend) private again." Among the benefits of this plan from the executive branch perspective, he emphasized, was obviating the need for "Congress to make a decision" about whether to nationalize the Companies, which entailed a "mighty high risk" of being voted down. Internal documents from Treasury further confirm that the Net Worth Sweeps were intentionally designed to serve "the Administration's commitment to ensure existing common equity holders will not have access to any positive earnings from [Fannie Mae and Freddie Mac] in the future." *See* Action Memorandum for Secretary Geithner from Jeffrey A. Goldstein, Under Secretary for Domestic Fin., Dep't of the Treasury (Dec. 20, 2010). This act of deliberately cutting off the Companies' owners from any future profit is the antithesis of FHFA's statutory mandate to act "as conservator."

15. The Net Worth Sweeps, which are set to continue indefinitely, have already led to the unlawful expropriation of well over a hundred billion dollars in excess payments made to Treasury above what would have been its 10% dividends, with untold billions more to come in the future. If the Net Worth Sweeps were authorized by HERA, the Government effected a Fifth Amendment taking of the Companies' property, and that of Plaintiffs, without just compensation. Alternatively, if Treasury's demand for all of the Companies' net worth, or FHFA's agreement, as conservator, to pay it, exceeded their HERA authority, the Net Worth Sweeps constitute illegal exaction and the Third Amendment is void and subject to reformation remedies. In all events, the Net Worth Sweeps breach the contract created by Fannie Mae's and Freddie Mac's Charter Acts, by-laws, and governing corporate law, and the covenant of good faith and fair dealing implicit in Fannie Mae's and Freddie Mac's Charter Acts.

II.
JURISDICTION AND VENUE

16. This Court has jurisdiction over this action, and venue is proper in this Court, pursuant to 28 U.S.C. §1491(a)(1).

III.
CONSTITUTIONAL, STATUTORY, REGULATORY AND CONTRACTUAL PROVISIONS

17. Plaintiffs' claims are founded on the Fifth Amendment to the United States Constitution, which provides, in pertinent part, that no person shall "be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation," and on the following statutory, regulatory and contractual provisions: HERA, 12 U.S.C. §§1455(*l*), 1719(g), 4617; 12 C.F.R. §§1229.13, 1237.12; Fannie Mae's Charter Act, 12 U.S.C. §1716, *et seq.*; Freddie Mac's Charter Act, 12 U.S.C. §1451, *et seq.*; 12 C.F.R. §1710.10; Fannie Mae Bylaws §1.05; and Delaware General Corporation Law §§151(c), 159.

IV.
PARTIES

18. Plaintiff Louise Rafter ("**Rafter**") is a retired nurse who resides in California. She owns 36,000 shares of Fannie Mae common stock, some of which she and her late husband purchased over 25 years ago and which she and/or her late husband have held continuously since then. She brings direct claims on behalf of herself and shareholder derivative claims on behalf of nominal party Fannie Mae.

19. Plaintiffs Josephine Rattien and Stephen Rattien (the "**Rattien Plaintiffs**") are a married couple who reside in Washington, D.C. Josephine Rattien is a retired psychiatric social worker and inner-city school counselor. Stephen Rattien is a retired senior science and technology policy manager. They jointly own 1,000 shares of Fannie Mae common stock, which they

purchased approximately 15 years ago and which they have held continuously since then. They bring direct claims on their own behalf and shareholder derivative claims on behalf of nominal party Fannie Mae.

20. Plaintiffs Pershing Square, L.P., a Delaware limited partnership, Pershing Square II, L.P., a Delaware limited partnership, Pershing Square Holdings, Ltd., a limited liability company incorporated in Guernsey, and Pershing Square International, Ltd., a Cayman Islands exempted company, (the "**Funds**"), are private investment funds. During a period commencing October 7, 2013, each Fund purchased common stock of each of Fannie Mae and Freddie Mac. Presently, the Funds' holdings amount, collectively, to approximately 10% of the outstanding common stock of each Company, and the Funds together constitute the Companies' largest common shareholder. Plaintiff Pershing Square Capital Management, L.P. ("**PSCM**"), is a limited partnership duly organized and existing under the laws of Delaware, with its principal place of business at 888 7th Avenue, 42nd Floor, New York, New York 10019. At all relevant times, PSCM acted as an investment advisor registered with the Securities and Exchange Commission under the Investment Advisor Act of 1940 to each Fund in connection with its purchases of the Companies' stock. PSCM and the Funds (collectively, "**Pershing Square**") bring direct claims with respect to both Companies.

21. Defendant United States of America includes all persons and entities falling within the previously defined term "Government."

22. Nominal party Fannie Mae is a federally chartered, privately owned corporation with its principal executive offices located at 3900 Wisconsin Avenue, N.W., Washington, D.C. 20016. Under its bylaws, Fannie Mae's corporate governance practices and procedures are governed by Delaware General Corporation law.

V.
FACTUAL ALLEGATIONS

A. Fannie Mae and Freddie Mac

23. Fannie Mae and Freddie Mac are government sponsored enterprises—private financial services corporations created by Congress pursuant to their Charter Acts to enhance the flow of credit to a targeted sector of the economy. "[A]ll of [their] business activities must be permissible under the Charter Act[s]." Fannie Mae, Annual Report (Form 10-K), at 13-19 (Feb. 27, 2008); Freddie Mac, Information Statement and Annual Report to Stockholders, at 1-2, 4, 7 (Feb. 28, 2008). The Companies fulfill their Congressional mandate by purchasing mortgages originated by private banks and bundling them into mortgage-related securities to be sold to private investors, which expands the banks' ability to extend credit for home purchases.

24. The Companies are for-profit corporations owned by private shareholders. Fannie Mae was originally established as a government agency in 1938 under the Federal National Mortgage Act. In 1968, Congress enacted the Housing and Urban Development Act of 1968, which provided that Fannie Mae would become a private shareholder-owned corporation, and Fannie Mae has remained a privately owned company since 1968. The Federal National Mortgage Act, as amended, is Fannie Mae's Charter Act and is codified as 12 U.S.C. §1716, *et seq*.

25. Similarly, Freddie Mac was originally established in 1970 as a private corporation owned by the Federal Home Loan Bank System under the Emergency Home Finance Act of 1970. In 1989, Congress enacted the Financial Institutions Reform, Recovery and Enforcement Act of 1989, which established Freddie Mac as a private shareholder-owned corporation, and Freddie Mac has remained a privately owned company since 1989. The Federal Home Loan Mortgage Corporation Act, as amended, is Freddie Mac's Charter Act and is codified as 12 U.S.C. §1451, *et seq*.

26. By 2008, Fannie Mae and Freddie Mac were two of the largest privately-owned financial corporations in the world. Together, they owned or guaranteed more than $5.3 trillion in mortgages, amounting to 47% of all residential mortgages in the United States, and, at that time "equal to the publicly held debt of the United States." James Lockhart III, Dir., FHFA, Statement Before the Senate Committee on Banking, Housing, and Urban Affairs, on the Appointment of FHFA as Conservator for Fannie Mae and Freddie Mac (Sept. 23, 2008). In the first half of 2008, their combined market share of all new mortgages was 76%. *Id.* Prior to the financial crisis of 2008, the Companies' businesses were self-sustaining and funded exclusively with private capital.

27. Both Companies issued common stock listed on the New York Stock Exchange and numerous series of non-cumulative preferred stock. Until 2008, each Company regularly declared and paid quarterly dividends to its common shareholders. Fannie Mae paid a dividend on its common stock every quarter from at least 1983 up to and including the third quarter of 2008. Freddie Mac paid a dividend on its common stock every quarter from at least the second quarter of 1989 up to and including the second quarter of 2008.

B. <u>The Financial Crisis and the Enactment of HERA</u>

28. After decades of consistent profits, the Companies were well-positioned to weather the financial crisis of 2008. While banks and other financial institutions involved in the mortgage markets had heavily invested in increasingly risky mortgages in the years leading up to the financial crisis, the mortgages that the Companies insured—primarily 30-year fixed rate conforming mortgages—were far safer than those held by the nation's largest banks. In 2007, when their "financial results suffered along with the results of other financial institutions," they reported "Freddie Mac's first annual net loss ever, and Fannie Mae's first since 1985." OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, REPORT TO CONGRESS 10 (2008). But the Companies

continued to generate enough cash to easily pay their debts; they retained billions of dollars of capital; and they also had ready access to credit.

29. The Companies' regulator at that time, the Office of Federal Housing Enterprise Oversight ("**OFHEO**"), expressed confidence that the Companies were fundamentally sound and attributed the 2007 losses to "turmoil in the housing and mortgage markets, loss of liquidity in the credit markets, and volatility in the capital markets [that] adversely impacted the financial performance of financial institutions in general, and in particular, the financial performance of institutions with significant exposure to mortgage markets." OFHEO, REPORT TO CONGRESS 10 (2008).

30. In March 2008, OFHEO Director James Lockhart III announced that "Fannie Mae and Freddie Mac … both … have prudent cushions above the OFHEO-directed capital requirements and have increased their reserves. We believe they can play an even more positive role in providing the stability and liquidity the markets need right now." Information Statement Supplement, OFHEO, Fannie Mae and Freddie Mac Announce Initiative to Increase Mortgage Market Liquidity (Mar. 19, 2008). On July 10, 2008, Lockhart again affirmed that the Companies were "adequately capitalized, holding capital well in excess of [regulatory requirements]," with "large liquidity portfolios, access to the debt market and over $1.5 trillion in unpledged assets." Press Release, James B. Lockhart III, Dir., OFHEO (July 10, 2008). Director Lockhart dismissed the idea of a bailout as "nonsense in my mind. The companies are safe and sound, and they will continue to be safe and sound." *As Crisis Grew, A Few Options Shrank To One*, N.Y. TIMES, Sept. 7, 2008.

31. Director Lockhart's assessment that the Companies were adequately capitalized was confirmed by Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben

Bernanke, who both testified before Congress in July 2008 that Fannie Mae and Freddie Mac were adequately capitalized. According to Secretary Paulson, Fannie Mae and Freddie Mac were "working through this challenging period" and "[t]heir regulator has made clear that they are adequately capitalized." *Paulson and Bernanke Seek Reforms*, N.Y. TIMES, July 11, 2008. Paulson urged "primary focus [on] supporting Fannie Mae and Freddie Mac in their current form as they carry out their important mission." Press Release, U.S. Dep't of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Fannie Mae and Freddie Mac (July 11, 2008). Indeed, in addition to their own capital cushions, the Companies also had easy access to financing because the Federal Reserve Bank of New York was granted the authority to lend to the Companies "at the primary credit rate" "should such lending prove necessary." Press Release, Federal Reserve, Board of Governors of the Federal Reserve System, Board grants Federal Reserve Bank of New York the authority to lend to Fannie Mae and Freddie Mac should such lending prove necessary (July 13, 2008).

32. Despite the financial stability of the Companies, HERA was enacted in July 2008 as part of Congress' response to the deepening financial crisis. During debate on this legislation, Senator Johnny Isakson emphasized that HERA was "not a bailout," but rather "an infusion of confidence the financial markets need" to overcome unfair "perception" of Fannie Mae and Freddie Mac, which were not "the institutions that made bad loans." He argued:

> If anybody would take the time to go look at the default rates, for example, they would look at the loans Fannie Mae holds, and they are at 1.2 percent, well under what is considered a normal, good, healthy balance. The subprime market's defaults are in the 4 to 6 to 8-point range. That is causing the problem. That wasn't Fannie Mae paper, and it wasn't securitized by Fannie Mae. They have $50 billion in capital, when the requirement is to have $15 billion, so they are sound. But the financial markets, because of the collapse of the mortgage market, have gotten worse.

Johnny Isakson, U.S. Senator, Floor Statement on Housing Stimulus Legislation, Statement Before

U.S. Senate (July 25, 2008). Treasury Secretary Paulson likewise described HERA as a measure intended to build confidence in the market: "If you've got a bazooka, and people know you've got it, you may not have to take it out." Andrew Ross Sorkin, *Paulson's Itchy Finger, on the Trigger of a Bazooka*, N.Y. TIMES, Sept. 9, 2008.

33. Among other things, HERA replaced the Companies' regulator, OFHEO, with FHFA and gave FHFA authority to act as "receiver" or "conservator" of the Companies, 12 U.S.C. §§4511, 4617(a). HERA provided that FHFA's director could place the Companies into either a conservatorship or receivership on specified "grounds," including if a Company's assets are less than its obligations to creditors, if a Company is in an "unsafe or unsound condition to transact business," or with the consent of a Company's Board of Directors. *See* 12 U.S.C. §4617(a)(2)-(3).

34. In creating this statutory scheme, Congress decided that FHFA would have a different role and different duties if it acted as conservator than if it acted as receiver. *See* 12 U.S.C. §4617(a), (b). HERA's plain language confirms that the statutory roles of "conservator" and "receiver" are mutually exclusive. HERA uniformly refers to appointment of FHFA to the role of "conservator <u>or</u> receiver." 12 U.S.C. §4617(a)(1)-(3), (5)-(7) (emphasis added); *id.* §4617(b)(2), (10)-(19); *id.* §4617(d)(1)-(11), (13), (15); *id.* §4617(g)(1), and <u>never</u> refers to "conservator <u>and</u> receiver." HERA provides that "[r]eceivership terminates conservatorship. … The appointment of the Agency as receiver of a regulated entity under this section shall immediately terminate any conservatorship established for the regulated entity under this chapter." 12 U.S.C. §4617(a)(4)(D)).

35. Further, HERA defines the different circumstances under which FHFA may be appointed conservator or receiver, the distinct policies and procedures governing conservatorship and receivership, the respective powers appurtenant to the roles of conservator and receiver, and

the precise extent to which those powers are shared or exclusive to one role or the other. As FHFA's notice promulgating regulations implementing the statute explains, "the ultimate responsibility of FHFA as receiver is to resolve and liquidate the existing entity," whereas "[a] conservator's goal is to continue the operations of a regulated entity, rehabilitate it and return it to a safe, sound and solvent condition. … These activities of a conservator may not be aligned with the ultimate duty of a receiver[.]" Conservatorship and Receivership, 76 Fed. Reg. 35,724, 35,730 (June 20, 2011).

36. HERA expressly limits FHFA's "powers as conservator" to "such action as may be–(i) necessary to put the regulated entity in a sound and solvent condition; and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity." 12 U.S.C. §4617(b)(2)(D). This statutory language was based on parallel statutory language describing a conservatorship under the Federal Deposit Insurance Act, *see* 12 U.S.C. §1821(d)(2)(D)—language which itself incorporated a long history of rights and duties. For centuries, the law has treated "conservators" as trustees, with a duty to conserve the assets of their ward. Thus, under HERA and the common law on which it is based, conservatorship is a process designed to stabilize a troubled institution with the objective of returning it to normal business operations. Like any conservator, when FHFA acts as a conservator under HERA, it has a duty to safeguard the interests of the Companies and all their shareholders. *See* 12 U.S.C. §4617(b)(2)(D).

37. In contrast, HERA provides that, "[i]n any case in which the Agency is acting as receiver, the Agency shall place the regulated entity in liquidation and proceed to realize upon the assets of the regulated entity in such manner as the Agency deems appropriate" pursuant to its "additional powers as receiver." 12 U.S.C. §4617(b)(2)(E) (emphasis added). In HERA, Congress

set out detailed procedures for FHFA as receiver—but not as conservator—to: (1) liquidate the Companies, (2) determine claims arising from their liquidation, and (3) transfer the Companies' assets to a limited-life regulated entity. *See, e.g.*, 12 U.S.C. §4617(b)(2)E), (b)(2)(K), (b)(3)-(9), (c), (i).

38. HERA also gave Treasury temporary authority to stabilize Fannie Mae or Freddie Mac, if defined "emergency" circumstances so warranted, by purchasing their securities. 12 U.S.C. §§1455(*l*)(1)(A), 1719(g)(1)(A). That authority ended on December 31, 2009. 12 U.S.C. §§1455(*l*)(1)(A), (*l*)(5); 1719(g)(1)(A), (g)(5). In connection with any use of HERA authority, Congress required the Secretary of the Treasury to consider factors including: "[t]he [Companies'] plan[s] for the orderly resumption of private market funding or capital market access"; "[t]he probability of the [Companies'] fulfilling the terms of any such obligation or other security, including repayment"; and "[t]he need to maintain the [Companies'] status as [] private shareholder-owned compan[ies]." *Id*. §§1455(l)(1)(C), 1719(g)(1)(C).

39. HERA effected Congress' policy decision that FHFA may only place a Company "in liquidation" by "winding up" its affairs as a receiver. 12 U.S.C. §4617(b)(2)(E), (b)(3)(B). Otherwise, the Companies maintained their status as private shareholder-owned entities that, as conservator, FHFA was obliged—in the tradition of a common law conservator—to "put" in "a sound and solvent condition." 12 U.S.C. §4617(b)(2)(D). Treasury was not authorized to purchase securities from the Companies unless it considered the "need to maintain [their] status as a private shareholder-owned company." 12 U.S.C. §§1455(*l*)(l)(A)-(C), 1719(g)(1)(A)-(C). Nor did HERA amend the Fannie Mae and Freddie Mac Charter Acts, which mandated that the Companies would be privately owned. *See* 12 U.S.C. §§1718(a), 1453(a). Rather, HERA explicitly provided that

"[i]n no case may" a HERA-appointed receiver "revoke, annul, or terminate" the Charter Acts which provided for the Companies' private ownership. *See* 12 U.S.C. § 4617(k).

C. <u>September 6, 2008: The Companies are Placed in Conservatorship</u>

40. In the weeks after HERA's enactment, the Companies' financial condition remained sound. In August 2008, the Companies issued their financial statements which reflected that as of the end of June 2008, Fannie Mae's assets exceeded its debts by over $41 billion and that Freddie Mac's assets exceeded its debts by nearly $13 billion. Fannie Mae's Board of Directors declared dividends on the Company's preferred and common stock out of cash available for distribution in August 2008, showing their confidence that Fannie Mae was solvent and healthy. On August 22, 2008, FHFA confirmed that Fannie Mae and Freddie Mac were adequately capitalized, even under additional capital requirements imposed by FHFA under its risk-based capital stress test. *See* Letter from Christopher H. Dickerson, Acting Deputy Dir., FHFA, to Daniel H. Mudd, President and Chief Exec. Officer, Fannie Mae (Aug. 22, 2008); Letter from Christopher H. Dickerson, Acting Deputy Dir., FHFA, to Richard F. Syron, Chairman and Chief Exec. Officer, Freddie Mac (Aug. 22, 2008). In September 2008, after the conservatorships were in place, FHFA and Treasury—well aware that a company may not legally pay dividends when it is insolvent or that would render it insolvent—confirmed that Fannie Mae was financially sound by consenting to its payment of the dividends declared in August 2008.

41. Although the Companies were solvent, on September 6, 2008, FHFA, at Treasury's behest, forced the Companies into conservatorship. As former Secretary Paulson has explained, Treasury was the driving force behind the imposition of the conservatorships: "FHFA had been balky all along [about the imposition of a conservatorship]… We had to convince its people that [conservatorship] was the right thing to do, while making sure to let them feel they were still in charge." HENRY M. PAULSON, ON THE BRINK 36 (2d ed. 2013). FHFA and Treasury gave the

Companies' boards "a Hobson's choice": agree to conservatorship, or they would face "nasty lawsuits" and Treasury would refuse to provide the Companies with any capital if they needed it. THE FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT 320 (Jan. 2011). The boards acquiesced.

42. Upon appointment of FHFA as conservator, the Government assumed control over Fannie Mae and Freddie Mac pursuant to HERA's provision for FHFA's succession, "by operation of law" and "immediately," to "all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity with respect to the regulated entity and the assets of the regulated entity," and to "title to the books, records, and assets of any other legal custodian of such regulated entity." 12 U.S.C. §4617(b)(2)(A).

43. FHFA Director Lockhart attributed the abrupt decision to impose conservatorship to market conditions that threatened the Companies' "public purpose"—their "critical mission of providing stability, liquidity, and affordability to the housing market." James B. Lockhart III, Dir., FHFA, Statement Before the Senate Committee on Banking, Housing, and Urban Affairs on the Appointment of FHFA as Conservator for Fannie Mae and Freddie Mac (Sept. 23, 2008). Lockhart explained: "<u>[A]ffordable housing and mission enforcement … rank among our most immediate concerns</u> in making the determination to place the Enterprises into conservatorship … <u>[C]easing new business activity and shedding assets was not acceptable, especially given the Enterprises' public purpose</u>." *Id.* (emphasis added).

44. In announcing the conservatorships, FHFA explicitly denied any intention to liquidate the Companies or wind down their businesses—and any power, as a HERA conservator, to do so. FHFA explained that a "conservatorship 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" and "[a] Conservator is the person or entity appointed to oversee the affairs of a Company for the purpose of bringing the Company back to financial health." FHFA, Questions and Answers on Conservatorship, at 1 (Sept. 7, 2008). FHFA stated that the conservatorships would be temporary and that "[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, the Director will issue an order terminating the conservatorship. …" *Id.* at 2. FHFA made clear that "[u]nder a conservatorship, the Compan[ies are] not liquidated" and that "[t]here are no plans to liquidate" them. *Id.* at 3. FHFA also represented that, notwithstanding conservatorship, the Companies' "stock will continue to trade" and "[s]tockholders will continue to retain all rights in the stock's financial worth, as such worth is determined by the market." *Id*.

D. September 7, 2008: Treasury's Purchase of Government Preferred Stock

45. On September 7, 2008, FHFA, acting as the Companies' conservator, and Treasury, exercising its HERA authority to purchase the Companies' securities, agreed on terms for Treasury's purchase of the Government Preferred Stock. The PSPAs between Treasury and each Company are identical in all material respects. In the PSPAs, Treasury committed to provide each Company with up to $100 billion, as needed to maintain that Company's positive net worth. For quarters in which either Company's liabilities exceeded its assets under Generally Accepted Accounting Principles, the PSPAs authorized each Company to drawn on Treasury's commitment in an amount equal to the difference between its liabilities and assets.

46. In exchange, each Company gave Treasury one million shares of the newly-created Government Preferred Stock and a warrant to purchase 79.9% of the common stock of that Company at a nominal price. If exercised, the warrants would give Treasury up to 79.9% of the Companies' future profits, subject to the Companies' obligation to satisfy their dividend obligations under the PSPAs and other series of preferred shares, while leaving the remaining

20.1% of profits with the Companies' private shareholders. As Treasury observed upon entering the PSPAs, the warrants provided "potential future upside." Action Memorandum for Secretary Paulson from Anthony W. Ryan, Acting Under Secretary for Domestic Fin., Dep't. of the Treasury (Sept. 7, 2008).

47. Each of the PSPAs (i) had an initial face value of $1 billion, to be increased by the amount of its issuer's draws against Treasury's funding commitment; (ii) ranked senior in priority to any other series of the issuing Company's preferred stock; and (iii) had a liquidation preference equal to $1,000 per share (for an aggregate of $1 billion each), plus the sum of all draws by that Company against the funding commitment.

48. Additionally, each of the PSPAs earned an annual dividend, payable quarterly, which gave Treasury the right to receive, at the Companies' election, either (i) a cash dividend, payable at a rate equal to 10% of the outstanding liquidation preference per year; or (ii) a "payment in kind" in the form of an increase in the amount of Treasury's liquidation preference, equivalent to a rate equal to 12% of the outstanding liquidation preference per year. If the Companies elected to make a payment in kind, then the dividend rate for all dividends would increase to 12% per year, until the Company paid all cumulative dividends in cash, at which point, the rate would return to 10%. The payment in kind option meant that the Companies were never required to pay a cash dividend, as Treasury and FHFA both knew. *See, e.g.*, Press Release, U.S. Treasury Dep't Office of Pub. Affairs, Fact Sheet: Treasury Senior Preferred Stock Purchase Agreement (Sept. 7, 2008) ("The rate shall increase to 12% if, in any quarter, the dividends are not paid in cash …"); Treasury Presentation to SEC, GSE Preferred Stock Purchase Agreements (PSPA) Overview and Key Considerations, at 9 (June 13, 2012) ("Dividend Rate Cash 10%; if elected to be paid in kind ('PIK') 12%"). If exercised, the payment in kind option would not decrease Treasury's funding

commitment under the PSPAs because it did not constitute "funding under the Commitment." PSPA §1 (definition of "Maximum Amount").

49. The PSPAs provided that, starting in March 2010, the Companies would pay Treasury a quarterly commitment fee (the "**Periodic Commitment Fee**"), "intended to fully compensate [it] for the support provided by the ongoing Commitment." PSPA §3.2(b). The PSPAs did not specify the fee; rather, they provided that the fee would be "determined with reference to the market value of the Commitment" every five years and "mutually agreed" by Treasury and each Company. *Id.* at §3.2(b). They also provided that Treasury could "waive" the fee "for up to one year at a time, in its sole discretion, based on adverse conditions in the United States mortgage market." *Id.* Treasury waived the Periodic Commitment Fee every year.

50. The PSPAs and the Government Stock Certificates explicitly contemplate that the Companies could pay down the liquidation preference and that when it is paid down "in full, such [Government Preferred Stock] shares shall be deemed to have been redeemed." Fannie Mae and Freddie Mac Government Preferred Stock Certificates §§3(c), 4(c). Indeed, the PSPAs were "structure[d]" to "enhance the probability of both Fannie Mae and Freddie Mac ultimately repaying amounts owed." Action Memorandum for Secretary Paulson from Antony W. Ryan, Acting Under Secretary for Domestic Fin., Dep't. of the Treasury (Sept. 7, 2008). Nevertheless, as long as Treasury's commitment remains outstanding, the PSPAs do not permit the Companies to repay amounts drawn from Treasury. *See* Fannie Mae and Freddie Mac Government Stock Certificates §3(a).

51. In approving the exercise of Treasury's temporary authority under HERA to purchase securities of the Companies, Treasury Secretary Paulson determined (1) "[u]nder conservatorship, Fannie Mae and Freddie Mac will continue to operate as going concerns"; (2)

"Fannie Mae and Freddie Mac may emerge from conservatorship to resume independent operations"; and (3) "[c]onservatorship preserves the status and claims of the preferred and common shareholders." Action Memorandum for Secretary Paulson from Antony W. Ryan, Acting Under Secretary for Domestic Fin., Dep't. of the Treasury (Sept. 7, 2008).

52. When Treasury announced the PSPAs, Treasury Secretary Paulson emphasized: "These agreements support market stability by providing additional security and clarity to GSE debt holders … and support mortgage availability by providing additional confidence to investors in GSE mortgage backed securities. This commitment will <u>eliminate any mandatory triggering of receivership</u> and will ensure that the conserved entities have the ability to fulfill their financial obligations." Press Release, U.S. Dep't of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008). Secretary Paulson emphasized: "Given the combination of actions we are taking, including the Preferred Share Purchase Agreements, <u>we expect the GSEs to be in a stronger position to fund their regular business activities in the capital markets</u>." *Id. See also* Press Release, U.S. Dep't of Treasury, Fact Sheet: Treasury Senior Preferred Stock Purchase Agreement (Sept. 7, 2008) (PSPAs "add[ ] to market stability," "provide additional confidence to investors," and "eliminate … triggering of receivership"); U.S. Dep't of the Treasury, FY 2010 BUDGET IN BRIEF, at 77 (2009) ("T]he function of the PSPAs is to instill confidence in investors that Fannie Mae and Freddie Mac will remain viable entities critical to the functioning of the housing and mortgage markets.").

53. The terms of the Government Preferred Stock were revised twice prior to the statutory date—December 31, 2009—for the expiration of Treasury's temporary authority to purchase new securities under HERA. In the first amendment ("**First Amendment**"), on May 6,

2009, Treasury and FHFA increased Treasury's funding commitment from $100 billion to $200 billion for each Company. Announcing the First Amendment to the PSPAs, Treasury Secretary Geithner reiterated Treasury's belief that "<u>Fannie Mae and Freddie Mac are critical to the functioning of the housing finance system in this country</u> and play a key role in making mortgage rates affordable and maintaining the stability and liquidity of our mortgage market," and Treasury's intention to "provide assurance to market participants that Congress gave these companies a special purpose to support housing finance [and] … we stand firmly behind their ability to provide that support." Press Release, U.S. Dep't of the Treasury, Statement by Secretary Tim Geithner on Treasury's Commitment to Fannie Mae and Freddie Mac (Feb. 18, 2009). Secretary Geithner stressed: "The increased funding will provide <u>forward-looking confidence</u> in the mortgage market and enable Fannie Mae and Freddie Mac to carry out ambitious efforts to ensure mortgage affordability for responsible homeowners." *Id.* (emphasis added).

54. In the second amendment ("**Second Amendment**"), on December 24, 2009, Treasury and FHFA replaced the $200 billion fixed cap with a formula to allow Treasury's total commitment to each Company to exceed (but not fall below) $200 billion, depending upon the Companies' finances up until December 31, 2012. In an action memorandum regarding the Second Amendment, Treasury stated that the amendment was intended as "a strong statement that the U.S. Government will make sure that these institutions continue to function" and that "[i]t is unlikely that either [Company] will reach the $200 billion existing cap unless the housing market worsens sharply from here."

55. Before executing the First and Second Amendments, Treasury made the findings and addressed the considerations required in connection with Treasury's exercise of its authority to "purchase any obligations and other securities" under HERA. *See* 12 U.S.C. §§1455(*l*)(l)(B)-

(C), 1719(g)(1)(B)-(C). These considerations included addressing "the need to maintain the regulated entities' status as private-shareholder owned companies." In its December 22, 2009 Action Memorandum for Secretary Geithner regarding the Second Amendment, Treasury recognized the limits HERA placed on its authority to change the terms of the PSPAs after December 31, 2009, explaining: "Treasury's authority to purchase [the Companies'] obligations and securities expires at year end. Therefore, after December 31, <u>our ability to make further changes to the PSPAs</u>, particularly with respect to the commitment amount, <u>is constrained</u>."

56. Between September 2008 and August 2012, the Companies' drew $187.5 billion from Treasury's commitment, increasing Treasury's liquidation preference from $2 billion to $189.5 billion. Their $187.5 billion draws on Treasury's funding commitment were necessitated mainly by conditions arising from the conservatorship itself. Specifically, FHFA ordered the Companies to declare large non-cash losses in the value of deferred tax assets and to book substantial loan loss reserves. Notwithstanding the accounting losses, by the end of 2012, both Companies were sufficiently profitable to pay the Government dividends from available cash. *See infra*.

57. During this time period, FHFA, working with Treasury, used its supervision of the Companies and their continued role in the mortgage market to "ensure[] the secondary mortgage market kept functioning," to "[e]nsur[e] families have access to mortgages to buy a home or refinance an existing mortgage," and to "[o]ffer[ ] borrowers in trouble on their mortgage an opportunity to modify their loan or other options to avoid foreclosure." FHFA, 2011 REPORT TO CONGRESS 1 (June 13, 2012).

E. <u>Early 2011: The Government Advocates Winding Down the Companies</u>

58. Under HERA, FHFA was congressionally authorized to act as a conservator by conserving the assets of the private shareholder-owned Companies and building up their capital

reserves to put them in "a sound and solvent condition." But as early as December 2010, an internal Treasury memorandum articulated the Administration's "commitment to ensure existing common equity holders will not have access to any positive earnings from the [Companies] in the future." Action Memorandum for Secretary Geithner from Jeffrey A. Goldstein, Under Secretary for Domestic Fin., Dep't of the Treasury (Dec. 20, 2010).

59. In a February 2011 White Paper, Treasury proposed the "orderly and deliberate wind down of Fannie Mae and Freddie Mac." U.S. DEP'T OF THE TREASURY, REFORMING AMERICA'S HOUSING FINANCE MARKET: A REPORT TO CONGRESS 2 (2011). Arguing that the "role of government in the housing market … should be limited," Treasury advocated "winding down Fannie Mae and Freddie Mac and reducing other government support to the housing market," and recommended that FHFA "employ a number of policy levers … to bring private capital back into the mortgage market and reduce taxpayer risk." *Id.* at 1-2. Treasury stated that "[t]he Administration will work with FHFA to determine the best way to responsibly reduce Fannie Mae and Freddie Mac's role in the market and ultimately wind down both institutions." *Id.* at 1.

60. Treasury's proposal to wind down the Companies contradicted its previously stated intent to place the Companies "in a stronger position to fund their regular business activities in the capital markets." Press Release, U.S. Dep't of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008). The proposal was also contrary to FHFA's position that the "statutory purpose of conservatorship is to preserve and conserve each company's assets and put them in a sound and solvent condition … [and] enhance their capacity to fulfill their mission." Edward J. DeMarco, Acting Dir., FHFA, Statement Before the U.S. House of Representatives Subcomm. on Capital Mkts., Ins., and Gov't-Sponsored Enters. on the Future of Housing Finance:

A Progress Update on the GSEs (Sept. 15, 2010). *See also, e.g.*, James B. Lockhart III, Dir., FHFA, Statement Before the Fin. Servs. Subcomm. on Capital Mkts., Ins., and Gov't-Sponsored Enters. on the Present Condition and Future Status of Fannie Mae and Freddie Mac (June 3, 2009) ("As the conservator, FHFA's most important goal is to preserve the assets of Fannie Mae and Freddie Mac over the conservatorship period. That is our statutory responsibility."); Letter from Edward J. DeMarco, Acting Dir., FHFA, to Christopher Dodd, Chairman, Comm. on Banking, Hous., and Urban Affairs, et al. (Feb. 2, 2010) ("FHFA is focused on conserving the [Companies'] assets" and "put[ting] [them] in a sound and solvent condition"; "the only [post-conservatorship option] that FHFA may implement today under existing law is to reconstitute the two companies under their current charters").

61. FHFA's public response to the Treasury White Paper paid lip service to its commitment to "the goals of the conservatorships, which include retaining value in the Enterprises' business operations." Edward DeMarco, Acting Dir., FHFA, Statement on the Administration's Housing Finance Report (Feb. 11, 2011). But FHFA agreed with Treasury that "the next chapter" in the housing market policy should "reduc[e]" the Companies' "dominant position in holding mortgage credit risk" and "encourage" "private capital" "back into that role." FHFA, A STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIPS: THE NEXT CHAPTER IN A STORY THAT NEEDS AN ENDING 4 (Feb. 21, 2012). FHFA explained that—instead of operating the Companies with the goal of rebuilding their capital and returning them to private control—"the unanticipated length of the conservatorships poses additional risks for taxpayers and markets not contemplated by HERA … best managed by contracting the [Companies'] footprint in the marketplace." *Id.* at 9.

62. FHFA nevertheless recognized that it did not have authority under HERA to achieve its policy goals: "The final chapter," FHFA conceded, "remains the province of lawmakers. Fannie Mae and Freddie Mac were chartered by Congress and by law, only Congress can abolish or modify those charters and set forth a vision for a new secondary market structure." FHFA, A STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIPS: THE NEXT CHAPTER IN A STORY THAT NEEDS AN ENDING 4, 20 (Feb. 21, 2012). FHFA has since repeatedly acknowledged that "lawmakers" must "determine the ultimate resolution of the conservatorships and the future legal structure for housing finance" and that, without legislative changes to HERA, FHFA remains "<u>constrained by law to conserve and protect Enterprise assets</u>." FHFA, 2011 PERFORMANCE AND ACCOUNTABILITY REPORT 31 (Nov. 14, 2011) (emphasis added). *See also* Letter from Edward J. DeMarco, Acting Dir., FHFA, to Senate (Nov. 10, 2011) ("<u>By law, the conservatorships are intended to rehabilitate the Enterprises as private firms</u>. … [T]he best assistance Congress could give FHFA on th[e] matter [of reform] is … to take action to provide a clear path forward to end the conservatorships … .") (emphasis added); FHFA, 2011 REPORT TO CONGRESS, at 8 (June 13, 2012) ("Fannie Mae and Freddie Mac were chartered by Congress and by law, <u>only Congress can abolish or modify those charters</u> … .") (emphasis added).

F. <u>The Companies' Return to Profitability in 2012</u>

63. By 2012, the housing market had revived and, with it, so did the Companies' fortunes. Defying FHFA's 2008 projections, in early August 2012 the Companies reported combined profits of more than $13 billion in the first two quarters of 2012.

64. In addition to increased earnings, the Companies' balance sheets also benefited from reversal of the excessive loan loss reserves that they had been forced to take early in the conservatorships because the Companies' loans suffered far fewer losses than FHFA had caused the Companies to estimate. On August 8, 2012, Fannie Mae reported second quarter income of

$5.4 billion, up from a $2.9 billion loss in the second quarter of 2011—largely attributable to a decrease in loan loss reserves. *See* Fannie Mae, Quarterly Report (Form 10-Q), at 3 (Aug. 8, 2012). Freddie Mac's income in the second quarter of 2012 was $2.9 billion, compared to a $1.1 billion loss for the second quarter of 2011. Freddie Mac's "provision for credit losses declined to $0.2 billion in the second quarter of 2012, compared to $2.5 billion in the second quarter of 2011, and was $2.0 billion in the first half of 2012 compared to $4.5 billion in the first half of 2011." Freddie Mac, Quarterly Report (Form 10-Q), at 1, 15 (Aug. 7, 2012).

65. That increased profitability allowed the Companies to begin paying Treasury's dividends from available cash. In the second quarter of 2012, the Companies paid Treasury's $4.7 billion quarterly dividend using their combined quarterly profit of $8.3 billion. Fannie Mae, Quarterly Report (Form 10-Q), at 2-3, 54 (Aug. 8, 2012); Freddie Mac, Quarterly Report (Form 10-Q), at 1 (Aug. 7, 2012).

66. By early 2013, Fannie Mae announced that its "financial results improved significantly in 2012, and we expect our annual earnings to remain strong over the next few years." Fannie Mae, Annual Report (Form 10-K), at 1 (Apr. 2, 2013). It announced that, among other things, a $14.3 billion decrease in loan loss reserves during 2012 contributed to "$17.2 billion in net income in 2012, the largest in our company's history and our first annual net income since 2006." *Id.* at 3, 5. Freddie Mac reported 2012 net income of $11.0 billion, compared to a net loss of $5.3 billion for the year 2011. The improvement was aided by "loan loss reserves declin[ing] in every quarter," from $10.7 billion at the end of 2011 to $1.9 billion at the end of 2012. Freddie Mac, Annual Report (Form 10-K), at 3, 10-11 (Feb. 28, 2013).

67. The Government was well-aware of the Companies' improved earning prospects even before their second quarter results were released. [redacted]

[redacted] On July 13, 2012, DeMarco and others at FHFA received minutes of a Fannie Mae executive management meeting reporting: "Current projections show that cumulative GSE dividends paid will surpass cumulative Treasury draws by 2020. … [T]he next 8 years are likely to be 'the golden years of GSE earnings.'" An August 9, 2012 email to DeMarco reported that: "For the first quarter since Fannie and Freddie entered conservatorship, both GSE's ha[d] a positive net worth at the end of 2Q12. ... [L]ast quarter, … both had net income firmly in the black … . This convincing return to profitability is the result of several factors ... ." And an August 9, 2012 "Fannie Mae Update" presentation to Treasury includes a graph of "Cumulative GSE Dividend Payments vs. Cumulative SPSPA Draws," which projects 2020 Cumulative Dividend Payments to Treasury (by both GSEs) exceeding Cumulative SPSPA Draws by $17 billion.

68. The Government also was specifically aware of the effect on the Companies' balance sheets of the reduced loan loss reserves and of income anticipated from removal of the valuation allowance against deferred tax assets:

- [redacted]
- In July 2012, Treasury officials were briefed on "how quickly [the Companies] forecast releasing credit reserves," and understood that releases of loan loss reserves could "increase the [Companies'] net [worth] substantially."
- [redacted]

- [redacted]
- An August 9, 2012 Treasury briefing on Freddie Mac has the handwritten notation: "expect material release of loan loss reserves in the future."

G. <u>August 2012: The Government Imposes Net Worth Sweeps</u>

69. On August 17, 2012, soon after it became clear that the Companies had regained their profitability, Treasury and FHFA announced their agreement to fundamentally change the terms of the PSPAs by executing the Third Amendment. The Third Amendment increased the dividend on the Government Preferred Stock from 10% of Treasury's liquidation preference (by then a combined $4.7 billion quarterly) to the Net Worth Sweep, which equals 100% of each Company's net worth, minus a capital reserve that starts at $3 billion and would decline to zero in 2018. The dividend is payable quarterly, in cash. If a Company's net worth includes non-cash assets, it must sell non-liquid assets or issue debt to pay the dividend. The Third Amendment also suspended the Periodic Commitment Fee.

70. Since "dividend payments do not offset prior Treasury draws," the Net Worth Sweeps ensure that the Companies will never be free of their debt, the principal of which will never decrease. *See* Press Release, Fannie Mae, Fannie Mae Reports Pre-Tax Income of $8.1 Billion for First Quarter 2013 (May 9, 2013); Press Release, Freddie Mac, Freddie Mac Reports Net Income of $4.6 Billion; Comprehensive Income of $7.0 Billion for First Quarter 2013 (May 8, 2013). In other words, no matter how profitable the Companies become, or how large the

dividend payments, all of the $189.5 billion then-owed on the Government Preferred Stock will remain outstanding, and Treasury will continue to make its quarterly sweep of all of the Companies' net worth for as long as they remain in business.

71. Moreover, Treasury's liquidation preference includes the amount of all unpaid dividends. The Net Worth Sweeps therefore guarantee that if and when the Companies are liquidated, Treasury will receive all of their remaining net worth. *See, e.g.*, Fannie Mae, Annual Report (Form 10-K), at 37 (Feb. 17, 2017) ("If we are liquidated, we believe it is unlikely that there would be sufficient funds remaining after payment of amounts to our creditors and to Treasury as holder of the senior preferred stock to make any distribution to holders of our common stock and other preferred stock.").

72. The Third Amendment gave the Companies no meaningful consideration for their agreement to give Treasury all of their net worth. Replacing the PSPAs' fixed dividends with the Net Worth Sweeps did not improve the Companies' financial circumstances under any scenario. Under the Net Worth Sweeps, (1) if the Companies' profits exceed the 10% dividend owed under the original PSPAs, they always pay more to Treasury than 10%, but can never build capital to repay Treasury's liquidation preference, and (2) if the Companies' profits do not exceed the 10% dividend owed under the original PSPAs, they still pay their entire net worth to Treasury and still cannot build capital or repay the Treasury's liquidation preference. By contrast, under the original PSPAs, (1) if the Companies' profits exceed the 10% dividend, they pay only 10% to Treasury, and can retain the balance to build capital to repay Treasury's liquidation preference, and (2) if the Company's profits do not exceed 10%, HERA does not permit the Companies to pay Treasury more than their net worth in cash toward Treasury's cash. *See* 12 U.S.C. §4614(e)(1) ("A regulated

entity shall make no capital distribution if, after making the distribution, the regulated entity would be undercapitalized.”).

73. Nor did the Third Amendment benefit the Companies by “eliminat[ing] the need for Fannie Mae and Freddie Mac to continue to borrow” from Treasury to pay dividends, as FHFA and Treasury have claimed. Edward J. DeMarco, Acting Dir., FHFA, Statement on Changes to Fannie Mae and Freddie Mac Preferred Stock Purchase Agreements (Aug. 17, 2012); *see also* Press Release, U.S. Dep’t of the Treasury, Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac (Aug. 17, 2012) (identifying “Ending the circular practice of the Treasury advancing funds to the GSEs simply to pay dividends back to Treasury” as one of the objectives of the Third Amendment). There was no risk of a debt spiral because the Companies had the option to pay dividends in kind, rather than in cash, before the Third Amendment. *See* Treasury Presentation to SEC, GSE Preferred Stock Purchase Agreements (PSPA) Overview and Key Considerations, at 9 (June 13, 2012) (“Dividend Rate Cash 10%; if elected to be paid in kind (‘PIK’) 12%”). [redacted]

74. The Government has since argued that the Companies benefitted from the Third Amendment’s suspension of the Periodic Commitment Fee, but this argument is litigation pretext. The Third Amendment suspended the Periodic Commitment Fee only so long as the Net Worth Sweeps were in place. *See* Third Amendment ¶4. When planning the Third Amendment, Treasury internally acknowledged that because Treasury would “capture all future net income and asset appreciation at the [Companies]” under the Net Worth Sweep, “no purpose [would be] served by

requiring additional compensation to taxpayers" through the Periodic Commitment Fee. Action Memorandum for Secretary Geithner from Michael Stegman, Counselor, Dep't of the Treasury (Aug. 15, 2012). Tellingly, FHFA did not bother to estimate the value of the Periodic Commitment Fee before entering into the Third Amendment. That is not surprising because Treasury had always waived the Periodic Commitment Fee, repeatedly acknowledging that the fee would not "generat[e] increased compensation to the American taxpayer." Given the Companies' return to profitability by August 2012, there was no need for the ongoing commitment, nor to further compensate Treasury therefor: Treasury was earning a 10% return on the money the Companies had drawn from it and was entitled to 79.9% of the Companies' common stock, enabling it to fully participate in and benefit from the Companies' return to profitability. And if a fee had ever been set at market rate in accordance with the terms of the original PSPA, the Companies had sufficient market power to pass the entire amount of this fee through to their customers—as the Companies do for other operating and financing costs—without affecting the profitability of the Companies.

75. The Third Amendment was imposed on the Companies by the Government. Treasury [redacted] and was the architect of the Third Amendment. [redacted] By that point, as expressed by Treasury Secretary Geithner, Treasury "had already effectively nationalized the GSEs [ ], and could decide how to carve up, dismember, sell or restructure those institutions." *Starr Int'l Co. v. United States*, No. 1:11-cv-779-TCW, Trial Transcript at 1446:7-9 (Fed. Cl. March 2, 2015), ECF No. 346. Or, in the words of his predecessor, Secretary Paulson, "seizing control" of the Companies was an action that "I took." Henry M. Paulson, ON THE BRINK 8 (2d ed. 2013) *See also Fannie Mae, Freddie Mac & FHA: Taxpayer Exposure in the Housing Markets: Hearing Before the H. Comm. on the Budget*, 112th Cong. 15

(2011) (congressional testimony by Congressional Budget Office Assistant Director for Financial Analysis, Deborah J. Lucas, stating that the Companies are subject to "ownership and control by the Treasury" and are "effectively part of the government"); CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: 2017 TO 2027, 78 n. 5 (January 2016) ("The government placed Fannie Mae and Freddie Mac into conservatorship in 2008 and now controls their operations.") (emphasis added).

76. [redacted] And one Treasury official who worked on the Net Worth Sweeps has conceded that Treasury was not interested in the Net Worth Sweeps' effect on the Companies' "financial[] sound[ness]." As that Treasury official later confirmed, he would have advocated proceeding with the Third Amendment even if he had known, specifically, that the Net Worth Sweeps would result in the Companies paying $128 billion more in dividends than would have been owed on the original 10% coupon, because "it was the Administration's policy [in 2012] to wind down the GSEs."

77. [redacted]

[redacted]

H. The Net Worth Sweeps Consume All of the Companies' Profits in Perpetuity

78. Treasury could have participated in the Companies' renewed profitability by exercising its warrants for 79.9% of each Company's common stock. But Treasury was not willing to share the value of the Companies with private shareholders. Instead, the Third Amendment's imposition of "a quarterly sweep of every dollar of profit that each firm earns going forward … ma[de] sure that every dollar of earnings that Fannie Mae and Freddie Mac generate" will go to Treasury. Press Release, U.S. Dep't of the Treasury, Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac (Aug. 17, 2012). In effect, the Net Worth Sweeps "narrows the difference between conservatorship and nationalization, by transferring essentially all profits and losses from the firms to the Treasury." *See* W. SCOTT FRAME, ET AL., THE RESCUE OF FANNIE MAE AND FREDDIE MAC, at 21, FEDERAL RESERVE BANK OF NEW YORK STAFF REPORT no. 719, at 21 (Mar. 2015).

79. At the time of the Third Amendment, the liquidation preference for the Government Preferred Stock was $189.5 billion, with approximately $117.1 billion attributable to Fannie Mae and approximately $72.3 billion attributable to Freddie Mac. Fannie Mae, Quarterly Report (Form 10-Q), at 4 (Aug. 8, 2012); Freddie Mac, Quarterly Report (Form 10-Q), at 7 (Aug. 7, 2012). Had the dividend not been revised, a continuing obligation to pay the prior 10% coupon would have resulted in quarterly payments from Fannie Mae and Freddie Mac to Treasury, from January 1, 2013, in approximately the following amounts:

	Fannie Mae	Freddie Mac	Combined Total
March 2013	$2.9 billion	$1.8 billion	$4.7 billion
June 2013	$2.9 billion	$1.8 billion	$4.7 billion
September 2013	$2.9 billion	$1.8 billion	$4.7 billion
December 2013	$2.9 billion	$1.8 billion	$4.7 billion
March 2014	$2.9 billion	$1.8 billion	$4.7 billion
June 2014	$2.9 billion	$1.8 billion	$4.7 billion
September 2014	$2.9 billion	$1.8 billion	$4.7 billion
December 2014	$2.9 billion	$1.8 billion	$4.7 billion
March 2015	$2.9 billion	$1.8 billion	$4.7 billion
June 2015	$2.9 billion	$1.8 billion	$4.7 billion
September 2015	$2.9 billion	$1.8 billion	$4.7 billion
December 2015	$2.9 billion	$1.8 billion	$4.7 billion
March 2016	$2.9 billion	$1.8 billion	$4.7 billion
June 2016	$2.9 billion	$1.8 billion	$4.7 billion
September 2016	$2.9 billion	$1.8 billion	$4.7 billion
December 2016	$2.9 billion	$1.8 billion	$4.7 billion
March 2017	$2.9 billion	$1.8 billion	$4.7 billion
June 2017	$2.9 billion	$1.8 billion	$4.7 billion
September 2017	$2.9 billion	$1.8 billion	$4.7 billion
December 2017	$2.9 billion	$1.8 billion	$4.7 billion
Total	$58.0 billion	$36.0 billion	$94.0 billion

80. The Net Worth Sweeps, in contrast, have captured the Companies' entire earnings, including every dollar of the Companies' record 2013 profits:

	Fannie Mae	Freddie Mac	Combined Total
March 2013	$4.2 billion	$5.8 billion	$10 billion
June 2013	$59.4 billion	$7.0 billion	$66.4 billion
September 2013	$10.2 billion	$4.4 billion	$14.6 billion
December 2013	$8.6 billion	$30.4 billion	$39.0 billion
March 2014	$7.2 billion	$10.4 billion	$17.6 billion
June 2014	$5.7 billion	$4.5 billion	$10.2 billion
September 2014	$3.7 billion	$1.9 billion	$5.6 billion
December 2014	$4.0 billion	$2.8 billion	$6.8 billion
March 2015	$1.9 billion	$0.9 billion	$2.8 billion
June 2015	$1.8 billion	$0.7 billion	$2.5 billion
September 2015	$4.4 billion	$3.9 billion	$8.3 billion
December 2015	$2.2 billion	$0 billion	$2.2 billion
March 2016	$2.9 billion	$1.7 billion	$4.6 billion
June 2016	$0.9 billion	$0 billion	$0.9 billion
September 2016	$2.9 billion	$0.9 billion	$3.8 billion
December 2016	$3.0 billion	$2.3 billion	$5.3 billion

	Fannie Mae	Freddie Mac	Combined Total
March 2017	$5.5 billion	$4.5 billion	$10.0 billion
June 2017	$2.8 billion	$2.2 billion	$5.0 billion
September 2017	$3.1 billion	$2.0 billion	$5.1 billion
December 2017	$0.6 billion	$2.3 billion	$2.9 billion
Total	$135.0 billion	$88.6 billion	$223.6 billion

81. The amount of the value transferred from the Companies and their shareholders to the Government by the Net Worth Sweeps is staggering. The Companies' collective dividend for June 2013 was $66.4 billion—more than fourteen times the $4.7 billion that Treasury would have received under the original 10% coupon on its Government Preferred Stock. From 2013 through February 2018, the Companies have paid approximately $130 billion more in Net Worth Sweeps than they would have owed on the prior 10% coupon (approximately $224 billion versus $94 billion). From 2008 through February 2018, the Government, as a result of the 10% coupon payments and the Net Worth Sweeps, has stripped approximately $87.7 billion more from the Companies than it invested in them ($278.8 billion in payments by the Companies versus $191.1 billion in draws by the Companies[2]). The Congressional Budget Office reported that the Net Worth Sweeps alone equaled 0.6% of the U.S. Gross Domestic Product for 2014 and 2015. CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: 2016 TO 2026, at 99 (January 2016).

I. <u>The Net Worth Sweeps Effectuate an Unauthorized Wind Down of the Companies</u>

82. When Treasury publicly announced the Net Worth Sweeps on August 17, 2012, it candidly described them as a measure that would "help expedite the wind down of Fannie Mae and Freddie Mac, make sure that every dollar of earnings each firm generates is used to benefit

[2] This figure includes draws announced as of the date of this Second Amended Verified Complaint.

taxpayers." Press Release, U.S. Dep't of the Treasury, Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac (Aug. 17, 2012). Treasury Secretary Jacob Lew reiterated that Treasury "ha[s] had a very clear policy on Fannie and Freddie, which is that we're winding them down." *The President's Fiscal Year 2015 Budget Proposals: Hearing on S. 113-518 Before the U.S. Senate Committee on the Budget,* 113th Cong. 325 (Mar. 12, 2014) (Senator Toomey questioning Secretary Lew). Another Treasury official has likewise since testified that Treasury's "core policy . . . was to wind down the GSEs over time."

83. An August 16, 2012 Treasury draft of "Talking Points" regarding the Net Worth Sweeps confirms that the Government fully intended to confiscate all of the Companies' profits and net worth in conjunction with the wind down. The draft talking points described Treasury's rationales for the Net Worth Sweeps as follows:

- "We are announcing steps to wind-down the enterprises more quickly and responsibly and make sure they are not allowed to recapitalize and return to the market in their prior form";
- "The full income sweep will mean that Fannie Mae and Freddie Mac *will not be allowed* to retain their profits, rebuild capital, and return to the market in their prior form" (emphasis in original);
- "100 percent of the funds in the reserve account and 100 percent of the profit of these entities generate, will be returned to Treasury and ultimately to taxpayers";
- "By taking all of their profits going forward, we are making clear that the GSEs will <u>*not*</u> ever be allowed to return to profitable entities at the center of our housing finance system" (emphasis in original);
- "Taxpayers will receive every dollar of profit the GSEs make";

- "Over time, [the Net Worth Sweeps] will result in all comprehensive income generated by the GSEs being paid to the government and thus the taxpayer";
- "We made these changes to make sure that these entities pay the taxpayer every dollar of profit that they make";
- "Taxpayers will receive all positive net worth from the GSEs";
- "The change protects the taxpayers' interest in the GSEs by ensuring that they will be the full beneficiary of any profits that the GSEs generate."

84. These draft talking points show that not only was Treasury aware of the Companies' expected profitability, but also that Treasury viewed that profitability as a *reason* to implement the Net Worth Sweeps. The document acknowledged the Companies' "[p]otential for near-term earnings to exceed the 10% dividend" and explained that, "[g]iven the GSEs improving operating performance and our goal to wind down the enterprises, we believe this change is appropriate today." The Third Amendment ensures that "Taxpayers will receive every dollar of profit the GSEs make" and implements Treasury's December 2010 decision not to allow "existing common equity holders … any positive earnings from the [Companies] in the future." Action Memorandum for Secretary Geithner from Jeffrey A. Goldstein, Under Secretary for Domestic Fin., Dep't of the Treasury (Dec. 20, 2010).

85. Discussing the Net Worth Sweeps in an August 17, 2012 email to Congressional staff, the White House's James Parrott (who worked on the Third Amendment with Treasury) said, "we've closed off possibility that [the Companies] ever go (pretend) private again and sped up the clock on the wind-down of their portfolio." Parrott explained that part of the goal of the Third Amendment was to ensure that the Companies did not "pay a dividend that …. [was] less than their profits in that quarter, allowing them to recapitalize." In another August 17, 2012 email,

Parrott remarked that an article, which described the Net Worth Sweeps as an attempt by Treasury to "deprive [the Companies] of all their capital so that" they do not "return as private companies backed by the government," was "exactly right on substance and intent."

86. FHFA adopted Treasury's plan to use the Third Amendment to ensure that the Companies did not return to private ownership after conservatorship. In public statements following the Third Amendment, FHFA embraced the Net Worth Sweeps' goal of "gradually contracting [the Companies'] operations." Edward J. DeMarco, Acting Dir., FHFA, Statement on Changes to Fannie Mae and Freddie Mac Preferred Stock Purchase Agreements (Aug. 17, 2012). FHFA has since acknowledged that "replacing the 10 percent dividend with a net worth sweep, reinforce[s] the notion that the [Companies] will not be building capital as a potential step to regaining their former corporate status." Edward J. DeMarco, Acting Dir., FHFA, Statement Before the U.S. Senate Comm. on Banking, Housing and Urban Affairs, at 3 (Apr. 18, 2013). *See also* FHFA, 2012, REPORT TO CONGRESS, at 13 (June 13, 2013) (the Net Worth Sweeps "ensure[ ] all the [Companies'] earnings are used to benefit taxpayers" and "reinforce[ ] the fact that the [Companies] will not be building capital."). [redacted]

87. By adopting the Net Worth Sweeps as the Companies were returning to profitability in August 2012—instead of deciding whether and how to respond if and when the Companies ever became unprofitable—FHFA has forced the Companies to give over a hundred billion dollars to

Treasury, to date, that they could have retained. As a result of the Net Worth Sweeps, the Companies are unable to retain or build capital and instead have been forced to operate on the brink of insolvency with an ever-dwindling capital buffer. That result is inconsistent with FHFA's mandate under HERA, as conservator, to put the Companies "in a sound and solvent condition" and "preserve and conserve the[ir] assets and property." 12 U.S.C. §4617(b)(2)(D).

88. The importance of guarding the Companies' capital under HERA is apparent from the statute's list of "grounds for appointing conservator." 12 U.S.C. §4617(a)(3). Eight out of twelve involve dissipating or inadequate capital. *See id.* §§4617(a)(3)(A) ("[a]ssets of the regulated entity are less than the obligations"); 4617(a)(3)(B) ("substantial dissipation of assets"); 4617(a)(3)(C) ("unsound condition to transact business"); 4617(a)(3)(F) ("[i]nability to meet obligations"); 4617(a)(3)(G) ("losses that will deplete all or substantially all of its capital"); 4617(a)(3)(H) ("practice or condition that is likely to . . . cause insolvency or substantial dissipation of assets or earnings"); 4617(a)(3)(J) ("undercapitalization"); 4617(a)(3)(K) ("[c]ritical undercapitalization"). Strikingly, every one of those threats to an entity's survival is an inevitable and intended *consequence* of the Net Worth Sweeps.

89. Indeed, the importance of FHFA conservation of the Companies' capital as conservator is reflected in FHFA's own rules implementing HERA, which generally prohibit capital distributions—including "[a]ny dividend or other distribution in cash or in kind made with respect to any shares of, or other ownership interest in, an Enterprise, except a dividend consisting only of shares of the Enterprise[,]" 12 C.F.R. §1229.13(1)—by an entity in conservatorship. *See* 12 C.F.R. §1237.12(a) ("Except as provided in paragraph (b) of this section, a regulated entity shall make no capital distribution while in conservatorship."). As FHFA explained when it adopted those regulations in 2011, "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 and Receivership, Conservatorship and Receivership, 76 Fed. Reg. 35,724, 35,727 (June 20, 2011). (emphasis added).

90. The Net Worth Sweeps are "especially irresponsible," in the words of FHFA Director Watt, because the Companies "need some kind of buffer to shield against short-term operating losses." Melvin L. Watt, Dir., FHFA, Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs on the Status of the Housing Finance System After Nine Years of Conservatorship (May 11, 2017). Without a sufficient "buffer," "a loss in any quarter would result in an additional draw of taxpayer support and reduce the fixed dollar commitment the Treasury Department has made to support the [Companies]" and "could erode investor confidence," "stifle liquidity in the mortgage-backed securities market," and "increase the cost of mortgage credit for borrowers." *Id.*

91. Treasury' internal documents show that [redacted] But Treasury proceeded anyway to advance its own interests.

92. In sum, the Net Worth Sweeps were part of a plan by Treasury to: (1) extract for itself (and the taxpayer) all of the future earnings and value of the Companies; and (2) wind down the Companies in order to reduce their role in the housing market. FHFA acquiesced in Treasury's plan, notwithstanding its statutory mandate to preserve the Companies' assets and put them in a sound and solvent condition. The Net Worth Sweeps appropriate all of the Companies' net worth, forever, and deprive the Companies permanently of any ability to accumulate capital reserves, or, consequently, pay dividends to any entity except the Government, redeem any of its securities, or retain any value distributable, upon liquidation, to any stakeholder except the Government. They ensure that—contrary to Congress' intent when it enacted HERA—the Companies will never emerge from conservatorship as privately owned entities. As a result, the Net Worth Sweeps deprive the Companies' shareholders of any right to participate in the Companies' future profit or of any right to control the Companies post-conservatorship. Through the Third Amendment, Treasury and FHFA have nationalized the Companies and reshaped the American mortgage and housing market at the expense of the Companies and their private their shareholders.

J. <u>December 21, 2017: the Fourth Amendment to the PSPAs</u>

93. On December 21, 2017, Treasury and FHFA executed a further amendment to the PSPAs (the "**Fourth Amendment**"). The Fourth Amendment provides that each Company's dividend for Treasury for the quarter ending December 31, 2017 would be reduced by $2.4 billion and that the dividend for each subsequent quarter will be in the amount of the Company's net worth minus $3 billion. In exchange for the Companies' limited right to preserve *their own capital*—which would otherwise be completely depleted by the Net Worth Sweeps as of January 1, 2018, but which could have accumulated in the Companies under the original PSPAs—the Fourth Amendment purports to "compensate taxpayers for the dividends that [they] would have received" under the Third Amendment by increasing Treasury's liquidation preference in each

Company by $3 billion as of December 31, 2017. Press Release, Dep't of the Treasury, Treasury Department and FHFA Modify Terms of Preferred Stock Purchase Agreements for Fannie Mae and Freddie Mac (Dec. 21, 2017). The increased liquidation preference—which went up to $195.5 billion as of December 31, 2017—thus precluded the Companies and their private shareholders from realizing any value from the capital buffer. To further underscore that point, the Fourth Amendment also provides that a Company's failure to declare and pay its full quarterly dividend "will result in the automatic, immediate termination of its capital buffer.

94. The Fourth Amendment permits the Companies to reserve a small capital buffer, which FHFA Director Watt believes is "necessary to cover ordinary income fluctuations." Press Release, Dep't of the Treasury, Treasury Department and FHFA Modify Terms of Preferred Stock Purchase Agreements for Fannie Mae and Freddie Mac (Dec. 21, 2017). This modest reversal in the depletion of the Companies' capital reserves concedes—but does not rectify—the recklessness of the Third Amendment and its detrimental impact on the Companies and their shareholders. In light of the Fourth Amendment's offsetting liquidation preference, the Net Worth Sweeps' uncompensated appropriation of the Companies' assets, even after the Fourth Amendment, is practically guaranteed to continue.

K. February 2018: the Companies Draw Money from Treasury to Cover Non-Cash Losses As a Result of the Net Worth Sweep

95. In February 2018, the Companies reported that, notwithstanding positive net income in 2017 in excess of $8.1 billion, they had a negative net worth as of December 31, 2017 and expected the Director of FHFA to submit a request to draw $3.7 billion from Treasury for Fannie Mae and $0.3 billion for Freddie Mac. The expected draws are not due to any problems with either Company's business. To the contrary, Fannie Mae's President and CEO reported that Fannie Mae's "business performance in the [fourth quarter of 2017] was excellent with pre-tax

income of $5 billion," but "[l]ike many companies," the Company's results for the quarter were affected by the 2017 Tax Cuts and Jobs Act, which required a "$9.9 billion provision for federal income taxes resulting from the remeasurement of the company's deferred tax assets." *See also* Fannie Mae, Annual Report (Form 10-K), at 2 (Feb. 14, 2018) (Fannie Mae "expect[s] to remain profitable on an annual basis for the foreseeable future"). Freddie Mac's CEO likewise described the Company as "fully competitive," although Freddie Mac also suffered losses because of a remeasurement of its deferred tax assets, which it reduced by $5.4 billion.

96. The Companies' expected draws will increase Treasury's liquidation preference in the Companies by $4 billion to approximately $199.5 billion, despite the Companies having paid Treasury $278.8 billion in dividends since the beginning of conservatorship. In effect, the Net Worth Sweeps forced the Companies to give the Government the value of the deferred tax assets recognized in 2013 as dividends and now force the Companies to draw from Treasury's commitment and increase its liquidation preference to fill "a net worth deficit" because the value of those deferred tax assets has declined. No further draws—nor the corresponding increase in the Companies' respective liquidation preferences and decrease in funds available to the Companies in the future under Treasury's commitment from $257.8 billion to $254.4 billion—would have been required if the Companies had been permitted to continue to pay a 10% dividend under the PSPAs and retain their remaining capital. Had the Companies been permitted to rebuild their capital, instead of being forced to pay to the Government the paper value of their deferred tax assets under the Net Worth Sweeps, the Companies would have been able to absorb such paper losses without further draws from Treasury. In other words, a Government action that was supposedly designed to avoid future draws on the Treasury commitment, has resulted in the Companies drawing on the Treasury commitment despite strong financial results. This is not a

defect with the Net Worth Sweeps; it is an entirely predictable consequence of the Government's plan to keep the Companies from rebuilding capital.

L. <u>Derivative Allegations -- Fannie Mae</u>

97. Plaintiff Rafter and the Rattien Plaintiffs bring Claims I, III and IV as shareholder derivative claims pursuant to Rule of the Court of Federal Claims 23.1.

98. These Plaintiffs bring these claims derivatively in the right and for the benefit of Fannie Mae to redress injuries suffered, and to be suffered, by Fannie Mae as a direct result of the violations described herein. Fannie Mae is named as a nominal defendant solely in a derivative capacity.

99. These Plaintiffs will adequately and fairly represent the interests of Fannie Mae and its shareholders in enforcing and prosecuting its rights.

100. Pursuant to Rule of the Court of Federal Claims 23.1(b)(2), this is not a collusive action to confer jurisdiction on this Court that it would not otherwise have.

101. These Plaintiffs were shareholders of Fannie Mae at the time of the actions complained of herein and remain shareholders.

102. To the extent that demand on Fannie Mae's board of directors would otherwise be required to maintain a derivative claim on Fannie Mae's behalf, such demand would be futile and is excused because: (a) Fannie Mae's directors, through the Company's Form 10-K filings with the Securities and Exchange Commission, have disclaimed any fiduciary duty or obligation to anyone other than FHFA; (b) Fannie Mae's directors, through the Company's Form 10-K filings, have acknowledged that the Company is not managed for the benefit of its common shareholders and that they will not "consider the interests of the company [or] the holders of our equity or debt securities . . . unless specifically directed to do so by the conservator [FHFA]"; and (c) FHFA purports to have assumed all of the powers of the board of directors and has not authorized the

board of directors to entertain this claim. *E.g.*, Fannie Mae, Annual Report (Form 10-K), at 1 (Feb. 20, 2015); Fannie Mae, Annual Report (Form 10-K), at 1 (Feb. 21, 2014); Fannie Mae, Annual Report (Form 10-K), at 1 (Apr. 2, 2013); Fannie Mae, Annual Report (Form 10-K), at 1 (Feb. 29, 2012).

103. To the extent that demand on FHFA would otherwise be required to maintain a derivative claim on Fannie Mae's behalf, such demand would be futile and is excused. It is inconceivable that FHFA, an agency of the United States Government, would sue the United States, particularly given that FHFA's own acquiescence in and implementation of the Net Worth Sweeps is directly at issue in this action. FHFA cannot reasonably be expected to initiate litigation challenging its own conduct as unlawful.

104. Nor can FHFA reasonably be expected to initiate litigation challenging the conduct of Treasury, given FHFA's demonstrable failure to challenge Treasury decisions that are contrary to the Companies' vital interests, or even to attempt meaningful participation in those decisions. FHFA, as conservator of Fannie Mae, has consistently acted at the direction, behest, or under the control of Treasury with respect to the Net Worth Sweeps. Treasury is the direct beneficiary of the Net Worth Sweeps, pocketing billions of dollars at the expense of the Companies' private shareholders as a result of the conduct challenged herein. FHFA's and Treasury's overwhelming conflicts of interest render FHFA incapable of exercising independent judgment.

105. Demand on FHFA would also be futile because the Net Worth Sweeps served no legitimate business purpose of Fannie Mae and were instead designed to benefit only the Government. The Net Worth Sweeps thus were not the product of a valid exercise of business judgment.

106. Plaintiffs aver that they reasonably believe that all factual contentions made on information and belief will likely have evidentiary support after a reasonable opportunity for further investigation and discovery.

CAUSES OF ACTION

CLAIM I

Just Compensation Under the Fifth Amendment for the Taking of Private Property for Public Use

(Derivative Claim on Behalf of Fannie Mae by Plaintiff Rafter and the Rattien Plaintiffs)

107. Plaintiffs re-allege and incorporate by reference all of the allegations contained in the preceding paragraphs.

108. The Fifth Amendment provides that no person shall "be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

109. Fannie Mae has a cognizable property interest in its own earnings protected by the Fifth Amendment. Fannie Mae has been a privately-owned, for-profit corporation since 1968. Like any private company, Fannie Mae has vested property rights in its quarterly profits, including, without limitation, the right to accumulate capital, invest and/or reinvest its earnings in its business, retain profits, or distribute them as dividends to shareholders.

110. From the time of its privatization in 1968, Fannie Mae had reasonable investment-backed expectations in its quarterly profits, including that such profits would not be expropriated in their entirety by the Government in perpetuity and without consideration. Fannie Mae has been profitable throughout nearly 50 years of its existence as a privately-owned, for-profit corporation.

111. Fannie Mae's property rights survived the imposition of FHFA's conservatorship in 2008, which was intended to "preserve and conserve the [Companies'] assets and property" and restore the Companies to a "sound and solvent condition" "with the objective of returning the [Companies] to normal business operations." 12 U.S.C. §§4617(b)(2)(B)(iv), 4617(b)(2)(D)(i). Fannie Mae reasonably expected that FHFA, as conservator, would follow its statutory mandate to preserve and protect its assets.

112. Fannie Mae also had a reasonable, investment-based expectation that conservatorship would not eliminate its entire net worth. In the months prior to appointment of their conservator, the Secretary of the Treasury, the Chairman of the Federal Reserve, and OFHEO, among others, confirmed that Fannie Mae's capital was adequate and business sound. The conservator stated unambiguously that Fannie Mae would not, and could not, be liquidated in conservatorship. *See, e.g.*, Press Release, FHFA, Questions and Answers on Conservatorship, at 3 (Sept. 7, 2008) ("The Conservator cannot make a determination to liquidate the Company … There are no plans to liquidate the Company.") FHFA has never been appointed receiver for Fannie Mae, and there is no statutory basis for HERA receivership. *See* 12 U.S.C. §§4617(a)(3)-(4).

113. The United States, through the Net Worth Sweeps, has confiscated Fannie Mae's property interest for its own use without paying any consideration. By means of the Net Worth Sweeps, the Government has appropriated "every dollar" earned by Fannie Mae for its own use. As of February 2018, the Government, through the Net Worth Sweeps, has taken more than $77 billion from Fannie Mae, and increased its own liquidation in the Company, for public use and without any compensation. Fannie Mae has suffered, and is continuing to suffer, a taking without just compensation.

114. Fannie Mae is entitled to just compensation for the Government's taking of its property.

CLAIM II

Just Compensation Under the Fifth Amendment for the Taking of Private Property for Public Use

(Direct Claim by All Plaintiffs)

115. Plaintiffs re-allege and incorporate by reference all of the allegations contained in the preceding paragraphs.

116. Plaintiffs' shareholdings carried vested rights to participate in the Companies' income stream and share their residual value. Common stock derives its entire value from the vested right to share corporate profits, as is evidenced by, for example, a common stockholder's acceptance of junior status among the corporation's stakeholders: "unlike creditors and depositors, stockholders stand to gain a share of corporate profits, [and] stockholders should [therefore] take the primary risk of the enterprise failing." Conservatorship and Receivership, 76 Fed. Reg. 35,724 at 35,726 (June 20, 2011). Common stock gives its issuer the "protection and security" of "the so-called 'equity cushion.'" *Id.* The Charter Acts of both Companies mandate issuance of common stock. *See* 12 U.S.C. §1718(a) (Fannie Mae "shall have common stock, … which shall be vested with all voting rights [and its] free transferability … shall not be restricted."); 12 U.S.C. §1453(a)-(b) ("The common stock of Freddie Mac … shall be vested with all voting rights [and its] free transferability … shall not be restricted.").

117. Plaintiffs' interests in their common stock in the Companies are cognizable property rights protected by the Fifth Amendment. These rights survived the imposition of conservatorships over the Companies in 2008; as explained by FHFA at the outset of the conservatorship, the equity holders "continue[d] to retain all rights in the stock's financial worth."

Moreover, Plaintiffs retain their direct and cognizable property interest in the residual value of the Companies.

118. Plaintiffs had reasonable, investment-backed expectations that the property rights of the Companies' common shareholders would be preserved.

119. The Net Worth Sweeps appropriate the entire value of Plaintiffs' Fannie Mae and Freddie Mac common stock. They deny Plaintiffs all economically beneficial or productive use of their vested property rights in their Fannie Mae and Freddie Mac common stock by wiping out any future income stream and residual value and making it impossible for Plaintiffs to realize the value of their ownership interest in the Companies. By preventing the Companies from emerging from conservatorship and returning to the control of private shareholders, the Net Worth Sweeps also deprive the common shareholders of any future right to participate in the control of the Companies. Plaintiffs have suffered concrete harm because, absent further amendment, the PSPAs ensure that the Companies will never be able to emerge from conservatorship and resume normal business operations, and they ensure that Treasury will maintain its approximately $199.5 billion total liquidation preference which will capture all of the Companies' residual value.

120. Plaintiffs have suffered, and are continuing to suffer, a taking and are entitled to just compensation.

CLAIM III

Illegal Exaction

(Derivative Claim on Behalf of Fannie Mae by Plaintiff Rafter and the Rattien Plaintiffs)

121. Plaintiffs re-allege and incorporate by reference all allegations contained in the preceding paragraphs.

122. "Fifth Amendment taking claims and illegal exaction claims are two sides of the same coin: taking claims are based upon authorized actions by government officials, whereas illegal exaction claims are based upon unauthorized actions of government officials." *Starr Int'l Co. v. United States*, 121 F. Cl. 428, at 34 (Fed. Cl. June 15, 2015*), affirmed in part, vacated in part*, 856 F.3d 953 (Fed. Cir. 2017). If Treasury and FHFA acted beyond their HERA authority in entering into the Third Amendment and causing payment of the Net Worth Sweeps, then the Net Worth Sweeps effect an illegal exaction.

123. The Net Worth Sweeps violate HERA's implementing rules, which prohibit capital distributions by an entity in conservatorship. The Net Worth Sweeps fall within the rules' definition of "capital distribution," which includes "[a]ny dividend or other distribution in cash or in kind made with respect to any shares of, or other ownership interest in, an Enterprise, except a dividend consisting only of shares of the Enterprise." 12 C.F.R. §1229.13(1). Under HERA, "a regulated entity shall make no capital distribution while in conservatorship." 12 C.F.R. §1237.12(a).

124. The ban has exceptions, but all are inapplicable here. The Net Worth Sweeps did not "enhance the ability of the [Companies] to meet [their] risk-based capital level and the minimum capital level," "contribute to the [Companies'] long-term financial safety and soundness," or serve any other interest of the Company. *Id.* §1237.12(b)(1)-(3). The Third Amendment's stated purpose was precisely the opposite: to strip Fannie Mae of its entire net worth and ensure that the Company would "be wound down and … not be allowed to retain profits, rebuild capital, and return to the market in [its] prior form." Press Release, Dep't. of the Treasury, Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac. Nor were the Net Worth Sweeps "in the public interest." 12 C.F.R. §1237.12(b)(4).

Their stated objective—winding down Fannie Mae and ending its business—was inimical to public interest in restoring Fannie Mae to a sound and solvent condition so it could fulfill its "critical mission of providing stability, liquidity, and affordability to the housing market." James B. Lockhart III, Dir., FHFA, Statement Before the Senate Committee on Banking, Housing, and Urban Affairs on the Appointment of FHFA as Conservator for Fannie Mae and Freddie Mac (Sept. 23, 2008).

125. The ban on capital distributions during conservatorship is a critical aspect of HERA, for obvious reasons. FHFA's "supervisory and regulatory authority over the regulated entities [is intended] expressly to ensure that the regulated entities operate in a safe and sound manner, including maintaining adequate capital … ." Conservatorship and Receivership, 76 Fed. Reg. 35,724, 35,727 (June 20, 2011).. FHFA has "broad authority as Conservator to manage the conservatorship estate, including the authority to restrict capital distributions that would cause a regulated entity to become undercapitalized." *Id.* That authority is intended "expressly to ensure that the regulated entities operate in a safe and sound manner, including maintaining adequate capital and internal controls." *Id.* at 35,724 "<u>[A]llowing 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</u>." *Id*. at 35,727 (emphasis added).

126. Fannie Mae has identified the Net Worth Sweeps as posing a "specific risk to [its] business" by prohibiting it from "build[ing] capital reserves." Fannie Mae, Universal Debt Facility, Offering Circular, at 11 (May 14, 2013). Fannie Mae blamed the Net Worth Sweeps for its inability to pass an April 2014 stress test mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. *See* Fannie Mae, Statement by Kelli Parsons, Senior Vice President and Chief

Communications Officer, on Stress Test Results (Apr. 30, 2014). Under that test's "severely adverse" scenario, Fannie Mae, which at that point had enjoyed two years of robust and increasing profitability, required a capital infusion of $34 billion to $98 billion. *Id.* Fannie Mae announced that "[t]hese results of the severely adverse scenario are not surprising given the [C]ompany's limited capital," which had been depleted by Net Worth Sweeps under which Fannie Mae's "ability to accumulate capital is severely restricted and the company is required to reduce its capital on a yearly basis. . . . Fannie Mae is not permitted to retain capital to withstand a sudden, unexpected economic shock of the magnitude required by the stress test." *Id.*. The Fourth Amendment concedes, but does not rectify, this risk. To the contrary, if not for the Net Worth Sweeps, Fannie Mae would be holding all or nearly all of the capital needed to pass its stress test.

127. In paying the Net Worth Sweeps, FHFA exceeded, and continues to exceed, its authority as a conservator, which is limited under HERA, to "such action as may be (i) necessary to put the regulated entity in a sound and solvent condition; and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity." 12 U.S.C. §4617(b)(2)(D). FHFA has never been granted, with respect to either Company, the "additional powers" HERA reserves to a "receiver," *id.* §4617(b)(2)(E). Nothing in HERA permits a conservator to effect an actual or *de facto* liquidation of an entity in conservatorship. In addition, by entering into the Net Worth Sweeps at the behest of Treasury, and ceding control of the conservatorships to Treasury, FHFA violated HERA's dictate that FHFA "shall not be subject to the direction or supervision of any other agency of the United States … in the exercise of the rights, powers, and privileges of the Agency." *Id*. §4617(a)(7).

128. Treasury's participation in the Net Worth Sweeps exceeded that agency's authority to purchase securities under HERA, which may only be exercised: (i) pursuant to an "emergency

determination" that purchase of the Companies' securities was "necessary" to "provide stability" and "prevent disruptions" in the markets, and (ii) in a manner that "[took] into consideration," *inter alia*, the Companies' continued operation "as a private shareholder-owned company" and "plan for the orderly resumption of private market funding or capital market access." 12 U.S.C. §§1455(*l*)(l)(B)-(C), 1719(g)(1)(B)-(C).

129. No such determination was made with respect to the Third Amendment, and none could have been. The Third Amendment was implemented shortly after Fannie Mae reported second quarter income of $5.4 billion, up from a $2.9 billion loss in the second quarter of 2011, Fannie Mae, Quarterly Report (Form 10-Q), at 3 (Aug. 8, 2012), and was poised to announce "$17.2 billion in net income in 2012, the largest in our company's history [thus far] and our first annual net income since 2006," Fannie Mae, Annual Report (Form 10-K), at 3, 5 (Apr. 2, 2013), and a new record in 2013: "We reported net income of $84.0 billion and pre-tax income of $38.6 billion in 2013, the highest annual net income and annual pre-tax income in our history." Fannie Mae, Annual Report (Form10-K), at 2 (Feb. 21, 2014).

130. Treasury's execution of the Third Amendment otherwise violated its authority under HERA because it post-dated—by more than two and a half years—the December 31, 2009 expiration of Treasury's statutory authority to purchase securities issued by the Companies. 12 U.S.C. §§1455(*l*)(4), 1719(g)(4). The Third Amendment gave rise to an entirely new security purchase because it effected a wholesale change to Treasury's securities, replacing the fixed 10% cash or 12% in kind quarterly dividends payable, with a right to the Companies' entire earnings, save for a dwindling capital buffer, forever.

131. Without statutory, or any other authority, the Government has exacted cash payments from Fannie Mae for improper and unauthorized Net Worth Sweeps of over $77 billion to date.

132. The Government's improper conduct is an illegal exaction of Fannie Mae's money without due process.

133. Fannie Mae has suffered, and continues to suffer, injury as a direct and proximate result of such illegal exaction, including but not limited to monetary damage. As a result of the conduct alleged herein, the United States is liable to Fannie Mae, and Fannie Mae is entitled to relief.

CLAIM IV

Breach of Contract

Reformation of Contract to Undo Unlawful Amendment to Contract and Restitution of Funds

(Derivative Claim on Behalf of Fannie Mae by Plaintiff Rafter and the Rattien Plaintiffs)

134. Plaintiffs re-allege and incorporate by reference all of the allegations contained in the preceding paragraphs.

135. If Treasury and FHFA acted beyond their HERA authority in entering into the Third Amendment and causing payment of the Net Worth Sweeps, then the Third Amendment was unlawful. 12 U.S.C. §4617(b)(2)(D).

136. Because the Third Amendment was unlawful, it is void. All money paid and other value conveyed by the Companies to the Government pursuant to the Third Amendment, including the Net Worth Sweeps, should be returned to the Companies.

137. Fannie Mae has suffered injury as a direct and proximate result of the unlawful Third Amendment, including monetary damage. As a result of the conduct alleged herein, the United States is liable to Fannie Mae, and Fannie Mae is entitled to relief including the reformation of the PSPAs to excise the Third Amendment and restitution of funds paid to the United States under the Third Amendment.

CLAIM V

Breach of Contract

Fannie Mae's Charter, By-Laws and the Delaware General Corporations Law

(Direct Claim by All Plaintiffs)

138. Plaintiffs re-allege and incorporate by reference all of the allegations contained in the preceding paragraphs.

139. Together, Fannie Mae's Charter, its by-laws and the Delaware General Corporation Law ("**DGCL**") form a contract (the "**Fannie Mae Contract**") to which the Government became party when FHFA, as conservator of Fannie Mae, succeeded to all rights, titles, powers and privileges of Fannie Mae and its shareholders, officers or directors, *see* 12 U.S.C. §4617(b)(2)(A)(i), and was otherwise authorized to act on behalf of Fannie Mae and its shareholders, officers and directors, *see, e.g., id*. §4617(b)(2)(B)-(D), (G)-(J). The Fannie Mae Contract obliges the Government, through FHFA as conservator of Fannie Mae, to operate in a manner that does not extinguish the rights of Fannie Mae's private shareholders, as recognized in Fannie Mae's Charter, and to refrain from actions that violate applicable Delaware laws. The Government breached the contract by agreeing to replace the Government Preferred Stock's original dividend with the Net Worth Sweeps, which capture Fannie Mae's entire value for the

Government by appropriating all of Fannie Mae's net worth and eliminating the residual value that belonged to the common shareholders.

140. The Fannie Mae Contract is a product of both federal and Delaware law. Fannie Mae's Charter, including the powers and privileges set forth therein, is a contract between and among the Government, as the granter of the charter, Fannie Mae and Fannie Mae's shareholders as a matter of federal law.

141. In addition, Fannie Mae's Charter, the Fannie Mae Bylaws and the DGCL form a binding and enforceable contract among Fannie Mae, its directors, officers and shareholders under Delaware law, to the extent that contract is not inconsistent with Fannie Mae's Charter and other federal law, rules and regulations. Pursuant to Section 1710.10 of the OFHEO corporate governance regulation, 12 C.F.R. §1710.1, *et seq*., to the extent not inconsistent with Fannie Mae's Charter, other federal laws, rules and regulations, and the "safe and sound" operations of Fannie Mae, Fannie Mae must follow the corporate governance practices and procedures of the law of the jurisdiction in which the principal office of Fannie Mae is located; the DGCL; or the Revised Model Business Corporation Act. Section 1.05 of the Fannie Mae Bylaws provides that, to the extent not inconsistent with Fannie Mae's Charter and other federal laws, rules and regulations, Fannie Mae "has elected to follow the applicable corporate governance practices and procedures of the Delaware General Corporation Law, as the same may be amended from time to time." Under Delaware law, the DGCL, a corporation's charter and its bylaws together form a contract among the corporation, its directors, officers and shareholders. Thus—to the extent not inconsistent with Fannie Mae's Charter and other federal law, rules and regulations—Fannie Mae's Charter, the Fannie Mae Bylaws and the DGCL form the Fannie Mae Contract, a binding and enforceable contract among Fannie Mae, its directors, officers and shareholders.

142. Pursuant to 12 U.S.C. §4617(b)(2), FHFA, as conservator of Fannie Mae, succeeded to all rights, titles, powers and privileges of Fannie Mae and its shareholders, officers and directors, and became otherwise authorized to act on behalf of Fannie Mae and its shareholders, officers and directors, and, thus, was bound by Fannie Mae's Charter and the Fannie Mae Contract.

143. Fannie Mae's Charter provides that Fannie Mae "shall have common stock," 12 U.S.C. §1718(a), contemplates that such "shares of common stock" will be "purchase[d]," "h[e]ld," and "dispose[d] of . . . subject to the provisions of [Fannie Mae's Charter]," *id*. §1718(d), and expressly recognizes Fannie Mae's status as a "private shareholder-owned company." *Id*. §1719(g)(1)(C)(v).

144. The DGCL recognizes property rights associated with common stock. *See, e.g.*, DGCL §159 (common stock "shall be deemed personal property"). DGCL §151(c) expressly protects one of these rights, the common shareholders' right to participate in any net profits or residual value by providing that preferred shareholders "shall be entitled to receive dividends <u>at such rates</u>" (emphasis added) as stated and which "shall be . . . payable in preference to, or in such relation to, the dividends payable on any other class" of stock, so that "[w]hen dividends upon the preferred . . . stock, if any, to the extent of the preference to which such stock are entitled, shall have been paid . . . a dividend on the remaining class or classes or series of stock may then be paid out of the remaining assets of the corporation available for dividends." One of the most material rights incident to common stock ownership, in addition to the right to participate in net profits, is the right of common shareholders to the residual value of the corporation.

145. The property rights associated with private ownership of Fannie Mae's common stock are explicitly recognized by Fannie Mae's Charter. The property rights associated with

private ownership of common stock under the DGCL are consistent with Fannie Mae's Charter and are not inconsistent with any other Federal law, rules and regulations (including HERA). These property rights comprise binding and enforceable provisions of the Fannie Mae Contract.

146. The Net Worth Sweeps extinguish the right and ability of the common shareholders to participate in any net profits or residual value of Fannie Mae. By appropriating all of Fannie Mae's profits and all of its net worth, less a dwindling capital reserve, the common shareholders are deprived of any and all actual or potential value of the shares they own in perpetuity, in violation of the Fannie Mae Contract.

147. The Net Worth Sweeps do not constitute "dividends *at such rates*," as required by Section 151(c). The Net Worth Sweeps set no rate and replace the 10% fixed dividend rate on the Government Preferred Stock with a perpetual, unlimited requirement that Fannie Mae pay its entire profit to Treasury without regard to the capital attributable to Treasury or other shareholders, or the common shareholders' right to a return in the amount of Fannie Mae's residual value.

148. The Net Worth Sweeps also violate Section 151(c)'s requirement that dividends be "payable in preference to, or in . . . relation to, the dividends payable on any other class or classes or of any other series of stock[.]" Because no earnings remain available to pay any dividends to shareholders other than Treasury after payment of the Net Worth Sweeps, the Government Preferred Stock does not carry a permissible dividend "preference," nor are the Net Worth Sweeps "in . . . relation to" dividends payable to any other shareholders.

149. The DGCL does not permit a corporation to have preferred stock if the corporation does not also have common stock entitled to receive the residual value that remains after the preferred stock's preference has been paid. Preferred stock that entitles its holder to receive all the

value of the corporation, leaving no residuum for common shareholders under any set of circumstances, is unlawful.

150. The Net Worth Sweeps on the Government Preferred Stock make it impossible for Fannie Mae to pay dividends or other distributions in respect of its common shares. Because the Net Worth Sweeps entitle the Government to Fannie Mae's entire value, they violate the DGCL, which is part of the Fannie Mae Contract.

151. The Government breached the Fannie Mae Contract by entering into the Third Amendment and agreeing to replace the Government Preferred Stock's original dividend with the Net Worth Sweeps, which entirely extinguish Fannie Mae's net and residual value by giving the Government Fannie Mae's entire net worth by 2018, in violation of the common shareholders' contractual rights.

152. Plaintiffs' claims are ripe. The Third Amendment was a voluntary affirmative act that amounts to a repudiation of the Fannie Mae Contract.

153. As a result of the Government's breach of the Fannie Mae Contract, Plaintiffs, as shareholders in Fannie Mae, have suffered damages in an amount to be determined at trial.

CLAIM VI

Breach of Contract

Covenant of Good Faith and Fair Dealing Implied in Fannie Mae's Charter

(Direct Claim by All Plaintiffs)

154. Plaintiffs re-allege and incorporate by reference all of the allegations contained in the preceding paragraphs.

155. As alleged in Claim V, above, Fannie Mae's Charter is a contract between and among the Government, as the granter of the charter, Fannie Mae, and Fannie Mae's shareholders.

When FHFA, as conservator of Fannie Mae, succeeded to all rights, titles, powers and privileges of Fannie Mae and its shareholders, officers or directors, *see* 12 U.S.C. §4617(b)(2)(A)(i), and was otherwise authorized to act on behalf of Fannie Mae and its shareholders, officers and directors, *see, e.g.*, *id*. §4617(b)(2)(B)-(D), (G)-(J), the Government also succeeded to Fannie Mae's position as a party to the contract that is Fannie Mae's Charter.

156. Fannie Mae's Charter provides that Fannie Mae "shall have common stock" and expressly recognizes Fannie Mae's status as a "private shareholder-owned company." 12 U.S.C. §1718(a), §1719(g)(1)(C)(v). Under general corporate law principles, a corporation's common shareholders have, collectively, a right to the corporation's residual value through a right to participate in the corporation's residual earnings and a right, upon dissolution, to share in any residual proceeds from liquidation of the assets. Thus, under Fannie Mae's Charter, the Government agreed that common shareholders of Fannie Mae would have common stock that is vested with a right to the residual value of Fannie Mae, including to share in Fannie Mae's earnings.

157. Fannie Mae has issued common stock.

158. Because Fannie Mae's Charter is a contract, it imposes on the Government an implied covenant of good faith and fair dealing in its performance and enforcement of the contract. The covenant of good faith and fair dealing requires the Government to refrain from taking actions that interfere with other contracting parties' enjoyment of the benefits contemplated by the contract.

159. Through the Net Worth Sweeps, the Government has breached the implied covenant of good faith and fair dealing by depriving Fannie Mae's shareholders of expected benefits under Fannie Mae's Charter. Specifically, Fannie Mae's shareholders have a right, under

Fannie Mae's Charter, to share in Fannie Mae's residual value. But as a result of the Net Worth Sweeps, the Government has subverted the shareholders' right to participate in the residual value of Fannie Mae by sending Treasury all of Fannie Mae's profits and net worth, less a dwindling capital reserve. Thus, the common shareholders are deprived of any and all actual or potential value of the shares they own in perpetuity.

160. Plaintiffs' claims are ripe. The Third Amendment was a voluntary affirmative act that amounts to a repudiation of the Fannie Mae Charter.

161. As a result of the Government's breach of the covenant of good faith and fair dealing, Plaintiffs, as shareholders in Fannie Mae, have suffered damages in an amount to be determined at trial.

CLAIM VII

Breach of Contract

Covenant of Good Faith and Fair Dealing Implied in Freddie Mac's Charter

(Direct Claim by Plaintiff Pershing Square)

162. Plaintiffs re-allege and incorporate by reference all of the allegations contained in the preceding paragraphs.

163. Freddie Mac's Charter is a contract between and among the Government, as the granter of the charter, Freddie Mac, and Freddie Mac's shareholders. When FHFA, as conservator of Freddie Mac, succeeded to all rights, titles, powers and privileges of Freddie Mac and its shareholders, officers or directors, *see* 12 U.S.C. §4617(b)(2)(A)(i), and was otherwise authorized to act on behalf of Freddie Mac and its shareholders, officers and directors, *see, e.g.*, *id.* §4617(b)(2)(B)-(D), (G)-(J), the Government also succeeded to Freddie Mac's position as a party to the contract that is Freddie Mac's Charter.

164. Freddie Mac's Charter provides that: "The common stock of the Corporation shall consist of voting common stock, which shall be issued to such holders in the manner and amount, and subject to any limitations on concentration of ownership, as may be established by the Corporation." 12 U.S.C. §1453(a). Under general corporate law principles, a corporation's common shareholders have, collectively, a right to the corporation's residual value through a right to participate in the corporation's residual earnings and a right, upon dissolution, to share in any residual proceeds from liquidation of the assets. Thus, under Freddie Mac's Charter, the Government has agreed that common shareholders of Freddie Mac would have common stock vested with a right to the residual value of Freddie Mac, including to share in Freddie Mac's earnings.

165. Freddie Mac has issued common stock.

166. Because Freddie Mac's Charter is a contract, it imposes on the Government an implied covenant of good faith and fair dealing in its performance and enforcement of the contract. The covenant of good faith and fair dealing requires the Government to refrain from taking actions that interfere with other contracting parties' enjoyment of the benefits contemplated by the contract.

167. Through the Net Worth Sweeps the Government has breached the implied covenant of good faith and fair dealing by depriving Freddie Mac's shareholders of expected benefits under Freddie Mac's Charter. Specifically, Freddie Mac's shareholders have a right, under Freddie Mac's Charter, to share in Freddie Mac's residual value. But as a result of the Net Worth Sweeps, the Government has subverted the shareholders' right to participate in the residual value of Freddie Mac by sending Treasury all of Freddie Mac's profits and net worth, less a dwindling capital

reserve. Thus, the common shareholders are deprived of any and all actual or potential value of the shares they own in perpetuity.

168. Plaintiffs' claims are ripe. The Third Amendment was a voluntary affirmative act that amounts to a repudiation of the Freddie Mac Charter.

169. As a result of the Government's breach of the covenant of good faith and fair dealing, Plaintiff Pershing Square, as a shareholder in Freddie Mac, has suffered damages in an amount to be determined at trial.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs respectfully pray for an order and judgment:

a. On Claim I, awarding Fannie Mae just compensation under the Fifth Amendment for the Government's taking of its property, in amount to be determined at trial;

b. On Claim II, awarding Plaintiffs just compensation under the Fifth Amendment for the Government's taking of their property, in an amount to be determined at trial;

c. On Claim III, awarding Fannie Mae damages for the Government's illegal exaction of its money, in amount to be determined at trial;

d. On Claims IV, awarding Fannie Mae damages, reformation, disgorgement, equitable restitution or other appropriate relief for the United States' illegal amendment to and breach of contract;

e. On Claims V, VI and VII, awarding Plaintiffs damages, disgorgement, restitution or other appropriate relief for the United States' breach of contract, in amount to be determined at trial;

f. Awarding Plaintiffs the costs and disbursements of this action, including reasonable attorneys' and experts' fees, costs and expenses; and

g. Granting such other, further and different relief as this Court deems just and proper.

By: s/ Gregory P. Joseph

Gregory P. Joseph
Counsel of Record

Of Counsel
Mara Leventhal
Sandra M. Lipsman
Christopher J. Stanley

JOSEPH HAGE AARONSON LLC
485 Lexington Avenue, 30th Floor
New York, New York 10017
Tel. (212) 407-1200
Fax (212) 407-1280
Email: gjoseph@jha.com

Counsel for Plaintiffs

792532

VERIFICATION

I, Louise Rafter, hereby verify and declare under penalty of perjury that I have reviewed a redacted copy of the Second Amended Verified Complaint, know the contents thereof, except for the portions that have been redacted pursuant to the Second Amended Protective Order entered in *Fairholme Funds, Inc. v. United States*, No. 13-465C (Fed. Cl.), and authorize its filing. The foregoing is true and correct to the best of my knowledge, information, and belief, based on investigation of counsel. I have personal knowledge of the facts stated in the Second Amended Verified Complaint regarding my personal shareholdings, which are true and correct.

Executed on April 20, 2018

Louise Rafter

Louise Rafter

VERIFICATION

I, Josephine Rattien, hereby verify and declare under penalty of perjury that I have reviewed a redacted copy of the Second Amended Verified Complaint, know the contents thereof, except for the portions that have been redacted pursuant to the Second Amended Protective Order entered in *Fairholme Funds, Inc. v. United States*, No. 13-465C (Fed. Cl.), and authorize its filing. The foregoing is true and correct to the best of my knowledge, information, and belief, based on investigation of counsel. I have personal knowledge of the facts stated in the Second Amended Verified Complaint regarding my personal shareholdings, which are true and correct.

Executed on April 18, 2018

Josephine Rattien
Josephine Rattien

VERIFICATION

I, Stephen Rattien, hereby verify and declare under penalty of perjury that I have reviewed a redacted copy of the Second Amended Verified Complaint, know the contents thereof, except for the portions that have been redacted pursuant to the Second Amended Protective Order entered in *Fairholme Funds, Inc. v. United States*, No. 13-465C (Fed. Cl.), and authorize its filing. The foregoing is true and correct to the best of my knowledge, information, and belief, based on investigation of counsel. I have personal knowledge of the facts stated in the Second Amended Verified Complaint regarding my personal shareholdings, which are true and correct.

Executed on April 18, 2018

Stephen Rattien

Stephen Rattien

VERIFICATION

On behalf of Pershing Square Capital Management, L.P., Pershing Square, L.P., Pershing Square II, L.P., Pershing Square Holdings, Ltd., and Pershing Square International, Ltd. (together, the "Pershing Square Entities"), I, David Klafter, hereby verify and declare under penalty of perjury that I have reviewed a redacted copy of the Second Amended Verified Complaint, know the contents thereof, except for the portions that have been redacted pursuant to the Second Amended Protective Order entered in *Fairholme Funds, Inc. v. United States*, No. 13-465C (Fed. Cl.), and authorize its filing. The foregoing is true and correct to the best of my knowledge, information, and belief, based on investigation of counsel. I have personal knowledge of the facts stated in the Second Amended Verified Complaint regarding the Pershing Square Entities' ownership or beneficial interest in common shares of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, which are true and correct. My execution of this verification on behalf of Pershing Square Entities has been duly authorized by the Pershing Square Entities.

Executed on April 19, 2018

David Klafter

David Klafter