UNITED STATES COURT OF FEDERAL CLAIMS

ARROWOOD INDEMNITY COMPANY, ARROWOOD SURPLUS LINES INSURANCE COMPANY, and FINANCIAL STRUCTURES LIMITED, Plaintiffs, v. THE UNITED STATES OF AMERICA, Defendant.	Case No. 1:13-cv-00698 MMS

PLAINTIFFS' MOTION FOR
LEAVE TO FILE SECOND AMENDED COMPLAINT

Pursuant to Rule 15(a)(2) of the Rules of the United States Court of Federal Claims, Plaintiffs Arrowood Indemnity Company, Arrowood Surplus Lines Insurance Company, and Financial Structures Limited (collectively, the "Arrowood Plaintiffs"), respectfully request that the Court grant the Arrowood Plaintiffs leave to file the proposed Second Amended Complaint (the "Arrowood SAC"), submitted as Exhibit A to this motion ("this Motion" or the "Arrowood Motion"). A copy of a blackline, showing the changes to Arrowood's First Amended Complaint (the "Arrowood FAC") is submitted as Exhibit B to this motion.

The proposed amendment set forth in the Arrowood SAC is similar to the proposed amendment that is the subject of the motion (the "Fairholme Motion") for leave to file a second amended complaint filed by Fairholme Funds, Inc., et al. in a related case, *Fairholme Funds, Inc.*

v. United States, No. 1:13-cv-00465-MMS ("*Fairholme* ").[1] The response of the United States to the Fairholme Motion is due August 31, 2018.

Both the Fairholme Motion and this Motion propose to amend the illegal exaction claim to include the theory that the imposition of the Net Worth Sweep and quarterly Net Worth Sweep dividend payments were unauthorized because at all relevant times the Federal Housing Finance Agency ("FHFA") has been operating in violation of constitutional separation of powers principles. The proposed amendments follow a recent decision of the United States Court of Appeals for the Fifth Circuit holding that FHFA is unconstitutionally insulated from Presidential control. *Collins v. Mnuchin,* 2018 WL 3430826, at *18 (5th Cir. July 16, 2018).

The United States has stated that it has not yet formulated a position on this Motion, and that it intends to file a response.

QUESTION PRESENTED

This Motion presents the same question as the Fairholme Motion: Whether Plaintiffs should be permitted to amend their illegal exaction claims to include the theory that FHFA's actions in adopting and implementing the Net Worth Sweep were unauthorized because they were taken while FHFA was operating in violation of constitutional separation of powers principles.

STATEMENT OF THE CASE

1. The Arrowood Plaintiffs adopt, and respectfully refer the Court to, the Statement of the Case in the Fairholme Motion. This Statement of the Case is limited to facts specific to the Arrowood Plaintiffs.

[1] Plaintiffs [Fairholme Funds, Inc. et al.]' Motion to Amend Complaint, Doc. 412 (Aug. 3, 2018), *Fairholme Funds, Inc. v. United States,* No. 1:13-cv-00465-MMS.

2. On September 18, 2013, the Arrowood Plaintiffs, who are shareholders of Fannie Mae and Freddie Mac, commenced this action, alleging that the Net Worth Sweep was a taking of their property, for which they are entitled to just compensation under the Fifth Amendment.

3. On March 8, 2018, after jurisdictional discovery in *Fairholme* and other proceedings, the Arrowood Plaintiffs timely filed the Arrowood FAC, adding factual allegations based on discovery materials and adding claims of illegal exaction, breach of fiduciary duty, and breach of implied-in-fact contract. All of the Arrowood Plaintiffs' claims are direct claims; none are derivative.

4. The Government filed an omnibus motion to dismiss in *Fairholme*, this action, and other related actions on August 1, 2018. Plaintiffs' response is due October 23, 2018, and the Government's reply is due January 22, 2019.

ARGUMENT

The Arrowood Plaintiffs respectfully refer the Court to, and incorporate by reference, the Argument set forth in the Fairholme Motion. The legal standards applicable to this Motion are the same as set forth in the Fairholme Motion. RCFC 15(a)(12)(the Court "should freely give leave" to amend "when justice so requires.") The relevant facts applicable to this Motion—including the absence of undue delay, the absence of bad faith, the absence of dilatory motive, and the absence of prejudice to the Government—are identical for this Motion and the Fairholme Motion.

CONCLUSION

For the foregoing reasons, the Arrowood Plaintiffs respectfully request that their motion for leave to file the attached proposed Arrowood SAC be granted.

Respectfully submitted,

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SECOND AMENDED COMPLAINT

Plaintiffs Arrowood Indemnity Company, Arrowood Surplus Lines Insurance Company, and Financial Structures Limited (collectively, "Plaintiffs" or the "Arrowood Parties"), by and through the undersigned attorneys, bring this action under the Fifth Amendment to the United States Constitution and 28 U.S.C. § 1491, seeking compensation for the taking or, alternatively, the illegal exaction of Plaintiffs' property, and damages for breach of fiduciary duty. In support of their Second Amended Complaint, Plaintiffs allege as follows:

NATURE AND SUMMARY OF THE ACTION

1. In August 2012, at a time when the housing market was recovering from the financial crisis and Federal National Mortgage Association ("Fannie") and Federal Home Loan Mortgage Corporation ("Freddie") (collectively, the "Companies") had returned to stable profitability in a growing economy, the federal government took for itself the entire value of the rights held by Plaintiffs and Fannie's and Freddie's other private shareholders by forcing these publicly-traded, shareholder-owned Companies to turn over their **entire** net worth, less a small capital reserve, to the federal government on a quarterly basis **forever**—an action the

government called the "Net Worth Sweep" and that effectively nationalizes the Companies. This action is brought by Plaintiffs, holders of non-cumulative preferred stock ("Preferred Stock") issued by Fannie and Freddie seeking just compensation for the taking of their property by the United States of America, acting by and through, *inter alia*, the Department of the Treasury ("Treasury"), the Federal Housing Finance Administration ("FHFA"), and agents acting at their direction. Plaintiffs alternatively seek damages for themselves for an illegal exaction in violation of the Fifth Amendment. And Plaintiffs finally seek damages for themselves for the Government's breach of fiduciary duty.

2. At Treasury's urging, in July 2008, Congress enacted the Housing and Economic Recovery Act of 2008 ("HERA"). HERA created the Federal Housing Finance Agency (Treasury and FHFA are sometimes collectively referred to herein as the "Agencies") to replace Fannie's and Freddie's prior regulator and authorized FHFA to appoint itself as conservator or receiver of the Companies in certain statutorily specified circumstances. HERA charges FHFA as conservator to rehabilitate Fannie and Freddie by taking action to put the Companies in a sound and solvent condition while preserving and conserving their assets.

3. HERA also granted Treasury temporary authority to invest in the Companies' stock until December 31, 2009. Congress made clear that in exercising this authority Treasury was required to consider the "need to maintain [Fannie's and Freddie's] status as . . . private, shareholder-owned compan[ies]."

4. On September 6, 2008—despite prior public statements assuring investors that the Companies were in sound financial shape—FHFA, at Treasury's urging, abruptly forced Fannie and Freddie into conservatorship. Immediately after the Companies were forced into conservatorship, Treasury exercised its temporary authority under HERA to enter into

agreements with FHFA to purchase securities of Fannie and Freddie ("Preferred Stock Purchase Agreements," "Purchase Agreements," or "PSPAs"). Under these PSPAs, Treasury designed an entirely new class of securities in the Companies, known as Senior Preferred Stock ("Government Stock"), which came with very favorable terms for Treasury. At the outset, Treasury received $1 billion of Government Stock (via one million shares) in each Company and warrants to acquire 79.9% of the Common Stock of the Companies at a nominal price in return for its commitment to acquire Government Stock in the future.

5. The Government Stock entitled Treasury to collect dividends at an annualized rate of 10% if paid in cash or 12% if paid in kind—an extraordinarily generous return in an economic environment in which interest rates on government debt were near zero. The Government Stock was entitled to receive cash dividends from each Company only to the extent declared by the Board of Directors "in its sole discretion, from funds legally available therefor." If the Companies did not wish to—or legally could not—pay a cash dividend, the unpaid dividends on the Government Stock could be capitalized (or paid "in kind") by increasing the liquidation preference of the outstanding Government Stock. Therefore, the Companies were *never* required to pay cash dividends on Government Stock. There was *never* any threat that the Companies would become insolvent by virtue of making cash dividend payments. The PSPAs specifically allowed the Companies to utilize this mechanism throughout the life of the agreements, thereby foreclosing any possibility that they would exhaust Treasury's funding commitment because of a need to make a dividend payment to Treasury.

6. The Government Stock diluted, but did not eliminate, the economic interests of the Companies' private shareholders. The warrants to purchase 79.9% of the Companies' Common Stock gave Treasury "upside" via economic participation in the Companies'

profitability, but this upside would be *shared* with preferred shareholders (who had to be paid before any payment could be made on common stock purchased with Treasury's warrants) and private common shareholders (who retained rights to 20.1% of the Companies' residual value). James Lockhart, the Director of FHFA, accordingly assured Congress shortly after imposition of the conservatorship that Fannie's and Freddie's "shareholders are still in place; both the preferred and common shareholders have an economic interest in the companies" and that "going forward there may be some value" in that interest.

7. Under FHFA's supervision, the Companies were forced to excessively write down the value of their assets, primarily due to decisions based on grossly improper accounting. By June 2012, the Agencies had forced Fannie and Freddie to issue $161 billion in Government Stock to make up for the balance-sheet deficits caused by the Agencies' unrealistic and overly pessimistic accounting decisions, even though there was no indication that the Companies' actual cash expenses could not be met by their cash receipts. The Companies were further forced to issue an additional $26 billion of Government Stock so that Fannie and Freddie would be able to pay *cash* dividends to Treasury even though, as explained above, the Companies were never required to pay cash dividends. Finally, because (i) the Companies were forced to issue Government Stock to Treasury in return for funds that they did not need to continue operations and (ii) the structure of Treasury's financial support did not permit the Companies to repay and redeem the Government Stock outstanding, the amount of the dividends owed on the Government Stock was artificially—and permanently—inflated.

8. As a result of these transactions, Treasury amassed a total of $189 billion in Government Stock—a substantial sum, albeit far less than the $5 trillion in assets held in the Companies' mortgage portfolios. But based on the Companies' performance in the second

quarter of 2012, it was apparent that there was still value in the Companies' private shares. By that time, the Companies were thriving and could easily pay 10% annualized cash dividends on the Government Stock without drawing additional capital from Treasury. And based on the improving housing market and the high quality of the newer loans backed by the Companies, it was apparent that they had returned to stable profitability. Indeed, the Agencies had specific information from the Companies demonstrating that this return to profitability was inevitable because the Companies would soon be reversing many of the non-cash accounting losses they had incurred under FHFA's supervision. In light of that information and the broad-based recovery in the housing industry that had occurred by the middle of 2012, the Agencies fully understood that the Companies were about to generate huge profits, far in excess of the dividends owed on the Government Stock.

9. The Government was not content to benefit from its investment like an investor in any other company and did not want to share the value of the Companies with private shareholders. Instead, it was committed to ensuring that, unlike all other companies that received financial assistance from the federal government during the financial crisis, Fannie and Freddie would be operated for the exclusive benefit of the federal government. Indeed, unbeknownst to the public, Treasury had secretly resolved "to ensure existing common equity holders will not have access to any positive earnings from the [Companies] in the future." Treasury also was seeking to transform the housing finance market by eliminating Fannie and Freddie, and it and FHFA had no intention of allowing the Companies to rehabilitate and exit conservatorship. By the middle of 2012, however, it was apparent that even the large amount of Government Stock outstanding would not achieve these surreptitious policy goals.

10. Therefore, on August 17, 2012, just days after the Companies announced record-breaking quarterly earnings, the Agencies unilaterally imposed the Net Worth Sweep to expropriate for the federal government the value of Fannie and Freddie shares held by private investors and to ensure that the Companies could not begin rebuilding their capital levels. Treasury itself said that the Net Worth Sweep was intended to ensure both that "every dollar of earnings that Fannie Mae and Freddie Mac generate will benefit taxpayers" and that the Companies "will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form." With the stroke of a pen, the Agencies had nationalized the Companies and taken all the value of the Companies for Treasury, thereby depriving the private shareholders of all their economic rights. No equivalent wipeout of private shareholder investments was imposed on other financial institutions that received assistance during the 2008 financial crisis, much less four years *after* that crisis was over.

11. The Companies received no incremental investment by Treasury or other meaningful consideration in return for the Net Worth Sweep, which restricts them to a small maximum capital level above which any profits they generate must be paid over to Treasury. This was done notwithstanding "the path laid out under HERA," which, as even Treasury acknowledged internally, was for FHFA to *rehabilitate* Fannie and Freddie, thus allowing them to "becom[e] adequately capitalized" and "exit conservatorship as private companies."

12. Despite the transparent fact that the Net Worth Sweep was designed to expropriate private property rights, the Government has claimed both in public and in prior filings in this case that the Net Worth Sweep was necessary to prevent the Companies from falling into a "death spiral" in which the Companies' increasing dividend obligations to Treasury

would consume Treasury's remaining funding commitment to the Companies. This made-for-litigation defense narrative is wholly inaccurate.

13. As an initial matter, the Government did not impose the Net Worth Sweep at a time when the Companies were struggling to generate enough income to pay the dividend on Treasury's stock. Rather, the Net Worth Sweep was imposed just days after the Companies disclosed that they had returned to stable profitability and had earned several billion dollars more than was necessary to pay the Treasury dividend in cash. And it was by then virtually inevitable, thanks to a strengthening housing market and the improving quality of loans guaranteed by the Companies, that they would soon reverse the non-cash accounting adjustments that were responsible for the great majority of the losses that they had experienced in the preceding years, thereby generating massive profits. More importantly, quite apart from the Companies' improved financial outlook, the Companies were contractually protected from a scenario in which their dividend obligation to Treasury could cause a death spiral: the Companies were entitled under the PSPAs to pay dividends to Treasury "in kind," with additional senior preferred stock, rather than in cash.

14. Materials produced in discovery further undermine the Government's death spiral narrative. Indeed, those materials reveal that the Net Worth Sweep was adopted not out of a concern that the Companies would earn too little, but rather out of concern that the Companies would make *too much* and thus would complicate the Administration's plans to keep Fannie and Freddie in perpetual conservatorship and to prevent their private shareholders from seeing any return on their investments. As a senior White House official stated in an email to a senior Treasury official on the day the Net Worth Sweep was announced, "we've closed off [the] possibility that [Fannie and Freddie] ever[] go (pretend) private again." That same official stated

in another email that Peter Wallison of the American Enterprise Institute was "exactly right on substance and intent" when he said that "[t]he most significant issue here is whether Fannie and Freddie will come back to life because their profits will enable them to re-capitalize themselves and then it will look as though it is feasible for them to return as private companies backed by the government. . . . What the Treasury Department seems to be doing here . . . is to deprive them of all their capital so that doesn't happen." An internal Treasury document dated August 16, 2012, expressed the same sentiment: "By taking all of their profits going forward, we are making clear that [Fannie and Freddie] will not ever be allowed to return to profitable entities . . . ."

15. The Net Worth Sweep has resulted in a massive and unprecedented financial windfall for the federal government at the expense of the Companies' private shareholders. From the fourth quarter of 2012, the first fiscal quarter subject to the Net Worth Sweep, through the fourth quarter of 2017, the most recently reported fiscal quarter, Fannie and Freddie generated $217 billion in comprehensive income. But rather than using those profits to prudently build capital reserves and prepare to exit conservatorship, Fannie and Freddie instead have been forced to pay substantially all of it as "dividends" to the federal government under the Net Worth Sweep—$124 billion more than the government would have received under the original PSPAs. Adding Net Worth Sweep dividends to the dividends Fannie and Freddie had already paid, Treasury has now recouped $87 billion *more* than it has invested in the Companies. Yet, according to the Government, these payments have not reduced Treasury's liquidation preference by one cent, and Treasury continues to insist that it has the right to Fannie's and Freddie's future earnings *in perpetuity*.

16. The Net Worth Sweep has resulted in a massive and unprecedented expropriation of private property. To the extent this ongoing expropriation is authorized by law, the Fifth Amendment compels the Government to pay just compensation to Plaintiffs for the taking. To the extent it is not authorized, the Fifth Amendment compels the Government to pay damages to Plaintiffs for the illegal exaction. Indeed, in addition to exceeding FHFA's powers under statute, FHFA itself is an unlawfully organized agency because the Constitution's separation of powers does not permit an independent agency with far-reaching powers such as FHFA to be headed by a single Director rather than a multi-member Board. HERA's concentration of power in one person who is only removable by the President for cause is unconstitutional. Finally, the extraordinary control exercised by FHFA as conservator over Fannie and Freddie created a fiduciary relationship between FHFA, on the one hand, and the Companies' shareholders, on the other. The Net Worth Sweep violated FHFA's fiduciary duties, and Plaintiffs are entitled to damages for the breach.

17. Accordingly, through this action, Plaintiffs seek the recompense to which they are entitled.

JURISDICTION AND VENUE

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

THE PARTIES

19. Plaintiff Arrowood Indemnity Company ("Arrowood Indemnity") is a Delaware corporation with its principal place of business at 3600 Arco Corporate Drive, Charlotte, North Carolina 28273. At the time of commencement of this action, Arrowood Indemnity owned the following shares of Fannie Mae Preferred Stock and Freddie Mac Preferred Stock, all of which were acquired prior to September 6, 2008, and had been continuously owned by Arrowood

Indemnity since the date of acquisition, other than 2000 shares of Fannie Mae Preferred Stock which were sold in 2013 and then repurchased later in 2013:

Entity	CUSIP	Coupon Rate	Series	Shares	Par Value Per Share	Aggregate Par Value
Fannie Mae	313586844	5.125%	L	38,800	$ 50.00	$ 1,940,000
Fannie Mae	313586877	5.375%	I	78,000	$ 50.00	$ 3,900,000
Fannie Mae	313586885	5.81%	H	147,400	$ 50.00	$ 7,370,000
Freddie Mac	313400855	5.10%	H	160,000	$ 50.00	$ 8,000,000
Freddie Mac	313400731	5.70%	R	100,000	$ 50.00	$ 5,000,000
Freddie Mac	313400772	5.81%	O	119,750	$ 50.00	$ 5,987,500
Freddie Mac	313400749	6.00%	P	60,000	$ 50.00	$ 3,000,000
			Total	703,950		$ 35,197,500

20. Arrowood Indemnity has continued to own and now owns:

Entity	CUSIP	Coupon Rate	Series	Shares	Par Value Per Share	Aggregate Par Value
Fannie Mae	313586877	5.375%	I	103,000	$ 50	$ 5,150,000
Freddie Mac	313400772	5.810%	O	19,750	$ 50	$ 987,500
			Total	**122,750**		**$ 6,137,500**

21. Plaintiff Arrowood Surplus Lines Insurance Company ("Arrowood Surplus Lines") is a Delaware corporation with its principal place of business at 3600 Arco Corporate Drive, Charlotte, North Carolina 28273. At the time of commencement of this action, Arrowood Surplus Lines owned the following shares of Fannie Mae Preferred Stock and Freddie Mac Preferred Stock, all of which were acquired prior to September 6, 2008, and had been continuously owned by Arrowood Surplus Lines since the date of acquisition:

Entity	CUSIP	Coupon Rate	Series	Shares	Par Value Per Share	Aggregate Par Value
Fannie Mae	313586877	5.375%	I	22,000	$ 50.00	$ 1,100,000
Freddie Mac	313400772	5.81%	O	40,000	$ 50.00	$ 2,000,000
Freddie Mac	313400749	6.00%	P	40,000	$ 50.00	$ 2,000,000
			Total	102,000		$ 5,100,000

22. Arrowood Surplus Lines has continued to own and now owns:

Entity	CUSIP	Coupon Rate	Series	Shares	Par Value Per Share	Aggregate Par Value
Fannie Mae	313586877	5.375%	I	22,000	$ 50	$ 1,100,000
Freddie Mac	313400772	5.810%	O	40,000	$ 50	$ 2,000,000
			Total	**62,000**		**$ 3,100,000**

23. Plaintiff Financial Structures Limited ("Financial Structures") is an insurance company organized under the laws of Bermuda, with an office at 7 Par-la-Ville Rd., Hamilton HM11, Bermuda. Financial Structures owns the following shares of Freddie Mac Preferred Stock, all of which were acquired prior to September 6, 2008, have been continuously owned by Financial Structures since the date of acquisition, and are still owned by Financial Structures:

Entity	CUSIP	Coupon Rate	Series	Shares	Par Value Per Share	Aggregate Par Value
Freddie Mac	313400772	5.81%	O	40,000	$ 50.00	$ 2,000,000
			Total	40,000		$ 2,000,000

24. Arrowood Surplus Lines and Financial Structures are wholly-owned subsidiaries of Arrowood Indemnity. Arrowood Indemnity is an indirect wholly-owned subsidiary of Arrowpoint Capital Corp., a Delaware corporation.

25. Arrowood Indemnity and Arrowood Surplus Lines are insurance companies that are now in "run-off" under the jurisdiction of the Commissioner of Insurance of the State of Delaware. Financial Structures is also an insurance company in run-off. As insurance companies

in run-off, the Arrowood Parties do not issue any new insurance policies, and have an obligation to manage their businesses, and conservatively invest their assets, so that funds will be available to fulfill their obligations to existing policyholders. Each of the Arrowood Parties regarded its investments in the Preferred Stock of Fannie Mae and Freddie Mac to be conservative investments.

26. Defendant United States of America includes Treasury, FHFA, and agents acting at their direction.

CONSTITUTIONAL AND STATUTORY PROVISIONS

27. 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 HERA, 12 U.S.C. §§ 1455(*l*), 1719(g), 4617.

FACTUAL ALLEGATIONS

Fannie and Freddie

28. Fannie is a for-profit, stockholder-owned corporation organized and existing under the Federal National Mortgage Act. Freddie is a for-profit, stockholder-owned corporation organized and existing under the Federal Home Loan Corporation Act. The Companies' business includes purchasing and guaranteeing mortgages originated by private banks and bundling the mortgages into mortgage-related securities that can be sold to investors. Prior to 2008, the Companies' mortgage portfolios had a combined value of $5 trillion.

29. Fannie and Freddie are owned by private shareholders and their securities are publicly traded. Fannie was chartered by Congress in 1938 and originally operated as an agency of the Federal Government. In 1968, Congress reorganized Fannie into a for-profit corporation owned by private shareholders. Freddie was established by Congress in 1970 as a wholly-owned

subsidiary of the Federal Home Loan Bank System. In 1989, Congress reorganized Freddie into a for-profit corporation owned by private shareholders.

30. Before being forced into conservatorship, both Fannie and Freddie had issued Common Stock and several series of Preferred Stock that were marketed and sold to community banks, insurance companies, and countless other institutional and individual investors. The several series of Preferred Stock of the Companies are in parity with each other with respect to their claims on income (i.e., dividend payments) and claims on assets (i.e., liquidation preference or redemption price), but they have priority over the Companies' Common Stock for these purposes. The holders of Common Stock are entitled to the residual economic value of the firms. The Companies have outstanding Preferred Stock with an aggregate liquidation preference of $33 billion.

31. Under the Certificates of Designation setting out the terms and conditions of the Preferred Stock issued by Fannie and Freddie prior to September 6, 2008, each series of Preferred Stock issued by the Companies enjoyed parity with all other issued and outstanding series of Preferred Stock as to the payment of dividends and the distribution of assets upon dissolution, liquidation, or winding up of the companies. Thus, the holders of each series of Preferred Stock had equal contractual rights to receive their respective liquidation preferences (or their respective pro rata portions thereof) upon dissolution, liquidation, or winding up of the Companies.

32. Prior to 2007, Fannie and Freddie were consistently profitable. In fact, Fannie had not reported a full-year loss since 1985 and Freddie had not reported a full-year loss since becoming owned by private shareholders. In addition, both Companies regularly declared and

paid dividends on each series of their respective Preferred Stock and their respective Common Stock.

Fannie and Freddie Are Forced into Conservatorship

33. The Companies were well-positioned to weather the decline in home prices and financial turmoil of 2007 and 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, Fannie and Freddie had taken a more conservative approach that meant that the mortgages that they insured (primarily 30-year fixed rate conforming mortgages) were far safer than those insured by the nation's largest banks. And although both Companies recorded losses in 2007 and the first two quarters of 2008—losses that largely reflected a temporary decline in the market value of their holdings caused by declining home prices—both Companies continued to generate enough cash to easily pay their debts and retained billions of dollars of capital that could be used to cover any future losses.

34. Neither Company was in danger of insolvency in 2008. Indeed, during the summer of 2008, both Treasury Secretary Henry Paulson and Office of Federal Housing and Enterprise Oversight ("OFHEO") Director James Lockhart publicly stated that Fannie and Freddie were financially healthy. For example, on July 8, 2008, Director Lockhart told CNBC that "both of these companies are adequately capitalized, which is our highest criteria." Two days later, on July 10, Secretary Paulson testified to the House Committee on Financial Services that Fannie's and Freddie's "regulator has made clear that they are adequately capitalized." On July 13, Director Lockhart issued a statement emphasizing that "the Enterprises' $95 billion in total capital, their substantial cash and liquidity portfolios, and their experienced management serve as strong supports for the Enterprises' continued operations." 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. An analysis of Freddie's financial condition in August 2008 for FHFA by BlackRock stated that Freddie's "long-term solvency does not appear endangered—we do not expect Freddie Mac to breach critical capital levels even in stress case." Furthermore, 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 sum, despite arguments to the contrary by lawyers for the Agencies in litigation related to the Net Worth Sweep, the Companies were not on the precipice of failure in 2008.

35. Despite (or perhaps because of) the Companies' comparatively strong financial position amidst the crisis, Treasury initiated a long-term policy of seeking to seize control of Fannie and Freddie and operate them for the exclusive benefit of the federal government. To that end, as early as March 2008, Treasury was internally discussing "potential costs and benefits of nationalization" of the Companies. Around the same time, a Treasury official was the off-the-record source for a Barron's article that inaccurately claimed that the Companies' books overstated assets and understated liabilities.

36. The Companies' sound financial condition in the weeks leading up to imposition of the conservatorships is further illustrated by the decision by Fannie's Board of Directors to declare dividends on both its preferred and common stock in August 2008 and by FHFA's

subsequent decision as conservator to direct Fannie to pay those dividends out of cash available for distribution in late September 2008. It is a fundamental principle of corporate law that a company may not declare dividends when it is insolvent, and dividends that a company improperly declares when insolvent may not be lawfully paid. Fannie's Board thus could not have lawfully declared dividends in August 2008 unless the Company was solvent at that time, and the Board's decision to declare those dividends showed its confidence that Fannie was financially healthy. Furthermore, it is evident that both FHFA and Treasury agreed that Fannie was solvent when it declared dividends in August 2008 because, rather than halting or voiding the dividends that the outgoing Fannie Board had declared, both Agencies publicly took the position that Fannie was legally obligated to pay them even after conservatorship was imposed in early September 2008

37. Also during the summer of 2008, Treasury pressed Congress to pass what became HERA. HERA created FHFA (which succeeded to the regulatory authority over Fannie and Freddie previously held by OFHEO) and authorized FHFA, under certain statutorily prescribed and circumscribed conditions, to place the Companies into either conservatorship or receivership.

38. In authorizing FHFA to act as conservator under specified circumstances, Congress took FHFA's conservatorship mission verbatim from the Federal Deposit Insurance Act ("FDIA"), *see* 12 U.S.C. § 1821(d)(2)(D), which itself incorporated a long history of financial supervision and rehabilitation of troubled entities under common law. HERA and the FDIA, as well as the common law concept on which both statutes draw, treat conservatorship as 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 fiduciary duty to safeguard the interests of the Companies and their shareholders.

39. According to HERA, FHFA "may, as conservator, take 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 acknowledged that "[t]he purpose of conservatorship is to preserve and conserve each company's assets and property and to put the companies in a sound and solvent condition," and "[t]o fulfill the statutory mandate of conservator, FHFA must follow governance and risk management practices associated with private-sector disciplines." FHFA, REPORT TO CONGRESS 2009 at i, 99 (May 25, 2010).

40. FHFA has repeatedly stated publicly that HERA *requires* and *mandates* FHFA as conservator to preserve and conserve Fannie's and Freddie's assets and to restore them to a sound and solvent condition. The following are just a few examples:

- The provisions of 12 U.S.C. § 4617(b)(2)(D) are "statutory mandates" and as conservator FHFA "must follow the mandates assigned to it by statute." FHFA, STRATEGIC PLAN: FISCAL YEARS 2018-2022 at 3-4 (Jan. 29, 2018). https://goo.gl/yDZmir.
- FHFA has "statutory obligations to operate the [Companies] in a safe and sound manner." Prepared Remarks of Melvin L. Watt, Dir., FHFA, at American Mortgage Conference (May 18, 2017). https://goo.gl/rT3f6C.
- FHFA's "statutory mandates obligate" it to "[c]onserve and preserve the assets of the Enterprises while they are in conservatorship." Statement of Melvin L. Watt,

Dir., FHFA, Before the U.S. Senate Comm. on Banking, Housing, and Urban Affairs (May 11, 2017). https://goo.gl/h44qRf.

- FHFA has a " 'preserve and conserve' mandate." FHFA STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIP: THE NEXT CHAPTER IN A STORY THAT NEEDS AN ENDING at 7 (Feb. 21, 2012), http://goo.gl/uXreKX ("A STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIP").
- "By law, the conservatorships are intended to rehabilitate [Fannie and Freddie] as private firms." Letter from Edward DeMarco, Acting Director, FHFA to Senators at 1 (Nov. 10, 2011), http://goo.gl/hbBe25.
- "The statutory role of FHFA as conservator requires FHFA to take actions to preserve and conserve the assets of the Enterprises and restore them to safety and soundness. FHFA REPORT TO CONGRESS 2009 at 99 (May 25, 2010), http://goo.gl/YOOgzC.
- "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." The Present Condition and Future Status of Fannie Mae and Freddie Mac: Hearing Before the Subcomm. of Capital Markets, Ins. & Gov't Sponsored Enters of the H. Comm. On Fin. Servs. 111th Cong. 136 (2009). (statement of James B. Lockhart III, Dir., FHFA).
- FHFA as conservator "preserves and conserves the assets and property of the Enterprises . . . and facilitates their financial stability and emergence from conservatorship." FHFA, STRATEGIC PLAN 2009–2014, at 33, http://goo.gl/UjCxf6. "The conservatorship of Fannie Mae and Freddie Mac

allows the FHFA to preserve the assets of the [Companies], ensure they focus on their housing mission and are positioned to emerge from conservatorship as financially strong . . . ." Id. at 20.

41. The Agencies' similarly acknowledged FHFA's mandates as conservator in internal documents produced in discovery. Treasury, for example, acknowledged that "FHFA as conservator is required to preserve assets" and that one of the "[l]egal [c]onstraints" imposed upon FHFA is its "mandate[ ] to 'conserve assets.' " FHFA recognized that it "has a responsibility to take such actions as may be necessary to put the Enterprises in a sound and solvent condition and to preserve and conserve their assets and property."

42. Under HERA, conservatorship is a status distinct from receivership, with very different purposes, responsibilities, and restrictions. When acting as a receiver, but *not* when acting as a conservator, FHFA is authorized and obliged to "place the regulated entity in liquidation and proceed to realize upon the assets of the regulated entity." *Id.* § 4617(b)(2)(E). The only "post-conservatorship outcome[] . . . that FHFA may implement today under existing law," by contrast, "is to reconstitute [Fannie and Freddie] under their current charters." Letter from Edward J. DeMarco, Acting Director, FHFA, to Chairmen and Ranking Members of the Senate Committee on Banking, Housing, and Urban Affairs and to the House Committee on Financial Services 7 (Feb. 2, 2010). In other words, receivership is aimed at winding down a company's affairs and liquidating its assets, while conservatorship aims to rehabilitate it and return it to normal operation. This distinction between the purposes and authorities of a receiver and a conservator is a well-established tenet of financial regulation and common law. In our nation's history, there has *never* been an example of a regulator forcing a healthy, profitable company to remain captive in a perpetual conservatorship (in this instance, going on ten years)

while facilitating the looting and plundering of the company's assets by another federal agency *and* simultaneously avoiding the organized claims process of a receivership.

43. In promulgating regulations governing its operations as conservator versus receiver of the Companies, FHFA specifically acknowledged the distinctions in its statutory responsibilities as conservator and as receiver: "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." 76 Fed. Reg. 35,724, 35,730. In contrast, when FHFA acts as a receiver, the regulation specifically provides that "[t]he Agency, as receiver, *shall* place the regulated entity in liquidation . . . ." 12 C.F.R. § 1237.3(b) (emphasis added). Consistent with this interpretation of HERA, a FHFA Advisory Bulletin describes "the conservator's or receiver's powers and responsibilities" as including "in the case of a conservator, to put the regulated entity in a sound and solvent condition, and to carry on its business and preserve and conserve its assets, and in the case of a receiver, to liquidate the regulated entity."

44. During conservatorship FHFA has dual and potentially conflicting roles as the Companies' conservator and regulator. As conservator, FHFA's mission is to preserve and conserve the Companies' assets and restore them to soundness and solvency. In contrast, as regulator, FHFA is charged with the public mission of ensuring that the Companies "foster liquid, efficient, competitive, and resilient national housing finance markets (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities)" and conduct their operations in a manner "consistent with the public interest." 12 U.S.C. § 4513(a)(1)(B). The FDIC, which has similar dual roles, has in the past sought to manage this conflict by erecting a "firewall" between personnel tasked with working for the agency as conservator and other

personnel tasked with working for the agency as regulator. *See Plaintiffs in All Winstar-Related Cases at Court v. United States*, 44 Fed. Cl. 3, 7 n.5 (1999). FHFA has not taken similar steps to protect the integrity of its conservatorship role and, as set forth in greater detail below, abandoned the traditional role of a conservator by disregarding the interests of the Companies when it took the actions that are the subject of this suit.

45. On September 6, 2008, FHFA and Treasury persuaded the Companies' boards to consent to 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, JR., ON THE BRINK 6 (2010). Given that the Companies were not in financial distress and were in no danger of defaulting on their debts, the Companies' directors were confronted with 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 REPORT 320 (Jan. 2011). The Agencies ultimately obtained the Companies' consent by threatening to seize them if they did not acquiesce and by informing them that the Agencies had already selected new CEOs and had teams ready to move in and take control. In agreeing to the FHFA takeover, both Companies' boards understood that the "conservatorship" FHFA and Treasury proposed would be like all other federal conservatorships in American history and that the Companies would be operated by their regulator acting in a fiduciary capacity for the benefit of all stakeholders, including private shareholders.

46. In publicly announcing the conservatorship, FHFA acknowledged that the Companies' stock remains outstanding during conservatorship and "continue[s] to trade," *FHFA Fact Sheet, Questions and Answers on Conservatorship* 3, https://goo.gl/DV4nAt, and Fannie's and Freddie's stockholders "continue to retain all rights in the stock's financial worth," *id.* Director Lockhart testified before Congress that Fannie's and Freddie's "shareholders are still in place; both the preferred and common shareholders have an economic interest in the companies" and that "going forward there may be some value" in that interest. *Oversight Hearing to Examine Recent Treasury & FHFA Actions Regarding the Housing GSEs: Hearing Before the H. Comm. on Fin. Servs.,* 110th Cong. 29–30, 34 (2008).

47. FHFA also emphasized that the conservatorship was temporary: "Upon the Director's determination that the Conservator's plan to restore the [Companies] to a safe and solvent condition has been completed successfully, the Director will issue an order terminating the conservatorship." *FHFA Fact Sheet, Questions and Answers on Conservatorship* 2. Investors were entitled to rely on these official statements of the purposes of the conservatorship, and public trading in Fannie's and Freddie's stock was permitted to, and did, continue.

48. In short, the Companies were not in financial distress when they were forced into conservatorship. The Companies' boards acquiesced to conservatorship based on the understanding that FHFA, like any other conservator, would operate the Companies as a fiduciary with the goal of preserving and conserving their assets and managing them in a safe and solvent manner. And in publicly announcing the conservatorships, FHFA confirmed that the Companies' private shareholders continued to hold an economic interest that could have value, particularly as the Companies generated profits in the future.

FHFA and Treasury Enter into the Purchase Agreements

49. On September 7, 2008, Treasury and FHFA, acting in its capacity as conservator of Fannie and Freddie, entered into the Preferred Stock Purchase Agreements.

50. In entering into the Purchase Agreements, Treasury exercised its temporary authority under HERA to purchase securities issued by the Companies. *See* 12 U.S.C. §§ 1455(*l*), 1719(g). To exercise that authority, the Secretary of the Treasury was required to determine that purchasing the Companies' securities was "necessary to. . .provide stability to the financial markets; . . . prevent disruptions in the availability of mortgage finance; and . . . protect the taxpayer." 12 U.S.C. §§ 1455(*l*)(1)(B), 1719(g)(1)(B). In making those determinations, the Secretary was required to consider six factors:

> (i) The need for preferences or priorities regarding payments to the Government.
> (ii) Limits on maturity or disposition of obligations or securities to be purchased.
> (iii) *The [Companies'] plan[s] for the orderly resumption of private market funding or capital market access*.
> (iv) The probability of the [Companies] fulfilling the terms of any such obligation or other security, including repayment.
> (v) *The need to maintain the [Companies'] status as . . . private shareholder-owned compan[ies]*.
> (vi) Restrictions on the use of [the Companies'] resources, including limitations on the payment of dividends and executive compensation and any such other terms and conditions as appropriate for those purposes.

Id. §§ 1455(*l*)(1)(C), 1719(g)(1)(C) (emphasis added).

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 (Sept. 7, 2008).

52. Treasury's authority under HERA to purchase the Companies' securities expired on December 31, 2009. *See* 12 U.S.C. §§ 1455(*l*)(4), 1719(g)(4). After that date, HERA authorized Treasury only "to hold, exercise any rights received in connection with, or sell" previously purchased securities. *Id.* §§ 1455(*l*)(2)(D), 1719(g)(2)(D).

53. Treasury's PSPAs with Fannie and Freddie are materially identical. Under the original agreements, Treasury committed to provide up to $100 billion to each Company to ensure that it maintained a positive net worth. In particular, for quarters in which either Company's liabilities exceed its assets under Generally Accepted Accounting Principles, the PSPAs authorize Fannie and Freddie to draw upon Treasury's commitment in an amount equal to the difference between its liabilities and assets.

54. In return for Treasury's funding commitment, Treasury received 1 million shares of Government Stock in each Company and warrants to purchase 79.9% of the common stock of each Company at a nominal price. Exercising these warrants would entitle Treasury to up to 79.9% of all future profits of the Companies, subject to the Companies' obligation to satisfy their dividend obligations with respect to the Government Stock and Preferred Stock and to share the remaining 20.1% of those profits with private common shareholders. As Treasury noted in entering the PSPAs, the warrants "provide potential future upside to the taxpayers." Action Memorandum for Secretary Paulson (Sept. 7, 2008).

55. Treasury's Government Stock in each Company had an initial liquidation preference of $1 billion. In other words, Treasury took an upfront fee of $1 billion from each of the Companies before either Company received *any* funding from Treasury in return. This liquidation preference increases by one dollar for each dollar the Companies receive from Treasury pursuant to the PSPAs. In the event the Companies liquidate, Treasury is entitled to

recover the full liquidation value of its shares before any other shareholder may recover anything.

56. While Treasury's commitment remains outstanding, Fannie and Freddie generally are prohibited from paying down amounts added to the liquidation preference due to draws from Treasury's commitment. *See* Fannie and Freddie Government Stock Certificates § 3(a). This extraordinary feature of the original PSPAs would play an important role in enabling the Government to permanently increase the size of the dividends on the Government Stock by artificially reducing the Companies' reported net worth through the accounting manipulations discussed below.

57. In addition to the liquidation preference, the original PSPAs provided for Treasury to receive either a cumulative cash dividend equal to 10% of the value of the outstanding liquidation preference or a stock dividend. If the Companies decided not to pay the dividend in cash, the value of the dividend would be added to the liquidation preference—effectively amounting to an in-kind dividend payment of additional Government Stock. After an in-kind dividend payment, the dividend rate would increase to 12% until such time as full cumulative dividends were paid in cash, at which point the rate would return to 10%. The plain terms of the PSPAs thus make clear that Fannie and Freddie never were required to pay a cash dividend to Treasury but rather had the discretion to pay dividends in kind. In other words, the Companies were never under any obligation to pay a fixed 10% cash dividend to Treasury. Moreover, there was never any risk that payment of dividends would render the Companies insolvent since it would have been illegal under state law for either Company to pay a dividend that would render it insolvent.

58. Numerous materials prove beyond any reasonable doubt that the Agencies recognized that the PSPAs were designed, as their express terms plainly provide, to allow the payment of dividends in kind—in additional senior preferred stock—rather than in cash. In an internal October 2008 email to Mario Ugoletti—who was then a Treasury official, but later moved to FHFA and was a key point of contact with Treasury in the development of the Net Worth Sweep—another Treasury official indicated that Treasury's consultant wanted to know "whether we expect [Fannie and Freddie] to pay the preferred stock dividends in cash or to just accrue the payments." Mr. Ugoletti did not forget about this feature of the PSPAs when he moved to FHFA. Indeed, he acknowledged the option to pay dividends "in kind" in an email that he sent the very day the Net Worth Sweep was announced. In a similar vein, a document attached to a September 16, 2008, email between FHFA officials expressly states that PSPA dividends may be "paid in-kind." In an October 2008 email to Treasury and FHFA officials, a Treasury consultant sought to clarify whether Fannie and Freddie "intend[ed] to pay cash at 10 percent or accrue at 12 percent as a matter of policy." An internal Treasury document says that the dividend rate "may increase to the rate of 12 percent if, in any quarter, the dividends are not paid in cash." And an internal FHFA document says that Treasury's senior stock pays "10 percent cash dividend (12 percent payment-in-kind)."

59. Documents that the Agencies placed in the public domain also support this understanding of the payment-in-kind option. Upon entering the PSPAs Treasury released a fact sheet stating that, "[t]he senior preferred stock shall accrue dividends at 10% per year. The rate shall increase to 12% if, in any quarter, the dividends are not paid in cash . . . ." U.S. TREASURY DEP'T OFFICE OF PUB. AFFAIRS, FACT SHEET: TREASURY SENIOR PREFERRED STOCK PURCHASE AGREEMENT (Sept. 7, 2008), https://goo.gl/ynb3TC. And a presentation Treasury included in the

administrative record in a case in the District of the District of Columbia acknowledges that the dividend rate of the PSPAs would be 12% "if elected to be paid in kind." Treasury Presentation to SEC, GSE Preferred Stock Purchase Agreements (PSPA), Overview and Key Considerations at 9, June 13, 2012.

60. The Companies shared this understanding of the terms of their agreements with Treasury. Fannie's and Freddie's Chief Financial Officers ("CFOs") have testified that they were aware of the payment-in-kind option. Various Freddie documents say that "[t]he dividend becomes 12% if Freddie Mac is unable to pay the dividend through organic income," that "[t]he senior preferred stock will pay quarterly cumulative dividends at a rate of 10% per year or 12% in any quarter in which dividends are not paid in cash," that Treasury's stock "[p]ays quarterly cumulative dividend rate at 10% per year, or 12% in any quarter in which dividends are not paid in cash," and that Treasury's stock "will pay quarterly cumulative dividends at a rate of 10% per year, or 12% in any quarter in which dividends are not paid in cash." Similarly, Fannie documents say that "Treasury's preferred stock "has an annual dividend rate of 10%, which could increase to 12% if not paid in cash," and that "[i]f at any time . . . the Company does not pay the cash dividends in a timely manner, . . . the annual dividend rate will be 12%."

61. An in-kind dividend payment would not decrease Treasury's funding commitment because only when the Companies receive "funding under the Commitment" does its size decrease. Fannie and Freddie Amended and Restated Senior Preferred Stock Purchase Agreements ("PSPA") § 1. Jeff Foster, one of the architects of the Net Worth Sweep at Treasury, accordingly has testified in a deposition that he could not identify any "problems of the circularity [in dividend payments that] would have remained had the [payment-in-kind] option been adopted." Thus, as the Congressional Research Service has acknowledged, under the

PSPAs' original terms the Companies could "pay a 12% annual senior preferred stock dividend indefinitely." N. ERIC WEISS, CONG. RESEARCH SERV., RL34661, FANNIE MAE'S AND FREDDIE MAC'S FINANCIAL PROBLEMS (Aug. 10, 2012). In other words, because of the payment-in-kind option, there was no risk—none whatsoever—that the PSPAs would force Fannie and Freddie to exhaust Treasury's funding commitment to facilitate the payment of dividends.

62. The PSPAs also provided for the Companies to pay Treasury a quarterly periodic commitment fee "intended to fully compensate [Treasury] for the support provided by the ongoing Commitment." PSPA § 3.2(a). The periodic commitment fee was to be set for five-year periods by agreement of the Companies and Treasury, but Treasury had the option to waive it for up to a year at a time. Treasury has exercised this option and has never received a periodic commitment fee under the PSPAs. Even if the fee had been charged, the Companies were always free under the express terms of the PSPAs to pay the fee in-kind with additional senior preferred stock rather than in cash. *See* PSPA § 3.2(c) ("At the election of Seller, the Periodic Commitment Fee may be paid in cash or by adding the amount thereof ratably to the liquidation preference of each outstanding share of Senior Preferred Stock . . . ."). This is a fact that Freddie's auditor recognized in a document produced in this case.

63. Finally, the PSPAs also grant Treasury substantial control over FHFA's operation of Fannie and Freddie and the conservatorships. In particular, from their inception through the adoption of the Net Worth Sweep the PSPAs provided as follows:

> From the Effective Date until such time as the Senior Preferred Stock shall have been repaid or redeemed in full in accordance with its terms:
>
> 5.1. *Restricted Payments.* Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, declare or pay any dividend (preferred or otherwise) or make any other distribution (by reduction of capital or otherwise), whether in cash, property, securities or a combination thereof, with respect to any of Seller's Equity Interests

(other than with respect to the Senior Preferred Stock or the Warrant) or directly or indirectly redeem, purchase, retire or otherwise acquire for value any of Seller's Equity Interests (other than the Senior Preferred Stock or the Warrant), or set aside any amount for any such purpose.

5.2. *Issuance of Capital Stock*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, sell or issue Equity Interests of Seller or any of its subsidiaries of any kind or nature, in any amount, other than the sale and issuance of the Senior Preferred Stock and Warrant on the Effective Date and the common stock subject to the Warrant upon exercise thereof, and other than as required by (and pursuant to) the terms of any binding agreement as in effect on the date hereof.

5.3. *Conservatorship*. Seller shall not (and Conservator, by its signature below, agrees that it shall not), without the prior written consent of Purchaser, terminate, seek termination of or permit to be terminated the conservatorship of Seller pursuant to Section 1367 of the FHE Act, other than in connection with a receivership pursuant to Section 1367 of the FHE Act.

5.4. *Transfer of Assets*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, sell, transfer, lease or otherwise dispose of (in one transaction or a series of related transactions) all or any portion of its assets (including Equity Interests in other persons, including subsidiaries), whether now owned or hereafter acquired (any such sale, transfer, lease or disposition, a "Disposition"), other than Dispositions for fair market value:

(a) to a limited life regulated entity ("LLRE") pursuant to Section 1367(i) of the FHE Act;

(b) of assets and properties in the ordinary course of business, consistent with past practice;

(c) in connection with a liquidation of Seller by a receiver appointed pursuant to Section 1367(a) of the FHE Act;

(d) of cash or cash equivalents for cash or cash equivalents; or

(e) to the extent necessary to comply with the covenant set forth in Section 5.7 below.[1]

[1] The Third Amendment, discussed below, added a provision to Section 5.4 permitting the Companies to sell up to $250,000,000 in assets in a single transaction without Treasury's consent.

> 5.5. *Indebtedness*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, incur, assume or otherwise become liable for (a) any indebtedness if, after giving effect to the incurrence thereof, the aggregate Indebtedness of Seller and its subsidiaries on a consolidated basis would exceed 110.0% of the aggregate Indebtedness of Seller and its subsidiaries on a consolidated basis as of June 30, 2008 or (b) any Indebtedness if such Indebtedness is subordinated by its terms to any other Indebtedness of Seller or the applicable subsidiary. For purposes of this covenant the acquisition of a subsidiary with Indebtedness will be deemed to be the incurrence of such Indebtedness at the time of such acquisition.
>
> 5.6. *Fundamental Changes*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, (i) merge into or consolidate or amalgamate with any other Person, or permit any other Person to merge into or consolidate or amalgamate with it, (ii) effect a reorganization or recapitalization involving the common stock of Seller, a reclassification of the common stock of Seller or similar corporate transaction or event or (iii) purchase, lease or otherwise acquire (in one transaction or a series of transactions) all or substantially all of the assets of any other Person or any division, unit or business of any Person.
>
> . . .
>
> 5.8. *Transactions with Affiliates*. Seller shall not, and shall not permit any of its subsidiaries to, without the prior written consent of Purchaser, engage in any transaction of any kind or nature with an Affiliate of Seller unless such transaction is (i) Pursuant to this Agreement, the Senior Preferred Stock or the Warrant, (ii) upon terms no less favorable to Seller than would be obtained in a comparable arm's-length transaction with a Person that is not an Affiliate of Seller or (iii) a transaction undertaken in the ordinary course or pursuant to a contractual obligation or customary employment arrangement in existence as of the date hereof.
>
> PSPAs at 8–10.

64. As Freddie has observed, these covenants "restrict [the Companies'] business activities" and prevent them from taking certain actions even at the direction of FHFA "without prior written consent of Treasury."

65. On May 6, 2009, FHFA and Treasury amended the PSPAs to increase Treasury's funding commitment to each Company from $100 billion to $200 billion. On December 24, 2009—one week before Treasury's temporary statutory authority to purchase the Companies'

securities expired—the agencies again amended the terms of Treasury's funding commitment. Instead of resetting the commitment at a specific dollar amount, the second amendment established a formula to allow Treasury's total commitment to each Company to exceed (but not fall below) $200 billion depending upon any net worth deficiencies experienced in 2010, 2011, and 2012, and any surplus existing as of December 31, 2012. In an action memorandum explaining the second of these two amendments, Treasury stated that the increased funding commitment was "a strong statement that the U.S. Government will make sure that the institutions continue to function" and that it was not expected that the Companies would require any additional increase because "[i]t is unlikely that either [Company] will reach the $200 billion existing cap unless the housing market worsens sharply from here." As Treasury acknowledged, in the same document, expiration of its authority to purchase the Companies' shares at the end of 2009 meant that its "ability to make further changes to the PSPAs . . . [was] constrained." Action Memorandum for Secretary Geithner at 3, 4 (Dec. 22, 2009).

The Agencies Force Accounting Changes To Increase
the Companies' Draws From Treasury

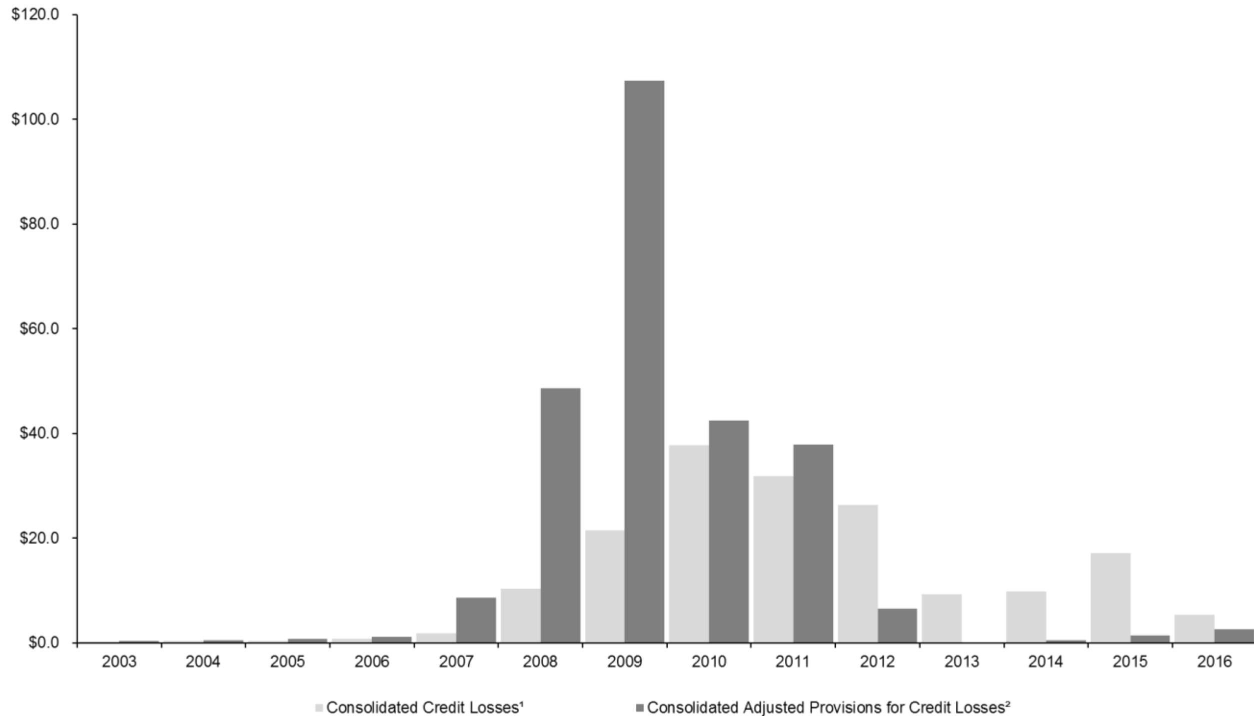
66. Beginning in the third quarter of 2008—when FHFA took control of the Companies as conservator—the Companies began to make wildly pessimistic and obviously unrealistic assumptions about their future financial prospects. Indeed, these assumptions would have only been accurate if the United States had suffered a catastrophic, multi-decade depression that no company, irrespective of its financial health, could have survived. These false assumptions triggered adjustments to the Companies' balance sheets, most notably write-downs of significant tax assets and the establishment of large loan loss reserves, which caused the Companies to report non-cash losses. Although reflecting nothing more than unjustifiable

accounting assumptions about the Companies' future prospects and having no effect on the cash flow the Companies were generating, these non-cash losses temporarily and misleadingly decreased the Companies' reported net worth by in excess of a hundred billion dollars. For example, in the first year and a half after imposition of the conservatorship, Fannie reported $127 billion in losses, but only $16 billion of that amount reflected actual credit-related losses. These excessive non-cash losses resulted in excessive purchases of Government Stock by Treasury. Had the Companies' net worth been properly calculated under Generally Accepted Accounting Principles, their liabilities would never have exceeded their assets. In 2010, during the period when these improper accounting adjustments were being made, FHFA also decided to order the Companies to de-list their shares from the New York Stock Exchange, a decision that had no effect on the stock's underlying economic value but caused a precipitous decline in its market price.

67. By the end of 2011, the Companies' reported net worth had fallen by $100 billion as a result of the decision made shortly after imposition of the conservatorship to write down the value of their deferred tax assets. A deferred tax asset is an asset that may be used to offset future tax liability. Under Generally Accepted Accounting Principles, if a company determines that it is unlikely that some or all of a deferred tax asset will be used, the company must establish a "valuation allowance" in the amount that is unlikely to be used. In other words, a company must write down a deferred tax asset if it is unlikely to be used to offset future taxable profits. Shortly after FHFA took control of the Companies, FHFA made the implausible assumption that the Companies would *never again* generate taxable income and that their deferred tax assets were therefore worthless. That incomprehensibly flawed decision dramatically reduced the Companies' reported net worth.

68. The decision to designate excessive loan loss reserves was another important factor in the artificial decline in the Companies' reported net worth during the early years of conservatorship. Loan loss reserves are an entry on the Companies' balance sheets that reduces their reported net worth to reflect anticipated losses on the mortgages they own. Beginning when FHFA took control of the Companies in the third quarter of 2008 and continuing through 2009, the Companies were forced to provision additional loan loss reserves far in excess of the credit losses they were actually experiencing. The extent to which excess loan loss reserve provisioning reduced the Companies' reported net worth is dramatically illustrated by the following chart, which compares the Companies' loan loss reserve provisioning to their actual credit losses. As the chart shows, FHFA caused the Companies to make grossly excessive loan loss reserve provisions in 2008 and 2009. The excessive nature of these loan loss provisions was readily apparent by 2012, and the inevitable reversals would appear as income on the Companies' balance sheet.

Loan Loss Reserve Provisions vs. Credit Expenses



Source: Company Financials

(1) Credit losses based on net charge-offs (charge-offs less recoveries), plus foreclosed property expense. Charge-offs taken in relation to credit-impaired loans of Fannie Mae have been reversed, and replaced with ultimately realized

(2) Provisions shown include stated provisions, plus foreclosed property expense for Fannie Mae, and REO expense and Transfers for Freddie Mac. Note, stated provisions based on provisions only and excludes impact of provision reversals

69. Despite the fact that the Companies' mortgage portfolios were safer than the similar portfolios held by banks involved in the mortgage business, banks were much more accurate—and, with the consent of their regulators, far less aggressive—in reducing their net worth to reflect expected loan losses. The following chart illustrates this fact:

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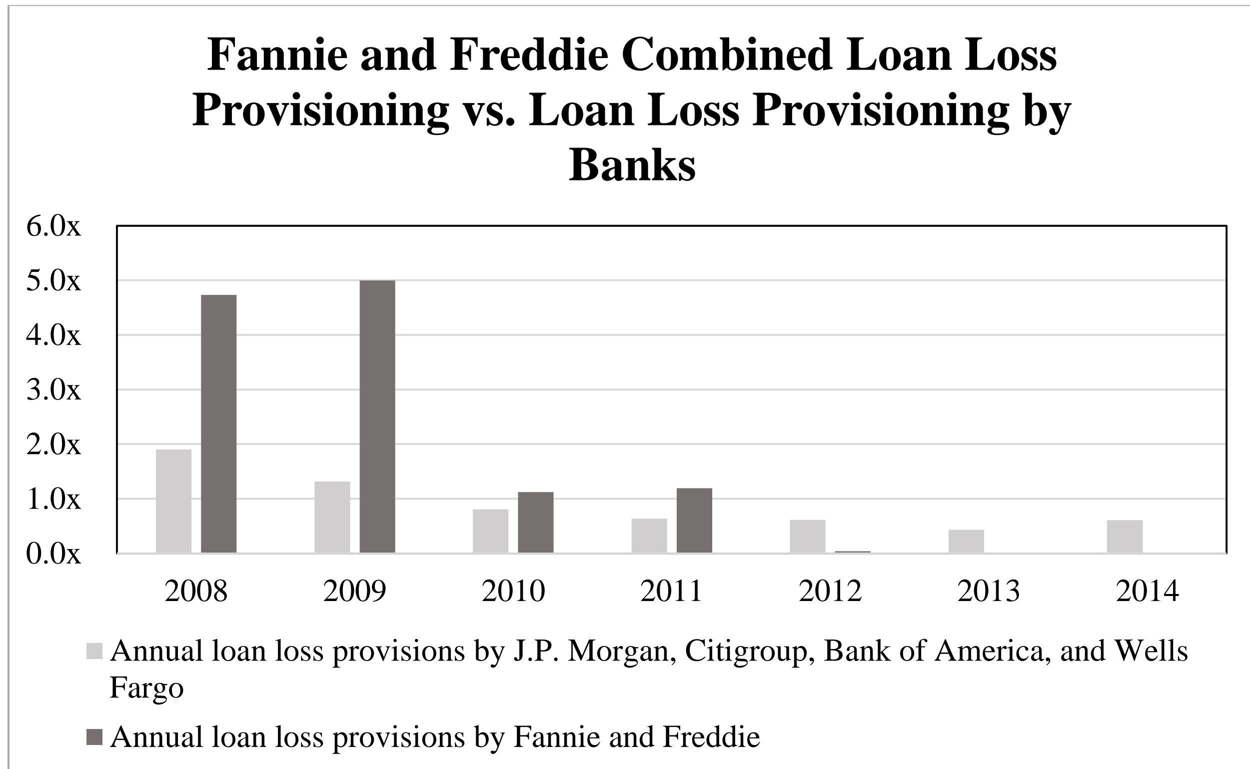


70. In June 2011, FHFA officials observed in an email exchange that Freddie was taking loan loss reserves in excess of what its own financial models supported but that Freddie would "face some hard questioning from FHFA" if it sought "to take down the reserves in the current clime." And in November 2011, a Treasury consultant that had reviewed Fannie financial projections previously used to justify loan loss reserve decisions observed that "actual net losses were typically lower than predicted in the optimistic and base cases . . . and far lower than forecasted in the stress cases."

71. By June of 2012, the Companies had drawn a total of $187 billion from Treasury, in large part to fill the holes in the Companies' balance sheets created by these artificial non-cash losses imposed under conservatorship. Approximately $26 billion of these combined amounts were drawn simply to pay the 10% dividend payments owed to Treasury. (In other words, FHFA

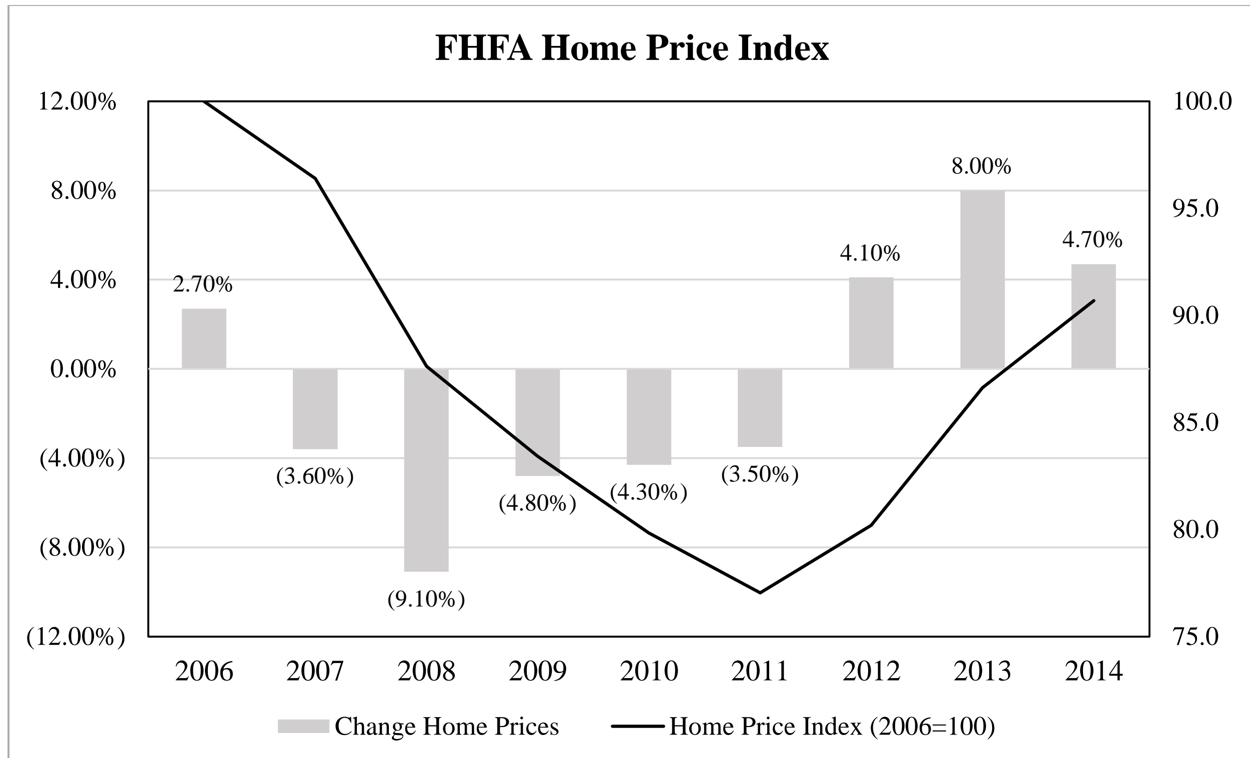
requested draws to pay Treasury this $26 billion in cash that was not otherwise available rather than electing to pay the dividends in kind. Had the dividends been paid in kind, FHFA would not have had to draw from—and, consequently, reduce the remaining size of—Treasury's commitment to pay them.) Thus, Treasury actually disbursed approximately $161 billion to the Companies, primarily reflecting temporary changes in the valuation estimates of assets and liabilities.

72. From the outset of the conservatorship through the imposition of the Net Worth Sweep, the Companies' net operating revenue exceeded their net operating expenses, and their actual losses were never so severe that they would have had a negative net worth but for the excessively pessimistic and unjustified treatment of deferred tax assets and loan loss reserves. In other words, despite manipulations made to the Companies' balance sheets while they were under the Government's control, they never had any difficulty paying their debts and other obligations. Over time, the Companies' cash receipts have consistently exceeded their expenses.

The Companies Return to Profitability and Stability

73. By 2012, Fannie and Freddie began generating consistent profits notwithstanding their overstated loss reserves and the write-down of their deferred tax assets. In fact, in the first two quarters of 2012, the Companies posted sizable profits totaling more than $11 billion. What is more, the Companies were well-positioned to continue generating robust profits for the foreseeable future.

74. Fannie's and Freddie's financial results are strongly influenced by home prices. And as FHFA's own Home Price Index shows, the market reached its bottom in 2011:



75. The improving housing market was coupled with stricter underwriting standards at Fannie and Freddie. As a result—and as the Agencies knew—Fannie- and Freddie-backed loans issued after 2008 had dramatically lower serious delinquency rates than loans issued between 2005 and 2008. To appreciate the significance of this point, it is useful to understand that the mortgages the Companies purchase and securitize in a given year are sometimes collectively referred to as that year's "vintage." Some vintages are more profitable than others; the Companies make more money from mortgages purchased in years when borrowers were on the whole more creditworthy and overall home prices were lower (factors that reduce the rate at which borrowers default). Although each vintage generates income for the Companies for many years (the Companies mostly purchase 30-year mortgages), it is possible to make an early assessment of how profitable a given vintage will be by examining the vintage's default rate in its first few years. In this manner, the Companies and the Agencies were able to examine the

quality of the mortgage vintages from after 2008, and by 2012 they fully understood that those newer vintages would be highly profitable.

76. The strong quality of these newer vintages of mortgages boded well for Fannie's and Freddie's future financial prospects. Indeed, as early as June 2011, a Treasury official observed that "[a]s Fannie and Freddie continue to work through their legacy book of business, —i.e., vintages from before 2009—" the actual realized losses are expected to decline significantly." And an internal Treasury document similarly observed that the Companies' losses during the early years of conservatorship "are almost entirely attributable to loans that were originated and guaranteed before conservatorship" and that "[t]he 2006, 2007, and 2008 vintages account for over 70% of all credit losses."

77. Together, the Companies' return to robust profitability and the stable recovery of the housing market showed in early 2012 that the Companies could in time redeem Treasury's Government Stock and that value remained in their Preferred Stock and Common Stock. Indeed, a presentation sent to senior Treasury officials in February 2012 indicated that "Fannie and Freddie could have the earnings power to provide taxpayers with enough value to repay Treasury's net cash investments in the two entities." The Companies' financial performance and outlook only further improved in the ensuing months. In the weeks leading up to the Net Worth Sweep, one Treasury official observed that Freddie's second quarter 2012 results were "very positive," and a report circulated among senior FHFA officials said that the agency deserved a "high five" for the Companies' strong financial outlook.

78. As a result of Fannie's and Freddie's return to sustained profitability, it was clear that the overly pessimistic accounting decisions weighing down the Companies' balance sheets would have to be reversed. Indeed, by early August 2012, the Agencies knew that Fannie and

Freddie were poised to generate massive profits well in excess of the Companies' dividend obligations to Treasury—profits that would make the $11 billion the Companies generated in the first half of 2012 look small by comparison.

79. By August 2012, the Agencies knew that the Companies' reserves for loan losses far exceeded their actual losses. These excess loss reserves artificially depressed the Companies' net worth, and reversing them would increase the Companies' net worth accordingly. Indeed, on July 19, 2012, a Treasury official observed that the release of loan loss reserves could "increase the [Companies'] net [worth] substantially." A Treasury document from early August 2012 likewise stated that the Companies were about to report "[r]ecord earnings" that would be "driven by [a] large credit loss reserve release." And the Agencies were focused on this issue. An internal briefing memorandum prepared for Under Secretary Miller in advance of August 9, 2012 meetings with Fannie and Freddie executives reveals that the number one question Treasury had for the Companies was "how quickly they forecast releasing credit reserves." And a handwritten note on a presentation from the August 9 meeting with Freddie says to "expect material release of loan loss reserves in the future." FHFA also knew that loan loss reserve releases would boost the Companies' profits going forward, as FHFA officials attended a meeting of Freddie's Loan Loss Reserve Governance Committee on August 8, 2012. FHFA's knowledge of the status of the Companies' loan loss reserves is also dramatically illustrated by a July 2012 FHFA presentation showing that starting in 2008 the Companies had set aside loan loss reserves far in excess of their actual losses.

80. Another principal driver of the outsized profits that the Companies would inevitably generate was the mandated release of the Companies' deferred tax assets valuation allowances. By mid-2012, Fannie and Freddie had combined deferred tax assets valuation

allowances of nearly $100 billion. Under relevant accounting rules, those valuation allowances would have to be reversed if the Companies determined that it was more likely than not that they would generate taxable income and therefore be able to use their deferred tax assets. The Treasury Department was intimately familiar with these issues, having seen such a reversal in February 2012 in connection with its massive investment in AIG. In 2011, it was also known within Fannie that the valuation allowance would be reversed; the only question was the timing.

81. The Companies' improved prospects came into even sharper focus on August 9, 2012, when Under Secretary Miller and other senior Treasury officials had meetings with the senior executives of both Fannie and Freddie. During the meeting with Fannie's management, Treasury was presented with ten-year projections showing the Company earning an average of more than $11 billion per year from 2012 through 2022 and having over $116 billion left of Treasury's funding commitment at the end of that time period. Those projections are reproduced below:

Annual Detail of Cumulative Dividends and SPSPA Draws

Fannie Mae

($ in Billions)	2008-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Comprehensive Income		11.6	7.5	11.0	12.5	13.9	13.2	12.2	11.4	10.9	10.5	10.5
Preferred Dividend Payment	19.8	11.6	11.8	12.1	12.2	12.2	12.2	12.2	12.2	12.2	12.3	12.5
Residual Equity	0.0	0.0	0.0	0.0	0.2	1.8	2.8	2.7	1.9	0.5	0.0	0.0
Cumulative Dividends	19.8	31.4	43.2	55.3	67.6	79.8	92.1	104.3	116.6	128.8	141.1	153.6
Cumulative SPSPA Draws	(116.1)	(116.1)	(119.0)	(121.2)	(121.5)	(121.5)	(121.5)	(121.5)	(121.5)	(121.5)	(122.9)	(124.8)
Cumulative Dividends Less Draws	*(96.3)*	*(84.7)*	*(75.8)*	*(65.9)*	*(53.9)*	*(41.7)*	*(29.4)*	*(17.2)*	*(4.9)*	*7.3*	*18.3*	*28.8*
SPSPA Funding Cap	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9
Remaining Funding under SPSPA	124.8	124.8	122.0	119.7	119.5	119.5	119.5	119.5	119.5	119.5	118.1	116.1

Note: 2012-2016 figures from Fannie Mae July BOD corporate forecast. 2017-2022 figures are based on simplifying assumptions derived from trends observed within the 2012-2016 horizon.

Freddie Mac

($ in Billions)	2008-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Comprehensive Income		11.6	7.5	8.2	8.6	9.0	8.7	8.3	7.7	7.1	6.7	6.5
Preferred Dividend Payment	16.3	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4
Residual Equity	0.0	0.0	0.4	1.7	3.5	5.6	6.9	7.9	8.1	7.9	7.2	6.3
Cumulative Dividends	16.3	23.7	31.1	38.4	45.8	53.2	60.6	68.0	75.4	82.8	90.2	97.6
Cumulative SPSPA Draws	(72.2)	(116.1)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)
Cumulative Dividends Less Draws	*(55.9)*	*(92.4)*	*(41.9)*	*(34.5)*	*(27.1)*	*(19.7)*	*(12.3)*	*(4.9)*	*2.5*	*9.9*	*17.3*	*24.7*
SPSPA Funding Cap	220.5	221.3	221.3	221.3	221.3	221.3	221.3	221.3	221.3	221.3	221.3	221.3
Remaining Funding under SPSPA	148.3	105.2	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3

Note: 2012-2022 figures are based on simplifying assumptions derived from Fannie Mae forecast trends and observed relationships between key Fannie Mae and Freddie Mac performance metrics. Reported 2011 results re-aligned as necessary to correspond to Fannie Mae management reporting.

Note: Numbers may not fool due to rounding

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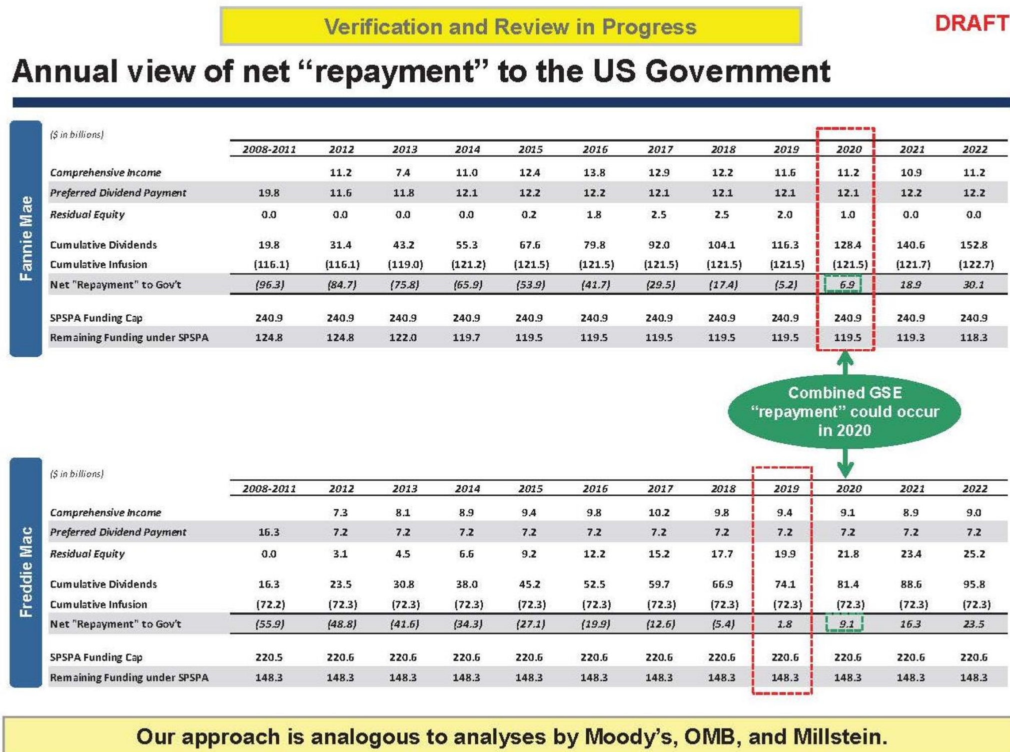
82. Furthermore, Treasury learned that Fannie's near-term earnings likely would be even higher than those in the projections due to the release of the Companies' deferred tax assets valuation allowance. During the August 9 meeting, Fannie CFO Susan McFarland informed Treasury that the criteria for reversing the deferred tax assets valuation allowance could be met in the not-so-distant future. And when asked for more specifics by Under Secretary Miller, Ms. McFarland stated that the reversal would be probably in the $50-billion range and probably sometime mid-2013, an assessment that proved remarkably accurate.

83. Like Treasury, FHFA was in possession of information showing that the Companies would soon generate substantial profits, thus making it inevitable that they would release their deferred tax asset valuation allowances. On July 13, 2012, Bradford Martin, Principal Advisor in FHFA's Office of Conservatorship Operations, broadly circulated within FHFA minutes from a July 9, 2012 Fannie executive management meeting. The recipients of the email included Acting Director DeMarco and Mr. Ugoletti. The minutes stated that Fannie Treasurer David Benson "referred to the next 8 years as likely to be 'the golden years of GSE earnings.' " Projections substantially similar to those shared with Treasury on August 9 were attached to the email containing the following slide:


Verification and Review in Progress

DRAFT

Annual view of net "repayment" to the US Government

Fannie Mae

($ in billions)	2008-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Comprehensive Income		11.2	7.4	11.0	12.4	13.8	12.9	12.2	11.6	11.2	10.9	11.2
Preferred Dividend Payment	19.8	11.6	11.8	12.1	12.2	12.2	12.1	12.1	12.1	12.1	12.2	12.2
Residual Equity	0.0	0.0	0.0	0.0	0.2	1.8	2.5	2.5	2.0	1.0	0.0	0.0
Cumulative Dividends	19.8	31.4	43.2	55.3	67.6	79.8	92.0	104.1	116.3	128.4	140.6	152.8
Cumulative Infusion	(116.1)	(116.1)	(119.0)	(121.2)	(121.5)	(121.5)	(121.5)	(121.5)	(121.5)	(121.5)	(121.7)	(122.7)
Net "Repayment" to Gov't	(96.3)	(84.7)	(75.8)	(65.9)	(53.9)	(41.7)	(29.5)	(17.4)	(5.2)	6.9	18.9	30.1
SPSPA Funding Cap	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9
Remaining Funding under SPSPA	124.8	124.8	122.0	119.7	119.5	119.5	119.5	119.5	119.5	119.5	119.3	118.3

Combined GSE "repayment" could occur in 2020

Freddie Mac

($ in billions)	2008-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Comprehensive Income		7.3	8.1	8.9	9.4	9.8	10.2	9.8	9.4	9.1	8.9	9.0
Preferred Dividend Payment	16.3	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2
Residual Equity	0.0	3.1	4.5	6.6	9.2	12.2	15.2	17.7	19.9	21.8	23.4	25.2
Cumulative Dividends	16.3	23.5	30.8	38.0	45.2	52.5	59.7	66.9	74.1	81.4	88.6	95.8
Cumulative Infusion	(72.2)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)
Net "Repayment" to Gov't	(55.9)	(48.8)	(41.6)	(34.3)	(27.1)	(19.9)	(12.6)	(5.4)	1.8	9.1	16.3	23.5
SPSPA Funding Cap	220.5	220.6	220.6	220.6	220.6	220.6	220.6	220.6	220.6	220.6	220.6	220.6
Remaining Funding under SPSPA	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3

Our approach is analogous to analyses by Moody's, OMB, and Millstein.

Note: Numbers may not foot due to rounding

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14

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84. Those projections expressly stated the assumption that Fannie would not be paying taxes because it would be using its deferred tax assets—and if Fannie was expecting to

use its deferred tax assets, it would have to release the valuation allowance it had established for them. FHFA knew this; indeed, FHFA accountants were monitoring the Companies' deferred tax assets situation, and FHFA knew that the Companies' audit committees were assessing the status of the valuation allowances on a quarterly basis. Indeed, in an August 14, 2012 email, an FHFA official indicated that both Companies had discussed the issue of "re-recording certain deferred tax assets that had been written off" during their most recent Board meetings "based on the view that they were going to be profitable going forward." In addition, Ms. McFarland testified that in July 2012 she would have mentioned the potential release of the valuation allowance at a Fannie executive committee meeting attended by at least one FHFA official, and she also testified that FHFA was on notice of the statement she made to Under Secretary Miller on August 9, 2012 regarding the potential release of the valuation allowance.

85. Rather than acknowledging the projections just discussed, the Government has instead sought to support the Net Worth Sweep by pointing to other financial projections that its own documents show were outdated and unreliable by August 2012. In other litigation, the Government has relied on a set of "June 13, 2012" projections that discovery in this case revealed were taken verbatim from projections prepared by Treasury consultant Grant Thornton in November 2011 using data from September 2011. Although not as positive as the more updated projections discussed above, the Grant Thornton analysis projected combined profits at the Companies of over $20 billion in 2014, with annual profits then gradually declining to a long-term figure of about $13.5 billion. Profits of this magnitude necessarily would have led to the reversal of the valuation allowances. And Treasury took notice. Hand-written notes on a Grant Thornton document produced by Treasury displaying Freddie's results through the first quarter of 2012 anticipate that Freddie could release its valuation allowance "probably [in] 2013,

2014." The agenda for a meeting indicates that by May 2012 Treasury and Grant Thornton were discussing "[r]eturning the deferred tax asset to the GSE balance sheets" and that Treasury planned to discuss this issue with FHFA and the Companies in early June. And a Grant Thornton document sent to Treasury on June 29, 2012 recognizes that two "key issues" for determining the value of Treasury's investment in 2012 were "whether and when the GSEs will return their deferred tax assets to their balance sheets" and "whether and when the GSEs will become taxpaying entities."

86. By August 2012, it was apparent that the Grant Thornton projections based on data from September 2011 drastically underestimated Fannie's and Freddie's earning capacity. The manager of Grant Thornton's valuation services to Treasury, Anne Eberhardt, admitted in a deposition that the projections based on September 2011 data were no longer valid 11 months later, and Fannie's Chief Financial Officer, the highest ranking and responsible financial expert at the Company, Susan McFarland, has testified that it was particularly important to have fresh financial forecasts at that time. Mr. Ugoletti and Ms. Eberhardt likewise have testified to the importance of using up-to-date financial information, and Mr. DeMarco testified that FHFA as conservator was "constantly responding to a changing economic environment." And as Mr. DeMarco also testified, one change that took place between September 2011 and mid-August 2012 "was strengthening in the housing market." Mr. Ugoletti also has admitted that FHFA's own projections consistently were overly pessimistic leading up to August 2012. Treasury and FHFA therefore knew that Fannie and Freddie were poised to be even more profitable than Grant Thornton had projected in 2011.

87. In other litigation, the Government has also relied on a set of financial projections sent to Secretary Geithner on June 6, 2012, that showed that starting in 2018 Fannie would report only $4.1 billion in comprehensive income per year.

88. In sum, by August 2012 the Agencies knew that Fannie and Freddie were poised to add tens of billions of dollars of deferred tax assets to their balance sheets and to reverse billions of dollars of loan loss reserves. Thanks to these inevitable accounting decisions, coupled with Fannie's and Freddie's strong earnings from their day-to-day operations, the Companies anticipated that they would be able to pay their 10% dividends to Treasury without drawing on Treasury's funding commitment in the future, and dividend payments on the Government Stock did not threaten to erode Treasury's unused funding commitment.

89. In addition to the release of loan loss reserves and deferred tax assets valuation allowances, Fannie and Freddie also had sizeable assets in the form of claims and suits brought by FHFA as conservator relating to securities law violations and fraud in the sale of private-label securities to Fannie and Freddie between 2005 and 2007. In 2013 and 2014, the Companies recovered over $18 billion from financial institutions via settlements of such claims and suits. The Companies, FHFA, and Treasury knew in August 2012 that the Companies would reap substantial profits from such settlements.

FHFA and Treasury Amend the PSPAs To Expropriate Private Shareholders' Investment and Ensure Fannie and Freddie Cannot Exit Conservatorship

90. With Fannie's and Freddie's return to consistent and indeed record profitability, the holders of the Companies' Preferred Stock and Common Stock had reason to believe and expect that they would in time receive a return on their investment. Moreover, the Companies' return to profitability led to a reasonable expectation that they would eventually be healthy enough to redeem Treasury's Government Stock, exit conservatorship, and be "return[ed] to

normal business operations," as FHFA's Director had vowed when the conservatorship was created.

91. These reasonable and realistic expectations were short-lived, however, not because of any change in the outlook for the housing market or broader economy, nor because of any change in the financial performance of Fannie or Freddie, but rather because of the Government's own self-dealing.

92. On August 17, 2012, within days after the Companies had announced their return to profitability and just as it was becoming clear that they had regained the earnings power to redeem Treasury's Government Stock and exit conservatorship, the Agencies unilaterally amended the PSPAs for a third time.

93. The centerpiece of this "Third Amendment" was the Net Worth Sweep. The Net Worth Sweep fundamentally changed the nature of Treasury's investment in the Companies. Instead of quarterly dividend payments at an annual rate of 10% (if paid in cash) or 12% (if paid in kind) of the total amount of Treasury's liquidation preference, the Net Worth Sweep entitles Treasury to *all*—*100%*—of the Companies' existing net worth and future profits. Beginning January 1, 2013, the Companies have been required to pay Treasury a quarterly dividend equal to their *entire net worth*, minus a capital reserve amount that starts at $3 billion and decreases to $0 by January 1, 2018. (In December 2017, FHFA and Treasury amended the PSPAs a fourth time to reset the capital reserve amount to $3 billion beginning in the first quarter of 2018. This change does not materially affect the claims in this litigation.)

94. The Companies did not receive any meaningful consideration for the imposition of the Net Worth Sweep. Because the Companies always had the option to pay dividends "in

kind" at a 12% interest rate, the Net Worth Sweep did not provide the Companies with any additional flexibility or benefit.

95. To be sure, the Net Worth Sweep provides that the Companies will not have to pay a periodic commitment fee under the PSPAs while the Net Worth Sweep is in effect. But Treasury had consistently waived the periodic commitment fee before the Net Worth Sweep, and it could only set the amount of such a fee with the agreement of the Companies and at a market rate. And that rate likely would have been, at most, a small fraction of the outstanding amount of Treasury's commitment. Freddie forecasted its "sensitivity" to imposition of a periodic commitment fee as follows: "Our sensitivity to a commitment fee based on remaining commitment available beginning in 2013 of $149 billion shows that a 25 bps fee results in a $0.4 billion annual impact on Stockholders' Equity." Further, the purpose of the fee was to compensate Treasury for its ongoing support in the form of the commitment to invest in the Companies' Government Stock. By the time of the Net Worth Sweep, the 10% return on the Government Stock and the warrants for 79.9% of the common stock provided a more than adequate return on the government's stand-by commitment, and thus any additional fee would have been inappropriate. In August of 2012, the Companies had returned to stable profitability and were no longer drawing from Treasury's commitment. Given the Companies' return to profitability, the market rate for the periodic commitment fee in 2012 and after would have been zero. Finally, even if a market-rate fee had been agreed between Treasury and FHFA and imposed pursuant to the 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 profitability or the value of the Companies' equity securities.

96. The Net Worth Sweep has had far-reaching effects. These effects were intended and anticipated by FHFA and Treasury, and the Agencies adopted the Net Worth Sweep in furtherance of their policy objectives as agencies of the federal government.

97. First, the Net Worth Sweep eliminated entirely the economic interests in Fannie and Freddie held by the Companies' private shareholders. The quarterly sweep of the Companies' net worth ensures that there never will be sufficient funds for the Companies to pay a dividend to private shareholders. It also ensures that private shareholders will receive nothing in the event of liquidation, as Treasury's Government Stock entitles it to an additional dividend payment *plus* its liquidation preference in the event of liquidation. Government Stock Certificate § 8. The dividend payment will leave Fannie and Freddie with negligible capital well shy of the Government's nearly $200 billion liquidation preference, guaranteeing that there will be nothing left for private shareholders. In light of this reality, it is not surprising that, as FHFA's Mr. Ugoletti observed, "the preferred stock got hammered the day the Net Worth Sweep was announced." Similarly, after the imposition of the Net Worth Sweep, Mr. Lockhart—FHFA's former Director—told a reporter that the Companies' privately-owned stock "is worthless and should be worthless."

98. Upon its announcement, Treasury emphasized that the Net Worth Sweep would ensure that "every dollar of earnings that Fannie Mae and Freddie Mac generate will be used to benefit 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). https://goo.gl/NDAKhQ. The necessary corollary to this, of course, is that nothing would be left for private shareholders. Unbeknownst to the public, this was a long-term Treasury goal. Indeed, as early as December 2010, an internal Treasury memorandum acknowledged 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 (Dec. 20, 2010).

99. FHFA shared Treasury's goal of advancing the Government's interests and ensuring that private shareholders would not benefit from their stock ownership. In its 2012 report to Congress, for example, FHFA explained that the Net Worth Sweep "ensures all the [Companies'] earnings are used to benefit taxpayers." FHFA, REPORT TO CONGRESS: 2012 at 1 (June 13, 2013), https://goo.gl/ocyB9J. And while FHFA had earlier resolved to operate Fannie and Freddie with a view toward "minimiz[ing] losses on behalf of taxpayers," A STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIPS: at 7, the Net Worth Sweep indicates that the agency in fact is operating them to maximize taxpayer profits at the expense of private shareholders. Director Watt summed up the situation succinctly when stating that he does not "lay awake at night worrying about what's fair to the shareholders" but rather focuses on "what is responsible for the taxpayers." C-SPAN, Newsmakers with Mel Watt, at 9:00-9:27 (May 16, 2014), http://goo.gl/s3XWqi. Consistent with this understanding of FHFA's goals, it stated that the Net Worth Sweep was intended to "fully capture financial benefits for taxpayers.".

100. Second, the Net Worth Sweep not only destroyed the economic interests of Fannie's and Freddie's private shareholders but also transferred their interests to the federal government, resulting in Fannie and Freddie being wholly nationalized entities. As a Staff Report from the Federal Reserve Bank of New York acknowledged, the Net Worth Sweep "effectively narrows the difference between conservatorship and nationalization, by transferring essentially all profits and losses from the firms to the Treasury." W. Scott Frame, et al., *The Rescue of Fannie Mae and Freddie Mac* at 21, FED. RES. BANK OF N.Y. STAFF REP., no. 719

(Mar. 2015) https://goo.gl/DKBlQ1. Fortune similarly has reported that the Net Worth Sweep "effectively nationalized" the Companies. Indeed, the Government itself has stated in a brief in another case that an "interest in residual profits is the defining feature of an equity interest in a corporation." Reply Brief of the United States at 24, *Starr Int'l.Co. v. United States*, No. 15-5103 (Fed. Cir. June 1, 2016). After the Net Worth Sweep, Treasury has the right to all residual profits, and it hence owns all the equity. All other equity interests have been eliminated.

101. Third, the nationalization effected by the Net Worth Sweep has enriched the federal government to the tune of ***$124 billion*** to date. As the Agencies anticipated, Fannie and Freddie have been extraordinarily profitable since the imposition of the Net Worth Sweep. From the third quarter of 2012 through the fourth quarter of 2017, Fannie and Freddie have reported total comprehensive income of $134 billion and $91 billion, respectively—numbers that include the release of the Companies' deferred tax assets valuation allowances, which in 2013 added over $50 billion and $20 billion to Fannie's and Freddie's earnings, respectively. The Companies' staggering net worth in 2013, 2014, and all subsequent years has been no higher than the Agencies anticipated when they imposed the Net Worth Sweep in August 2012.

102. Because of Fannie's and Freddie's tremendous profitability, the Net Worth Sweep dividend payments to Treasury have been enormous, as the following chart demonstrates:

Dividend Payments Under the Net Worth Sweep (in billions)

		Fannie	**Freddie**	**Combined**
2013	Q1	**$4.2**	**$5.8**	**$10.0**
	Q2	**$59.4**	**$7.0**	**$66.4**
	Q3	**$10.2**	**$4.4**	**$14.6**
	Q4	**$8.6**	**$30.4**	**$39.0**

2014	Q1	**$7.2**	**$10.4**	**$17.6**
	Q2	**$5.7**	**$4.5**	**$10.2**
	Q3	**$3.7**	**$1.9**	**$5.6**
	Q4	**$4.0**	**$2.8**	**$6.8**
2015	Q1	**$1.9**	**$0.9**	**$2.8**
	Q2	**$1.8**	**$0.7**	**$2.5**
	Q3	**$4.4**	**$3.9**	**$8.3**
	Q4	**$2.2**	**$0.0**	**$2.2**
2016	Q1	**$2.9**	**$1.7**	**$4.6**
	Q2	**$0.9**	**$0.0**	**$0.9**
	Q3	**$2.9**	**$0.9**	**$3.8**
	Q4	**$3.0**	**$2.3**	**$5.3**
2017	Q1	**$5.5**	**$4.5**	**$10.0**
	Q2	**$2.8**	**$2.2**	**$5.0**
	Q3	**$3.1**	**$2.0**	**$5.1**
	Q4	**$0.7**	**$2.3**	**$3.0**
2018	Q1	**$0.0**	**$0.0**	**$0.0**
Total		**$135.1**	**$88.6**	**$223.7**

103. As the above chart shows, the Companies have paid Treasury $223.7 billion in "dividends" under the Net Worth Sweep. Had they instead been paying 10% cash dividends, they would have paid Treasury $99.5 billion by the end of the first quarter of 2018. The Government has thus profited from the Net Worth Sweep by $124 billion.

104. The chart above also shows that the Companies' dividend obligations in the fourth quarter of 2017 and first quarter of 2018 totaled $3.0 billion. But this is not in any way a sign that the Companies are in distress or that they are no longer positioned to generate large profits. In the third quarter of 2017, the Companies generated $7.7 billion of comprehensive income, and under the Net Worth Sweep that total was the dividend due in the fourth quarter. Before that

dividend was paid, however, Treasury and FHFA agreed that the Companies could each retain $2.4 billion, and, as noted above, that moving forward the capital buffer under the sweep would be $3 billion, rather than decreasing to $0 in 2018. This "Fourth Amendment" does not affect the substance of Plaintiffs' claims in this litigation. Indeed, FHFA and Treasury specified that the liquidation preference of Treasury's stock in each company would be increased by $3.0 billion, making clear that the capital buffer ultimately would benefit Treasury, not private shareholders.

105. In the fourth quarter of 2017, Fannie and Freddie were required to write down the value of their deferred tax assets to account for the recent decrease in the corporate income tax rate. This write-down decreased their comprehensive income for the quarter by $15.3 billion. Thus, instead of reporting comprehensive income of $5.3 billion, the Companies reported a comprehensive loss of $10 billion, and they announced that they will be requesting a $4 billion draw from Treasury's commitment. This one-time event does not change the Companies' underlying profitability and, in fact, moving forward the decrease in the tax rate enhances the Companies' outlook.

106. Another way to gauge the financial impact of the Net Worth Sweep is to compare it to what would have happened had the Companies instead been allowed to use their quarterly profits above Treasury's 10% dividend to partially retire Treasury's senior preferred stock. In that alternative scenario, Treasury's remaining investment in Freddie would have been fully redeemed in 2017. Indeed, Freddie has paid Treasury $6.3 billion *more* than the amount needed to redeem the Government Stock completely. Similarly, had Fannie been allowed to use its profits in excess of Treasury's original 10% dividend to partially redeem the Government Stock, the remaining liquidation preference on that stock would today stand at only $2.1 billion. Furthermore, given the Companies' strong financial condition when the Net Worth Sweep was

announced and the very low interest rates that prevailed at the time, the Companies could have used debt and equity markets to obtain additional capital at a rate far lower than the 10% cash or 12% in kind rate mandated by the original terms of the Government Stock.

107. The Net Worth Sweep has become a major revenue source for the United States Government. Indeed, the federal government's record-breaking $53.2 billion surplus for the month of December 2013 was driven in large part by the $39 billion swept from Fannie and Freddie.

108. These massive influxes of cash began to arrive just when the government was confronting the statutory debt ceiling and accompanying political deadlock. *See* Jody Shenn & Ian Katz, *Fannie Mae Profit May Swell Treasury Coffers as Debt Limit Looms*, Bloomberg (Apr. 8, 2013), http://www.bloomberg.com/news/articles/2013-04-08/fannie-mae-profit-may-swell-treasury-coffers-as-debt-limit-looms. And because they were characterized as "dividends," and not a redemption of Treasury's Stock, the Pay It Back Act allowed the cash to be used for the government's general operating expenses rather than only for debt reduction. *See* 12 U.S.C. § 1719(g)(2); 12 U.S.C. § 1455(*l*)(2); 12 U.S.C. § 1455 note.

109. All told, Fannie has requested $119.8 billion in draws from Treasury under the PSPAs, and Treasury has recouped a total of $166.4 billion from Fannie in the form of purported "dividends." Freddie has requested $71.6 in draws from Treasury under the PSPAs and Treasury has recouped a total of $112.4 billion from Freddie in the form of purported "dividends." Combined, Fannie and Freddie have paid Treasury approximately $87 billion more than they have received.

110. As explained above, when entering the Net Worth Sweep FHFA and Treasury knew that the Companies were poised to generate earnings well in excess of 10% dividend

payments, and they therefore knew that the Net Worth Sweep would be profitable for the federal government. It is thus not surprising that a document prepared for internal Treasury consumption and dated August 16, 2012 listed the Companies' "improving operating performance" and the "potential for near-term earnings to exceed the 10% dividend" as reasons for "putting in place a better deal for taxpayers" by promptly adopting the Net Worth Sweep. Another Treasury document emphasized that the Net Worth Sweep would put the taxpayer "in a better position" because rather than having "Treasury's upside . . . capped at the 10% dividend, now the taxpayer will be the beneficiary of any future earnings produced by the GSEs." Additional Treasury communications indicate that the Agency anticipated that Treasury's receipts under the Net Worth Sweep "will likely exceed the amount that would have been paid if the 10% was still in effect" and that the Net Worth Sweep would lead to "a better outcome" for Treasury.

111. Fourth, the Net Worth Sweep guarantees that Fannie and Freddie can never be rehabilitated to a sound and solvent condition, and it positions them to be wound down and eliminated. The Net Worth Sweep makes the Companies unique in financial regulation. All other financial institutions are required to retain minimum levels of capital that ensure that they can withstand the vicissitudes of the economic cycle and are prohibited from paying dividends when they are not adequately capitalized. The FDIC's Risk Management Manual of Examination Policies explains why capital is critical to any financial institution: "It absorbs losses, promotes public confidence, helps restrict excessive asset growth, and provides protection to [market participants]." For this reason, in all other contexts financial regulators work to ensure that financial institutions maintain minimum capital levels.

112. The Companies, in contrast, are not allowed to retain capital but instead must pay nearly their entire net worth over to Treasury as a quarterly dividend. In other words, whereas

other financial institutions are subject to *minimum* capital standards, the Net Worth Sweep makes the Companies subject to a capital *maximum*—any amount of retained capital that they hold in excess of a small capital buffer is swept to Treasury on a quarterly basis. The effect of the Net Worth Sweep is thus to force the Companies to operate in perpetuity on the brink of insolvency and to prohibit them from operating in a safe and sound manner. Indeed, HERA itself recognizes that a fundamental aspect of the Companies' soundness is the "maintenance of adequate capital." 12 U.S.C. § 4513(a)(1)(B)(i). Director Watt has expressed the same view, describing the Companies' inability to build capital reserves under the Net Worth Sweep as a "serious risk" that erodes investor confidence in the Companies because they have "no ability to weather quarterly losses." Indeed, the fact that the Companies were required to take a draw because of a tax cut demonstrates the perversity of the Government's decision to strip the Companies of their capital.

113. The timing of the Net Worth Sweep was driven by the Companies' return to profitability. Notwithstanding the Agencies' statutory duties, the Administration had decided that Fannie and Freddie would be wound down and would *not* be allowed to exit conservatorship in their current form. Allowing Fannie and Freddie to rebuild their capital levels, however, would make that political decision more difficult to explain and sustain. The Economist stated the obvious in reporting that the Net Worth Sweep "squashe[d] hopes that [Fannie and Freddie] may ever be private again." *Back to Black*, THE ECONOMIST, (Aug. 25, 2012 http:goo.gl/1PHMs.

114. Treasury openly proclaimed that the Net Worth Sweep would "expedite the wind down of Fannie Mae and Freddie Mac. 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). https://goo.gl/NDAKhQ. Indeed, Treasury emphasized that the Net Worth

Sweep would ensure that the Companies "will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form." *Id*.

115. FHFA Acting Director Edward DeMarco similarly informed a Senate Committee that the "recent changes to the PSPAs, replacing the 10 percent dividend with a net worth sweep, reinforce the notion that the [Companies] will not be building capital as a potential step to regaining their former corporate status." Edward J. DeMarco, Acting Director, FHFA, Statement Before the U.S. Sen. Comm. on Banking, Housing & Urban Affairs (Apr. 18, 2013), https://goo.gl/oxdMc6.. And in its 2012 report to Congress, FHFA explained that it had begun "prioritizing [its] actions to move the housing industry to a new state, one without Fannie Mae and Freddie Mac." FHFA, FHFA, REPORT TO CONGRESS: 2012 at 13 (June 13, 2013), https://goo.gl/ocyB9J. The Net Worth Sweep thus "reinforces the fact that the [Companies] will not be building capital." *Id.* at 1, 13.

116. As a result of the Net Worth Sweep, it is clear that FHFA will not allow Fannie and Freddie to exit conservatorship but rather will continue to operate them essentially as wards of the state, unless and until Congress takes action. Indeed, FHFA's website states that "FHFA will continue to carry out its responsibilities as Conservator" until "Congress determines the future of Fannie Mae and Freddie Mac and the housing finance market." *FHFA as Conservator of Fannie Mae and Freddie Mac,* FHFA, http://goo.gl/PjyPZb. This is consistent with the testimony of former Acting Director DeMarco, who stated that he had no intention of returning Fannie and Freddie to private control under charters he perceived to be "flawed." Mr. Ugoletti also testified that FHFA's objective "was not for Fannie and Freddie Mac to emerge from conservatorship."

117. This understanding of the purpose of the Net Worth Sweep is further supported by the testimony of Ms. McFarland, Fannie's CFO at the time. She believed that the Agencies imposed the Net Worth Sweep in response to what she told Treasury on August 9, and she thought its purpose "was probably a desire not to allow capital to build up within the enterprises and not to allow the enterprises to recapitalize themselves." According to Ms. McFarland, Fannie "didn't believe that Treasury would be too fond of a significant amount of capital buildup inside the enterprises."

118. Communications involving White House official Jim Parrott provide further proof that the Net Worth Sweep was intended to advance the policy objectives discussed above. At the time of the Net Worth Sweep, Mr. Parrott was a senior advisor at the National Economic Council, where he led a team of advisors charged with counseling President Obama and the cabinet on housing issues. He worked closely with Treasury in the development and rollout of the Net Worth Sweep. Indeed, the day after the Net Worth Sweep was announced, he emailed Treasury officials congratulating them on achieving an important policy goal: "Team Tsy, You guys did a remarkable job on the PSPAs this week. You delivered on a policy change of enormous importance that's actually being recognized as such by the outside world . . . , and as a credit to the Secretary and the President. It was a very high risk exercise, which could have gone sideways on us any number of ways, but it didn't." What Treasury had accomplished, Mr. Parrott's emails make clear, was maximizing Treasury's profits and guaranteeing that Fannie and Freddie would be unable to rebuild capital and escape conservatorship:

- In an August 13, 2012 email, Parrott wrote that "[w]e are making sure that each of these entities pays the taxpayer back every dollar of profit that they make, not just a 10%

dividend," and that "[t]he taxpayer will thus ultimately collect more money with the changes."

- In an email to a Treasury official on the day the Net Worth Sweep was announced, Mr. Parrott stated that "we've closed off [the] possibility that [Fannie and Freddie] ever[] go (pretend) private again."
- That same day, Mr. Parrott received an email from a market analyst stating that the Net Worth Sweep "should lay to rest permanently the idea that the outstanding privately held pref[ferred stock] will ever get turned back on." He forwarded the email to Treasury officials and commented that "all the investors will get this very quickly."
- At 8:30 a.m. on August 17, Mr. Parrott wrote an email to Alex Pollock, Peter Wallison, and Edward Pinto offering "to walk you through the changes we're announcing on the pspas today. Feel like fellow travelers at this point so I owe it to you." Pollock, Wallison, and Pinto had written a policy paper for the American Enterprise Institute in 2011 recommending that "Fannie Mae and Freddie Mac should be eliminated as government-sponsored enterprises (GSEs) over time."
- Also on August 17, Mr. Wallison was quoted in Bloomberg saying the following: "The most significant issue here is whether Fannie and Freddie will come back to life because their profits will enable them to re-capitalize themselves and then it will look as though it is feasible for them to return as private companies backed by the government. . . . What the Treasury Department seems to be doing here, and I think it's a really good idea, is to deprive them of all their capital so that doesn't happen." In an email to Wallison that evening, Mr. Parrott stated, "Good comment in Bloomberg—**you are exactly right on substance and intent.**"

- In another email to Wallison that evening, Mr. Parrott wrote that, "[d]ividend is variable, set at whatever profit for quarter is, eliminating ability to pay down principal (so they can't repay their debt and escape as it were)."
- Mr. Parrott also wrote on August 17 that, "we're not reducing their dividend but including in it every dime these guys make going forward and ensuring they can't recapitalize."

119. Mr. Parrott, who has left the White House and is now with the Urban Institute, told The Economist that "[i]n the aftermath of the crisis there was widespread agreement that [Fannie and Freddie] needed to be replaced or overhauled." *A Funny Form of Conservation*, THE ECONOMIST, (Nov. 21, 2015), http:goo.gl/gJVJrN. The Net Worth Sweep ensured that the Companies' return to profitability did not threaten this goal.

120. In short, the Government's Net Worth Sweep is designed to raise general revenue and further the policy goals of the Agencies at the expense of the Companies and their shareholders, and it thereby imposes on the Companies and their shareholders a disproportionate burden that, in all fairness, should be borne by the public as a whole.

121. The Government has advanced an alternative explanation for the Net Worth Sweep—that it was intended to stave off the risk of a "death spiral" caused by drawing from Treasury's commitment to pay Treasury's dividends. But this "death spiral" explanation is belied by the following facts, in addition to those discussed above regarding the Net Worth Sweep's true purposes.

122. First, given Fannie and Freddie's return to profitability, there was no imminent risk that the Companies would be depleting Treasury's funding commitment—that risk was at its lowest point since the start of the conservatorships. Indeed, a memo prepared by Treasury staff

indicates that on June 25, 2012, FHFA Acting Director DeMarco informed Treasury Secretary Geithner and Under Secretary Miller that he saw no "urgency of amending the PSPAs this year" because Fannie and Freddie "will be generating large revenues over the coming years, thereby enabling them to pay the 10% annual dividend well into the future." Communications within both FHFA and Treasury in the months leading up to the Net Worth Sweep indicate that the Companies' bond investors regarded Treasury's funding commitment as sufficient. And on August 13, 2012, a Treasury official observed that an explanation that the Net Worth Sweep was needed because "the 10 percent dividend was likely to be unstable" was one that "[d]oesn't hold water."

123. Second, as explained above, the original terms of the PSPAs entitled the Companies to pay Treasury's dividends in kind with additional stock, thus avoiding the need to make draws on Treasury's funding commitment to finance cash dividends they could not otherwise afford. Furthermore, an internal Treasury memorandum from 2011 acknowledged that any threat to Treasury's funding commitment from dividend payments potentially could be addressed by "converting [Treasury's] preferred stock into common or cutting or deferring payment of the dividend (under legal review)." Memorandum from Jeffery A. Goldstein, Undersecretary, Domestic Finance, to Timothy Geithner, Secretary, United States Treasury, 3 (Jan. 4, 2011). In other words, the problem the Government was purportedly trying to solve with the Net Worth Sweep, a cash dividend too high to be serviced by earnings, could be addressed by other means already known to Treasury, such as cutting or deferring payment of the dividend. Of course, given the payment-in-kind option, the purported problem was wholly illusory. An internal Treasury document explicitly recognized this point: "To the extent that required dividend payments exceed net income, FHFA, as conservator, could consider not declaring

dividends pursuant to the certificates of designation for the preferred shares, so that draws on the PSPAs are not used to pay dividends, preserving as much funding as possible to cover any unanticipated losses at Fannie Mae and Freddie Mac."

124. Third, the Agencies actually considered an alternative to the arrangement they ultimately adopted that would have had the Net Worth Sweep only kick in if Treasury's remaining funding commitment fell below $100 billion. The only plausible explanation for the Agencies' decision not to embrace that alternative is that they knew it would allow the Companies to rebuild capital in contravention of the Administration's commitment to wipe out private shareholders and prevent the Companies from exiting conservatorship.

125. Fourth, the structure and timing of the Net Worth Sweep—coming when the Companies were about to add tens of billions of dollars to their balance sheets—had the effect of *reducing* the amount of money available to guarantee that the Companies would maintain a positive net worth. If the Agencies were genuinely concerned about reassuring the Companies' bond investors that they would be repaid, the Agencies would have delayed imposing the Net Worth Sweep so long as the Companies maintained a substantial positive net worth. Instead, they adopted the Net Worth Sweep at a time when they knew that its near-term effect would be to transfer to Treasury massive profits that the Companies could have otherwise retained as a capital buffer and used to avoid making draws on Treasury's funding commitment in any subsequent unprofitable quarters. Indeed, FHFA has acknowledged how the Net Worth Sweep increases the chances of further draws on Treasury's funding commitment, observing that the Companies "are constrained by the PSPAs from building capital" and that the lack of retained capital combined with "mark-to-market volatility from the [Companies'] derivatives portfolio" has the effect of increasing "the likelihood of negative net worth in future quarters." Thus, even

if the Agencies believed that the Companies could not generate enough profits in the long term to finance a 10% dividend on Treasury's investment, they would not have imposed the Net Worth Sweep when they did if their goal was to preserve Treasury's funding commitment. Doing so only increased the likelihood of future draws. Accordingly, the Net Worth Sweep has not ensured continued access to capital for the Companies or preserved their financial stability and solvency.

126. Fifth, the Net Worth Sweep, announced on the heels of Fannie and Freddie announcing earnings allowing them to begin rebuilding capital, was adopted when it was not because the Companies would be earning too little, but rather because they would be earning too much in light of the Agencies' policy goals of keeping Fannie and Freddie under government control and prohibiting their private shareholders from realizing any value from their investments. An internal Treasury document prepared on July 30, 2012, stated that the Net Worth Sweep should be announced shortly after August 7, when Treasury anticipated the Companies would "report very strong earnings . . . that will be in excess of the 10% dividend." On August 1, a Treasury official similarly emphasized that the Net Worth Sweep should be announced in mid-August because the Companies' "[e]arnings will be in excess of current 10% dividend." FHFA's Mr. Ugoletti reported a "renewed push" from Treasury to implement the Net Worth Sweep on August 9, 2012—the same day that Fannie's CFO told Treasury that it was likely that her company would soon be in a position to make an accounting decision that would add tens of billions of dollars to its earnings. And on August 17, 2012, Mr. Ugoletti wrote to Mr. DeMarco and other FHFA officials that "other than a transitory buffer," the Net Worth Sweep "does not allow the Enterprises to build up a retained surplus, which may give the impression that they are healthy institutions."

127. That the Net Worth Sweep was not intended to advance any legitimate interest of FHFA as conservator is further demonstrated by the fact Treasury was the driving force behind the initiative. Indeed, FHFA agreed to the Net Worth Sweep only at the insistence and under the direction and supervision of Treasury. The Net Worth Sweep was a Treasury initiative and reflected the culmination of Treasury's long-term plan to seize the Companies and see that they were operated for the exclusive benefit of the federal government. Indeed, Mr. Parrott has testified that the Net Worth Sweep was imposed through a "Treasury-driven process." It was Treasury that informed the Companies just days before the Net Worth Sweep that it was forthcoming, and a meeting addressing the Net Worth Sweep was held at Treasury during which a senior Treasury official announced the changes. Secretary Geithner apparently believed that even before the Net Worth Sweep was imposed, "we had already effectively nationalized the GSEs . . ., and could decide how to carve up, dismember, sell or restructure those institutions." Plaintiff's Corrected Post-Trial Proposed Findings of Fact 26.2.1(a), *Starr Int'l Co. v. United States*, No. 1:11-cv-779-TCW (Fed. Cl. Mar. 2, 2015), ECF No. 430. And Treasury officials intimately involved in the development of the Net Worth Sweep testified that they could not recall Treasury making any backup or contingency plans to prepare for any possibility that FHFA would reject the Net Worth Sweep proposal.

128. The Net Worth Sweep is just one example of the significant influence Treasury has exerted over FHFA from the beginning of the conservatorship. Secretary Paulson has written that "seizing control" of Fannie and Freddie, an action that is statutorily reserved to FHFA, was an action "I took." HENRY M. PAULSON, JR., ON THE BRINK xiv (2010). Secretary Geithner, who was president of the Federal Reserve Bank of New York at the time, understood the federal takeover of Fannie and Freddie to be a "Treasury operation," and then-Chairman of the Federal

Reserve Ben Bernanke has said that "Treasury took over Fannie and Freddie." Similarly, Congressional Budget Office Assistant Director for Financial Analysis Deborah Lucas told Congress that the Companies are subject to "ownership and control by the Treasury." *Fannie Mae, Freddie Mac & FHA: Taxpayer Exposure in the Housing Markets: Hearing Before the H. Comm. on the Budget*, 112th Cong. 15 (2011). When asked whether Fannie had ever considered paying Treasury's dividends in-kind, rather than a cash dividend, Ms. McFarland testified that "in my mind, what form of payment we would make and what we were able to do was what Treasury would allow us to do." In its SEC filings, Freddie has said that it and Treasury are "related parties," as defined by Statement of Financial Accounting Standards 57.

129. The Net Worth Sweep was merely one element of a broader Treasury plan to transform the housing finance market and to eliminate Fannie and Freddie. Indeed, a housing finance reform plan drafted by Treasury in early 2012 listed "restructur[ing] the PSPAs to allow for variable dividend payment based on positive net worth"—i.e., implementing a net worth sweep—as among the first steps to take in transitioning to Treasury's desired outcome. Other elements of that plan included the development of a single securitization utility to be used by both Fannie and Freddie—and by other entities once Fannie and Freddie are eliminated. FHFA has made the development of such a utility a key initiative of the conservatorships, providing further evidence that FHFA is operating according to Treasury's playbook.

COUNT I

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

130. Plaintiffs incorporate by reference and reallege each allegation set forth above, as though fully set forth herein.

131. 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."

132. In the August 2012 Net Worth Sweep amendment to the Purchase Agreements, the Federal Government entered into an agreement with itself to take "every dollar of earnings each firm generates . . . to benefit taxpayers." One federal agency—FHFA, supposedly acting as conservator for the Companies—struck a deal with a second federal agency—Treasury—to effectively confiscate the Common and Preferred Stock held by the Plaintiffs and other private investors in Fannie and Freddie.

133. At the outset of conservatorship, FHFA's Director confirmed that both the preferred and common shareholders of Fannie and Freddie retained an economic interest in the Companies. As equity shareholders, that economic interest took the form of a claim on the Companies' equity that could be paid out in the form of dividends or a liquidation payment. Plaintiffs had both a property interest and a reasonable, investment-backed expectation in the economic interest in the Companies they held due to their ownership of Common and Preferred Stock. The Net Worth Sweep expropriated this economic interest by assigning the right to all of Fannie's and Freddie's equity to Treasury.

134. Treasury was the driving force behind the Net Worth Sweep, and both FHFA and Treasury entered the Net Worth Sweep to advance the interests of the United States Government. The policy interests the Agencies sought to advance through the Net Worth Sweep included: prohibiting Fannie and Freddie from recapitalizing and positioning themselves to exit conservatorship; ensuring that Fannie and Freddie would be wound down and, eventually,

eliminated; enriching the Federal Government; and expropriating the economic interests of Fannie's and Freddie's common and preferred shareholders.

135. Plaintiffs who are holders of Preferred Stock had both a property interest and a reasonable, investment-backed expectation in their Preferred Stock and in the share of the Companies' future earnings to which they and other holders of Preferred Stock were contractually entitled. Such Plaintiffs also had both a property interest and a reasonable, investment-backed expectation in the liquidation preference to which such Preferred Stock was contractually entitled in the event that Fannie and Freddie were dissolved or liquidated.

136. The Government, by operation of the Net Worth Sweep, has expropriated Plaintiffs' property interests in theirPreferred Stock and has destroyed Plaintiffs' reasonable, investment-backed expectations without paying just compensation.

137. As a result of the Net Worth Sweep, Plaintiffs have been deprived of all economically beneficial uses of their Preferred Stock in Fannie and Freddie.

138. Plaintiffs are entitled to just compensation for the Government's taking of their property.

COUNT II

Illegal Exaction Under the Fifth Amendment

(Alternative Claim)

139. Plaintiffs incorporate by reference and reallege each allegation set forth above, as though fully set forth herein.

140. In the August 2012 Net Worth Sweep amendment to the Purchase Agreements, the Federal Government entered into an agreement with itself to take "every dollar of earnings each firm generates . . . to benefit taxpayers." One federal agency—FHFA, supposedly acting as conservator for the Companies—struck a deal with a second federal agency—Treasury—to

effectively confiscate the Preferred Stock held by the Plaintiffs and other private investors in Fannie and Freddie.

141. At the outset of conservatorship, FHFA's Director confirmed that both the preferred and common shareholders of Fannie and Freddie retained an economic interest in the Companies. As equity shareholders, that economic interest took the form of a claim on the Companies' equity that could be paid out in the form of dividends or a liquidation payment. Plaintiffs had both a property interest and a reasonable, investment-backed expectation in the economic interest in the Companies they held due to their ownership of Preferred Stock. The Net Worth Sweep expropriated this economic interest by assigning the right to all of Fannie's and Freddie's equity to Treasury.

142. Treasury was the driving force behind the Net Worth Sweep, and both FHFA and Treasury entered the Net Worth Sweep to advance the interests of the United States Government. The policy interests the Agencies sought to advance through the Net Worth Sweep included: prohibiting Fannie and Freddie from recapitalizing and positioning themselves to exit conservatorship; ensuring that Fannie and Freddie would be wound down and, eventually, eliminated; enriching the Federal Government; and expropriating the economic interests of Fannie's and Freddie's common and preferred shareholders.

143. In agreeing to the Net Worth Sweep, FHFA purportedly acted pursuant to its authority as conservator of Fannie and Freddie under 12 U.S.C. § 4617, and Treasury purportedly acted pursuant to authority granted to it under 12 U.S.C. §§ 1455 and 1719. These statutes, however, did not authorize either FHFA or Treasury to expropriate Plaintiffs' economic interest in Fannie and Freddie for the benefit of the Federal Government.

144. In addition, FHFA acted unlawfully because it is an unconstitutional "independent" agency whose Director was removable only for cause in violation of the Appointments Clause.

145. The Constitution provides that the "executive Power shall be vested in a President," U.S. Const. art. II, § 1, and that "he shall take Care that the Laws be faithfully executed," U.S. Const. art. II, § 3. Those provisions vest all executive power in the President of the United States.

146. By making FHFA's head a single Director rather than a multi-member Board and eliminating the President's power to remove the Director at will, HERA violates the Constitution's separation of powers. An independent agency headed by a single Director is virtually unprecedented in our Nation's history, and this structure impermissibly concentrates power in a single person who is not the President.

147. Neither Congress nor the President can negate the constitution's structural requirements by signing or enacting (and thereby acceding to) HERA. "Perhaps an individual President"—or Congress—"might find advantages in tying his own hands," the Supreme Court has noted, "[b]ut the separation of powers does not depend on the views of individual Presidents"—or particular Congresses. *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.,* 130 S. Ct. 3138, 3155 (2010). The Constitution's separation of powers does not depend "on whether 'the encroached-upon branch approves the encroachment.'" *Id*. (quoting *New York v. United States*, 505 U.S. 144, 182 (1992)).

148. "The diffusion of power" away from Congress and the President, to the independent FHFA, "carries with it a diffusion of accountability. . . . Without a clear and effective chain of command, the public cannot 'determine on whom the blame or the punishment

of a pernicious measure, or series of pernicious measures ought really to fall." *Id.* (quoting The Federalist No. 70, p. 476 (J. Cooke ed. 1961) (A. Hamilton)).

149. FHFA and Treasury therefore have illegally exacted Plaintiffs' economic interest in Fannie and Freddie without due process.

COUNT III

Breach of Fiduciary Duty

150. Plaintiffs incorporate by reference and reallege each allegation set forth above, as though fully set forth herein.

151. The conservatorship provisions of HERA create a fiduciary relationship between the United States Government, on the one hand, and the Companies' shareholders, on the other hand. *See United States v. Mitchell*, 463 U.S. 206 (1983). FHFA therefore has a fiduciary responsibility to manage the conservatorships of Fannie and Freddie for the benefit of the Companies' shareholders.

152. As conservator, FHFA is given elaborate control over Fannie and Freddie. As conservator, the Agency is vested with "all rights, titles, powers, and privileges of [Fannie and Freddie], and of any stockholder, officer, or director of [Fannie and Freddie] with respect to [Fannie and Freddie] and [their] assets." 12 U.S.C. § 4617(b)(2)(A). As conservator, FHFA accordingly has the authority to "take over the assets of and operate [Fannie and Freddie] with all the powers of the shareholders, the directors, and the officers of [Fannie and Freddie] and conduct all business of [Fannie and Freddie]." *Id.* § 4617(b)(2)(B).

153. The term "conservator" has long been understood to denote a position of fiduciary responsibility. HERA accordingly makes clear that FHFA is to exercise its conservatorship authorities for the benefit of the Companies' shareholders, and that the overriding purpose of the conservatorship is "rehabilitating" Fannie and Freddie. 12 U.S.C. § 4617(a)(2). For example,

FHFA is authorized to "take such action as may be—(i) necessary to put [Fannie and Freddie] in a sound and solvent condition; and (ii) appropriate to carry on the business of [Fannie and Freddie] and preserve and conserve [their] assets and property." *Id.* § 4617(b)(2)(D). And when taking any action involving the disposition of Fannie's and Freddie's assets, FHFA is required to "conduct its operations in a manner which . . . maximizes the net present value return from the sale or disposition of such assets." *Id.* § 4617(b)(2)(E)(i).

154. In promulgating regulations implementing its conservator authorities, FHFA has recognized that "[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." 76 Fed. Reg. 35724, 35730.

155. Given the existence of a fiduciary relationship between FHFA and the Companies' shareholders, it naturally follows that the Government should be liable in damages for the breach of its fiduciary duties.

156. The Net Worth Sweep is a self-dealing transaction with a sister agency of the Federal Government, and it improperly expropriates the economic interest in Fannie and Freddie held by holders of the Companies' Common and Preferred Stock for the benefit of the Federal Government.

157. The Net Worth Sweep was neither entirely nor intrinsically fair.

158. The Net Worth Sweep constituted waste, gross and palpable overreaching, and a gross abuse of discretion.

159. The Net Worth Sweep did not further any valid business purpose or reasonable business objective of Fannie and Freddie, did not reflect FHFA's good faith business judgment of what was in the best interest of Fannie and Freddie, and was unfair to the Companies' common and preferred shareholders.

160. Thus, by entering the Net Worth Sweep, FHFA violated its fiduciary duty to Plaintiffs and the other holders of Preferred Stock.

COUNT IV

Breach of Implied-in-Fact Contract Between the United States and the Companies

161. Plaintiffs incorporate by reference and reallege each allegation set forth above, as though fully set forth herein.

162. Prior to appointing itself conservator on September 6, 2008, FHFA, along with Treasury, unambiguously offered to place Fannie Mae and Freddie Mac into conservatorship by consent, under § 4617(a)(3)(I), with certain conditions described below, and the boards of directors of the Companies accepted this offer. The Government made no finding of insolvency, undercapitalization, or any other ground to impose conservatorship under § 4617(a)(3)(A)-(H) or (J)-(L).

163. FHFA, with the urging of Treasury, offered, and the boards of Fannie Mae and Freddie Mac accepted, a conservatorship that would aim to "preserve and conserve the [Companies'] assets and property" and restore the Companies to a "sound and solvent condition." See § 4617(b)(2)(D). The offer was also of a conservatorship that would end when that goal was achieved. Neither of these conditions was ambiguous.

164. Underlying the offer was its promise that FHFA would not, as conservator, wind down or liquidate the Companies. When it publicly announced the conservatorship, FHFA stated that it could not, as conservator, place the Companies into liquidation. FHFA stated at the time, and for several years into the conservatorship, that its goal was instead to "restore the [Companies'] assets and property to a sound and solvent condition," which continued course of

performance constitutes evidence of the offer's original terms. The Companies' boards shared this understanding of conservatorship when they consented.

165. When consenting to the conservatorship, the boards of the Companies furnished good and valuable consideration to the Government by agreeing to forbear from a judicial or legislative challenge that the United States feared. See § 4617(a)(5). This forbearance was unambiguously furnished in exchange for the Agencies' promises to act to restore the Companies to a safe and solvent condition.

166. The United States and the Companies, through the acts described above, entered into an implied-in-fact contract. The terms of that contract, as relevant here, were that FHFA if made conservator would "preserve and conserve the [Companies'] assets and property," that its conservatorship would continue only until the Companies were placed in a safe and solvent condition, and that, in exchange, the boards of the Companies would consent to, and not challenge or litigate, such a course of action. Both the Government and the Companies intended that an implied contract would exist. That contract required FHFA to preserve the Companies' assets and property, and forbade it from diminishing or expropriating the Companies' assets and property. This intent was demonstrated through the offer and acceptance detailed above. The Government's offer was not ambiguous in its terms, and the boards' acceptance was manifested in its subsequent imposition of conservatorship based on the boards' consent.

167. Each Agency had actual authority, as an agency of the United States Government, to bind the United States.

168. The imposition of the Net Worth Sweep breached the contract by rendering it impossible for the Companies to build and retain the capital necessary to exit conservatorship and return to normal business operations.

169. Each subsequent Net Worth Sweep payment independently breaches that contract by depleting the Companies of capital (rather than "preserv[ing] and conserv[ing]" it), in a manner that FHFA has expressly recognized undermines the goals of conservatorship.

170. The Net Worth Sweep, thus, directly harmed Plaintiffs, by preventing the termination of the conservatorship; stripping the Companies of their ability to generate and retain funds to ever distribute as dividends to holders of the Preferred and Common Stock; and nullifying Plaintiffs' contractual right as shareholders to ever receive a liquidation preference upon the dissolution, liquidation, or winding up of the Companies. Plaintiffs are accordingly entitled to damages.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs seek a judgment as follows:

A. Awarding Plaintiffs just compensation under the Fifth Amendment for the Government's taking of their property;

B. Awarding Plaintiffs damages for the Government's illegal exaction of their stock;

C. Awarding Plaintiffs damages for the Government's breach of fiduciary duty;

D. Awarding Plaintiffs damages for the Government's breach of implied-in-fact contract;

E. Awarding Plaintiffs pre-judgment interest, the costs and disbursements of this action, including reasonable attorneys' and experts' fees, costs and expenses; and

F. Granting such other and further relief as the Court deems just and proper.

Respectfully submitted,

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August 28, 2018

UNITED STATES COURT OF FEDERAL CLAIMS

ARROWOOD INDEMNITY COMPANY, ARROWOOD SURPLUS LINES INSURANCE COMPANY, and FINANCIAL STRUCTURES LIMITED, Plaintiffs, v. THE UNITED STATES OF AMERICA, Defendant.	Case No. 1:13-cv-00698 MMS

SECOND AMENDED COMPLAINT

Plaintiffs Arrowood Indemnity Company, Arrowood Surplus Lines Insurance Company, and Financial Structures Limited (collectively, "Plaintiffs" or the "Arrowood Parties"), by and through the undersigned attorneys, bring this action under the Fifth Amendment to the United States Constitution and 28 U.S.C. § 1491, seeking compensation for the taking or, alternatively, the illegal exaction of Plaintiffs' property, and damages for breach of fiduciary duty. In support of their ~~complaint~~Second Amended Complaint, Plaintiffs allege as follows:

NATURE AND SUMMARY OF THE ACTION

1. In August 2012, at a time when the housing market was recovering from the financial crisis and Federal National Mortgage Association ("Fannie") and Federal Home Loan Mortgage Corporation ("Freddie") (collectively, the "Companies") had returned to stable profitability in a growing economy, the federal government took for itself the entire value of the rights held by Plaintiffs and Fannie's and Freddie's other private shareholders by forcing these publicly-traded, shareholder-owned Companies to turn over their **entire** net worth, less a small

capital reserve, to the federal government on a quarterly basis **forever**—an action the government called the "Net Worth Sweep" and that effectively nationalizes the Companies. This action is brought by Plaintiffs, holders of non-cumulative preferred stock ("Preferred Stock") issued by Fannie and Freddie seeking just compensation for the taking of their property by the United States of America, acting by and through, *inter alia*, the Department of the Treasury ("Treasury"), the Federal Housing Finance Administration ("FHFA"), and agents acting at their direction. Plaintiffs alternatively seek damages for themselves for an illegal exaction in violation of the Fifth Amendment. And Plaintiffs finally seek damages for themselves for the Government's breach of fiduciary duty.

2. At Treasury's urging, in July 2008, Congress enacted the Housing and Economic Recovery Act of 2008 ("HERA"). HERA created the Federal Housing Finance Agency (Treasury and FHFA are sometimes collectively referred to herein as the "Agencies") to replace Fannie's and Freddie's prior regulator and authorized FHFA to appoint itself as conservator or receiver of the Companies in certain statutorily specified circumstances. HERA charges FHFA as conservator to rehabilitate Fannie and Freddie by taking action to put the Companies in a sound and solvent condition while preserving and conserving their assets.

3. HERA also granted Treasury temporary authority to invest in the Companies' stock until December 31, 2009. Congress made clear that in exercising this authority Treasury was required to consider the "need to maintain [Fannie's and Freddie's] status as . . . private, shareholder-owned compan[ies]."

4. On September 6, 2008—despite prior public statements assuring investors that the Companies were in sound financial shape—FHFA, at Treasury's urging, abruptly forced Fannie and Freddie into conservatorship. Immediately after the Companies were forced into

conservatorship, Treasury exercised its temporary authority under HERA to enter into agreements with FHFA to purchase securities of Fannie and Freddie ("Preferred Stock Purchase Agreements," "Purchase Agreements," or "PSPAs"). Under these PSPAs, Treasury designed an entirely new class of securities in the Companies, known as Senior Preferred Stock ("Government Stock"), which came with very favorable terms for Treasury. At the outset, Treasury received $1 billion of Government Stock (via one million shares) in each Company and warrants to acquire 79.9% of the Common Stock of the Companies at a nominal price in return for its commitment to acquire Government Stock in the future.

5. The Government Stock entitled Treasury to collect dividends at an annualized rate of 10% if paid in cash or 12% if paid in kind—an extraordinarily generous return in an economic environment in which interest rates on government debt were near zero. The Government Stock was entitled to receive cash dividends from each Company only to the extent declared by the Board of Directors "in its sole discretion, from funds legally available therefor." If the Companies did not wish to—or legally could not—pay a cash dividend, the unpaid dividends on the Government Stock could be capitalized (or paid "in kind") by increasing the liquidation preference of the outstanding Government Stock. Therefore, the Companies were *never* required to pay cash dividends on Government Stock. There was *never* any threat that the Companies would become insolvent by virtue of making cash dividend payments. The PSPAs specifically allowed the Companies to utilize this mechanism throughout the life of the agreements, thereby foreclosing any possibility that they would exhaust Treasury's funding commitment because of a need to make a dividend payment to Treasury.

6. The Government Stock diluted, but did not eliminate, the economic interests of the Companies' private shareholders. The warrants to purchase 79.9% of the Companies'

Common Stock gave Treasury "upside" via economic participation in the Companies' profitability, but this upside would be *shared* with preferred shareholders (who had to be paid before any payment could be made on common stock purchased with Treasury's warrants) and private common shareholders (who retained rights to 20.1% of the Companies' residual value). James Lockhart, the Director of FHFA, accordingly assured Congress shortly after imposition of the conservatorship that Fannie's and Freddie's "shareholders are still in place; both the preferred and common shareholders have an economic interest in the companies" and that "going forward there may be some value" in that interest.

7. Under FHFA's supervision, the Companies were forced to excessively write down the value of their assets, primarily due to decisions based on grossly improper accounting. By June 2012, the Agencies had forced Fannie and Freddie to issue $161 billion in Government Stock to make up for the balance-sheet deficits caused by the Agencies' unrealistic and overly pessimistic accounting decisions, even though there was no indication that the Companies' actual cash expenses could not be met by their cash receipts. The Companies were further forced to issue an additional $26 billion of Government Stock so that Fannie and Freddie would be able to pay *cash* dividends to Treasury even though, as explained above, the Companies were never required to pay cash dividends. Finally, because (i) the Companies were forced to issue Government Stock to Treasury in return for funds that they did not need to continue operations and (ii) the structure of Treasury's financial support did not permit the Companies to repay and redeem the Government Stock outstanding, the amount of the dividends owed on the Government Stock was artificially—and permanently—inflated.

8. As a result of these transactions, Treasury amassed a total of $189 billion in Government Stock—a substantial sum, albeit far less than the $5 trillion in assets held in the

Companies' mortgage portfolios. But based on the Companies' performance in the second quarter of 2012, it was apparent that there was still value in the Companies' private shares. By that time, the Companies were thriving and could easily pay 10% annualized cash dividends on the Government Stock without drawing additional capital from Treasury. And based on the improving housing market and the high quality of the newer loans backed by the Companies, it was apparent that they had returned to stable profitability. Indeed, the Agencies had specific information from the Companies demonstrating that this return to profitability was inevitable because the Companies would soon be reversing many of the non-cash accounting losses they had incurred under FHFA's supervision. In light of that information and the broad-based recovery in the housing industry that had occurred by the middle of 2012, the Agencies fully understood that the Companies were about to generate huge profits, far in excess of the dividends owed on the Government Stock.

9. The Government was not content to benefit from its investment like an investor in any other company and did not want to share the value of the Companies with private shareholders. Instead, it was committed to ensuring that, unlike all other companies that received financial assistance from the federal government during the financial crisis, Fannie and Freddie would be operated for the exclusive benefit of the federal government. Indeed, unbeknownst to the public, Treasury had secretly resolved "to ensure existing common equity holders will not have access to any positive earnings from the [Companies] in the future." Treasury also was seeking to transform the housing finance market by eliminating Fannie and Freddie, and it and FHFA had no intention of allowing the Companies to rehabilitate and exit conservatorship. By the middle of 2012, however, it was apparent that even the large amount of Government Stock outstanding would not achieve these surreptitious policy goals.

10. Therefore, on August 17, 2012, just days after the Companies announced record-breaking quarterly earnings, the Agencies unilaterally imposed the Net Worth Sweep to expropriate for the federal government the value of Fannie and Freddie shares held by private investors and to ensure that the Companies could not begin rebuilding their capital levels. Treasury itself said that the Net Worth Sweep was intended to ensure both that "every dollar of earnings that Fannie Mae and Freddie Mac generate will benefit taxpayers" and that the Companies "will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form." With the stroke of a pen, the Agencies had nationalized the Companies and taken all the value of the Companies for Treasury, thereby depriving the private shareholders of all their economic rights. No equivalent wipeout of private shareholder investments was imposed on other financial institutions that received assistance during the 2008 financial crisis, much less four years *after* that crisis was over.

11. The Companies received no incremental investment by Treasury or other meaningful consideration in return for the Net Worth Sweep, which restricts them to a small maximum capital level above which any profits they generate must be paid over to Treasury. This was done notwithstanding "the path laid out under HERA," which, as even Treasury acknowledged internally, was for FHFA to *rehabilitate* Fannie and Freddie, thus allowing them to "becom[e] adequately capitalized" and "exit conservatorship as private companies."

12. Despite the transparent fact that the Net Worth Sweep was designed to expropriate private property rights, the Government has claimed both in public and in prior filings in this case that the Net Worth Sweep was necessary to prevent the Companies from falling into a "death spiral" in which the Companies' increasing dividend obligations to Treasury would

consume Treasury's remaining funding commitment to the Companies. This made-for-litigation defense narrative is wholly inaccurate.

13. As an initial matter, the Government did not impose the Net Worth Sweep at a time when the Companies were struggling to generate enough income to pay the dividend on Treasury's stock. Rather, the Net Worth Sweep was imposed just days after the Companies disclosed that they had returned to stable profitability and had earned several billion dollars more than was necessary to pay the Treasury dividend in cash. And it was by then virtually inevitable, thanks to a strengthening housing market and the improving quality of loans guaranteed by the Companies, that they would soon reverse the non-cash accounting adjustments that were responsible for the great majority of the losses that they had experienced in the preceding years, thereby generating massive profits. More importantly, quite apart from the Companies' improved financial outlook, the Companies were contractually protected from a scenario in which their dividend obligation to Treasury could cause a death spiral: the Companies were entitled under the PSPAs to pay dividends to Treasury "in kind," with additional senior preferred stock, rather than in cash.

14. Materials produced in discovery further undermine the Government's death spiral narrative. Indeed, those materials reveal that the Net Worth Sweep was adopted not out of a concern that the Companies would earn too little, but rather out of concern that the Companies would make *too much* and thus would complicate the Administration's plans to keep Fannie and Freddie in perpetual conservatorship and to prevent their private shareholders from seeing any return on their investments. As a senior White House official stated in an email to a senior Treasury official on the day the Net Worth Sweep was announced, "we've closed off [the] possibility that [Fannie and Freddie] ever[] go (pretend) private again." That same official stated

in another email that Peter Wallison of the American Enterprise Institute was "exactly right on substance and intent" when he said that "[t]he most significant issue here is whether Fannie and Freddie will come back to life because their profits will enable them to re-capitalize themselves and then it will look as though it is feasible for them to return as private companies backed by the government. . . . What the Treasury Department seems to be doing here . . . is to deprive them of all their capital so that doesn't happen." An internal Treasury document dated August 16, 2012, expressed the same sentiment: "By taking all of their profits going forward, we are making clear that [Fannie and Freddie] will not ever be allowed to return to profitable entities . . . ."

15. The Net Worth Sweep has resulted in a massive and unprecedented financial windfall for the federal government at the expense of the Companies' private shareholders. From the fourth quarter of 2012, the first fiscal quarter subject to the Net Worth Sweep, through the fourth quarter of 2017, the most recently reported fiscal quarter, Fannie and Freddie generated $217 billion in comprehensive income. But rather than using those profits to prudently build capital reserves and prepare to exit conservatorship, Fannie and Freddie instead have been forced to pay substantially all of it as "dividends" to the federal government under the Net Worth Sweep—$124 billion more than the government would have received under the original PSPAs. Adding Net Worth Sweep dividends to the dividends Fannie and Freddie had already paid, Treasury has now recouped $87 billion *more* than it has invested in the Companies. Yet, according to the Government, these payments have not reduced Treasury's liquidation preference by one cent, and Treasury continues to insist that it has the right to Fannie's and Freddie's future earnings *in perpetuity*.

16. The Net Worth Sweep has resulted in a massive and unprecedented expropriation of private property. To the extent this ongoing expropriation is authorized by law, the Fifth

Amendment compels the Government to pay just compensation to Plaintiffs for the taking. To the extent it is not authorized, the Fifth Amendment compels the Government to pay damages to Plaintiffs for the illegal exaction. Indeed, in addition to exceeding FHFA's powers under statute, FHFA itself is an unlawfully organized agency because the Constitution's separation of powers does not permit an independent agency with far-reaching powers such as FHFA to be headed by a single Director rather than a multi-member Board. HERA's concentration of power in one person who is only removable by the President for cause is unconstitutional. Finally, the extraordinary control exercised by FHFA as conservator over Fannie and Freddie created a fiduciary relationship between FHFA, on the one hand, and the Companies' shareholders, on the other. The Net Worth Sweep violated FHFA's fiduciary duties, and Plaintiffs are entitled to damages for the breach.

17. Accordingly, through this action, Plaintiffs seek the recompense to which they are entitled.

JURISDICTION AND VENUE

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

THE PARTIES

19. Plaintiff Arrowood Indemnity Company ("Arrowood Indemnity") is a Delaware corporation with its principal place of business at 3600 Arco Corporate Drive, Charlotte, North Carolina 28273. At the time of commencement of this action, Arrowood Indemnity owned the following shares of Fannie Mae Preferred Stock and Freddie Mac Preferred Stock, all of which were acquired prior to September 6, 2008, and had been continuously owned by Arrowood Indemnity since the date of acquisition, other than 2000 shares of Fannie Mae Preferred Stock which were sold in 2013 and then repurchased later in 2013:

Entity	CUSIP	Coupon Rate	Series	Shares	Par Value Per Share	Aggregate Par Value
Fannie Mae	313586844	5.125%	L	38,800	$ 50.00	$ 1,940,000
Fannie Mae	313586877	5.375%	I	78,000	$ 50.00	$ 3,900,000
Fannie Mae	313586885	5.81%	H	147,400	$ 50.00	$ 7,370,000
Freddie Mac	313400855	5.10%	H	160,000	$ 50.00	$ 8,000,000
Freddie Mac	313400731	5.70%	R	100,000	$ 50.00	$ 5,000,000
Freddie Mac	313400772	5.81%	O	119,750	$ 50.00	$ 5,987,500
Freddie Mac	313400749	6.00%	P	60,000	$ 50.00	$ 3,000,000
			Total	703,950		$ 35,197,500

20. Arrowood Indemnity has continued to own and now owns:

Entity	CUSIP	Coupon Rate	Series	Shares	Par Value Per Share	Aggregate Par Value
Fannie Mae	313586877	5.375%	I	103,000	$ 50	$ 5,150,000
Freddie Mac	313400772	5.810%	O	19,750	$ 50	$ 987,500
			Total	**122,750**		**$ 6,137,500**

21. Plaintiff Arrowood Surplus Lines Insurance Company ("Arrowood Surplus Lines") is a Delaware corporation with its principal place of business at 3600 Arco Corporate Drive, Charlotte, North Carolina 28273. At the time of commencement of this action, Arrowood Surplus Lines owned the following shares of Fannie Mae Preferred Stock and Freddie Mac Preferred Stock, all of which were acquired prior to September 6, 2008, and had been continuously owned by Arrowood Surplus Lines since the date of acquisition:

Entity	CUSIP	Coupon Rate	Series	Shares	Par Value Per Share	Aggregate Par Value
Fannie Mae	313586877	5.375%	I	22,000	$ 50.00	$ 1,100,000
Freddie Mac	313400772	5.81%	O	40,000	$ 50.00	$ 2,000,000
Freddie Mac	313400749	6.00%	P	40,000	$ 50.00	$ 2,000,000
			Total	102,000		$ 5,100,000

22. Arrowood Surplus Lines has continued to own and now owns:

Entity	CUSIP	Coupon Rate	Series	Shares	Par Value Per Share	Aggregate Par Value
Fannie Mae	313586877	5.375%	I	22,000	$ 50	$ 1,100,000
Freddie Mac	313400772	5.810%	O	40,000	$ 50	$ 2,000,000
			Total	**62,000**		**$ 3,100,000**

23. Plaintiff Financial Structures Limited ("Financial Structures") is an insurance company organized under the laws of Bermuda, with an office at 7 Par-la-Ville Rd., Hamilton HM11, Bermuda. Financial Structures owns the following shares of Freddie Mac Preferred Stock, all of which were acquired prior to September 6, 2008, have been continuously owned by Financial Structures since the date of acquisition, and are still owned by Financial Structures:

Entity	**CUSIP**	**Coupon Rate**	**Series**	**Shares**	**Par Value Per Share**	**Aggregate Par Value**
Freddie Mac	313400772	5.81%	O	40,000	$ 50.00	$ 2,000,000
			Total	40,000		$ 2,000,000

24. Arrowood Surplus Lines and Financial Structures are wholly-owned subsidiaries of Arrowood Indemnity. Arrowood Indemnity is an indirect wholly-owned subsidiary of Arrowpoint Capital Corp., a Delaware corporation.

25. Arrowood Indemnity and Arrowood Surplus Lines are insurance companies that are now in "run-off" under the jurisdiction of the Commissioner of Insurance of the State of Delaware. Financial Structures is also an insurance company in run-off. As insurance companies in run-off, the Arrowood Parties do not issue any new insurance policies, and have an obligation to manage their businesses, and conservatively invest their assets, so that funds will be available to fulfill their obligations to existing policyholders. Each of the Arrowood Parties regarded its investments in the Preferred Stock of Fannie Mae and Freddie Mac to be conservative investments.

26. Defendant United States of America includes Treasury, FHFA, and agents acting at their direction.

CONSTITUTIONAL AND STATUTORY PROVISIONS

27. 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 HERA, 12 U.S.C. §§ 1455(*l*), 1719(g), 4617.

FACTUAL ALLEGATIONS

Fannie and Freddie

28. Fannie is a for-profit, stockholder-owned corporation organized and existing under the Federal National Mortgage Act. Freddie is a for-profit, stockholder-owned corporation organized and existing under the Federal Home Loan Corporation Act. The Companies' business includes purchasing and guaranteeing mortgages originated by private banks and bundling the mortgages into mortgage-related securities that can be sold to investors. Prior to 2008, the Companies' mortgage portfolios had a combined value of $5 trillion.

29. Fannie and Freddie are owned by private shareholders and their securities are publicly traded. Fannie was chartered by Congress in 1938 and originally operated as an agency of the Federal Government. In 1968, Congress reorganized Fannie into a for-profit corporation owned by private shareholders. Freddie was established by Congress in 1970 as a wholly-owned subsidiary of the Federal Home Loan Bank System. In 1989, Congress reorganized Freddie into a for-profit corporation owned by private shareholders.

30. Before being forced into conservatorship, both Fannie and Freddie had issued Common Stock and several series of Preferred Stock that were marketed and sold to community banks, insurance companies, and countless other institutional and individual investors. The

several series of Preferred Stock of the Companies are in parity with each other with respect to their claims on income (i.e., dividend payments) and claims on assets (i.e., liquidation preference or redemption price), but they have priority over the Companies' Common Stock for these purposes. The holders of Common Stock are entitled to the residual economic value of the firms. The Companies have outstanding Preferred Stock with an aggregate liquidation preference of $33 billion.

31. Under the Certificates of Designation setting out the terms and conditions of the Preferred Stock issued by Fannie and Freddie prior to September 6, 2008, each series of Preferred Stock issued by the Companies enjoyed parity with all other issued and outstanding series of Preferred Stock as to the payment of dividends and the distribution of assets upon dissolution, liquidation, or winding up of the companies. Thus, the holders of each series of Preferred Stock had equal contractual rights to receive their respective liquidation preferences (or their respective pro rata portions thereof) upon dissolution, liquidation, or winding up of the Companies.

32. Prior to 2007, Fannie and Freddie were consistently profitable. In fact, Fannie had not reported a full-year loss since 1985 and Freddie had not reported a full-year loss since becoming owned by private shareholders. In addition, both Companies regularly declared and paid dividends on each series of their respective Preferred Stock and their respective Common Stock.

Fannie and Freddie Are Forced into Conservatorship

33. The Companies were well-positioned to weather the decline in home prices and financial turmoil of 2007 and 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, Fannie and Freddie had taken a more conservative approach that meant that

the mortgages that they insured (primarily 30-year fixed rate conforming mortgages) were far safer than those insured by the nation's largest banks. And although both Companies recorded losses in 2007 and the first two quarters of 2008—losses that largely reflected a temporary decline in the market value of their holdings caused by declining home prices—both Companies continued to generate enough cash to easily pay their debts and retained billions of dollars of capital that could be used to cover any future losses.

34. Neither Company was in danger of insolvency in 2008. Indeed, during the summer of 2008, both Treasury Secretary Henry Paulson and Office of Federal Housing and Enterprise Oversight ("OFHEO") Director James Lockhart publicly stated that Fannie and Freddie were financially healthy. For example, on July 8, 2008, Director Lockhart told CNBC that "both of these companies are adequately capitalized, which is our highest criteria." Two days later, on July 10, Secretary Paulson testified to the House Committee on Financial Services that Fannie's and Freddie's "regulator has made clear that they are adequately capitalized." On July 13, Director Lockhart issued a statement emphasizing that "the Enterprises' $95 billion in total capital, their substantial cash and liquidity portfolios, and their experienced management serve as strong supports for the Enterprises' continued operations." 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. An analysis of Freddie's financial condition in August 2008 for FHFA by BlackRock stated that Freddie's "long-term solvency does not appear endangered—we do not expect Freddie Mac to breach critical capital levels even in stress case." Furthermore, 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 sum, despite arguments to the contrary by lawyers for the Agencies in litigation related to the Net Worth Sweep, the Companies were not on the precipice of failure in 2008.

35. Despite (or perhaps because of) the Companies' comparatively strong financial position amidst the crisis, Treasury initiated a long-term policy of seeking to seize control of Fannie and Freddie and operate them for the exclusive benefit of the federal government. To that end, as early as March 2008, Treasury was internally discussing "potential costs and benefits of nationalization" of the Companies. Around the same time, a Treasury official was the off-the-record source for a Barron's article that inaccurately claimed that the Companies' books overstated assets and understated liabilities.

36. The Companies' sound financial condition in the weeks leading up to imposition of the conservatorships is further illustrated by the decision by Fannie's Board of Directors to declare dividends on both its preferred and common stock in August 2008 and by FHFA's subsequent decision as conservator to direct Fannie to pay those dividends out of cash available for distribution in late September 2008. It is a fundamental principle of corporate law that a company may not declare dividends when it is insolvent, and dividends that a company improperly declares when insolvent may not be lawfully paid. Fannie's Board thus could not have lawfully declared dividends in August 2008 unless the Company was solvent at that time, and the Board's decision to declare those dividends showed its confidence that Fannie was financially healthy. Furthermore, it is evident that both FHFA and Treasury agreed that Fannie

was solvent when it declared dividends in August 2008 because, rather than halting or voiding the dividends that the outgoing Fannie Board had declared, both Agencies publicly took the position that Fannie was legally obligated to pay them even after conservatorship was imposed in early September 2008

37. Also during the summer of 2008, Treasury pressed Congress to pass what became HERA. HERA created FHFA (which succeeded to the regulatory authority over Fannie and Freddie previously held by OFHEO) and authorized FHFA, under certain statutorily prescribed and circumscribed conditions, to place the Companies into either conservatorship or receivership.

38. In authorizing FHFA to act as conservator under specified circumstances, Congress took FHFA's conservatorship mission verbatim from the Federal Deposit Insurance Act ("FDIA"), *see* 12 U.S.C. § 1821(d)(2)(D), which itself incorporated a long history of financial supervision and rehabilitation of troubled entities under common law. HERA and the FDIA, as well as the common law concept on which both statutes draw, treat conservatorship as 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 fiduciary duty to safeguard the interests of the Companies and their shareholders.

39. According to HERA, FHFA "may, as conservator, take 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 acknowledged that "[t]he purpose of conservatorship is to preserve and conserve each company's assets and property and to put the companies in a sound and solvent condition," and "[t]o fulfill the statutory mandate of

conservator, FHFA must follow governance and risk management practices associated with private-sector disciplines." FHFA, REPORT TO CONGRESS 2009 at i, 99 (May 25, 2010).

40. FHFA has repeatedly stated publicly that HERA *requires* and *mandates* FHFA as conservator to preserve and conserve Fannie's and Freddie's assets and to restore them to a sound and solvent condition. The following are just a few examples:

- The provisions of 12 U.S.C. § 4617(b)(2)(D) are "statutory mandates" and as conservator FHFA "must follow the mandates assigned to it by statute." FHFA, STRATEGIC PLAN: FISCAL YEARS 2018-2022 at 3-4 (Jan. 29, 2018). https://goo.gl/yDZmir.

- FHFA has "statutory obligations to operate the [Companies] in a safe and sound manner." Prepared Remarks of Melvin L. Watt, Dir., FHFA, at American Mortgage Conference (May 18, 2017). https://goo.gl/rT3f6C.

- FHFA's "statutory mandates obligate" it to "[c]onserve and preserve the assets of the Enterprises while they are in conservatorship." Statement of Melvin L. Watt, Dir., FHFA, Before the U.S. Senate Comm. on Banking, Housing, and Urban Affairs (May 11, 2017). https://goo.gl/h44qRf.

- FHFA has a " 'preserve and conserve' mandate." FHFA STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIP: THE NEXT CHAPTER IN A STORY THAT NEEDS AN ENDING at 7 (Feb. 21, 2012), http://goo.gl/uXreKX ("A STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIP").

- "By law, the conservatorships are intended to rehabilitate [Fannie and Freddie] as private firms." Letter from Edward DeMarco, Acting Director, FHFA to Senators at 1 (Nov. 10, 2011), http://goo.gl/hbBe25.

- "The statutory role of FHFA as conservator requires FHFA to take actions to preserve and conserve the assets of the Enterprises and restore them to safety and soundness. FHFA REPORT TO CONGRESS 2009 at 99 (May 25, 2010), http://goo.gl/YOOgzC.

- "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." The Present Condition and Future Status of Fannie Mae and Freddie Mac: Hearing Before the Subcomm. of Capital Markets, Ins. & Gov't Sponsored Enters of the H. Comm. On Fin. Servs. 111th Cong. 136 (2009). (statement of James B. Lockhart III, Dir., FHFA).

- FHFA as conservator "preserves and conserves the assets and property of the Enterprises . . . and facilitates their financial stability and emergence from conservatorship." FHFA, STRATEGIC PLAN 2009–2014, at 33, http://goo.gl/UjCxf6. "The conservatorship of Fannie Mae and Freddie Mac allows the FHFA to preserve the assets of the [Companies], ensure they focus on their housing mission and are positioned to emerge from conservatorship as financially strong . . . ." Id. at 20.

41. The Agencies' similarly acknowledged FHFA's mandates as conservator in internal documents produced in discovery. Treasury, for example, acknowledged that "FHFA as conservator is required to preserve assets" and that one of the "[l]egal [c]onstraints" imposed upon FHFA is its "mandate[ ] to 'conserve assets.' " FHFA recognized that it "has a responsibility to take such actions as may be necessary to put the Enterprises in a sound and solvent condition and to preserve and conserve their assets and property."

42. Under HERA, conservatorship is a status distinct from receivership, with very different purposes, responsibilities, and restrictions. When acting as a receiver, but *not* when

acting as a conservator, FHFA is authorized and obliged to "place the regulated entity in liquidation and proceed to realize upon the assets of the regulated entity." *Id.* § 4617(b)(2)(E). The only "post-conservatorship outcome[] . . . that FHFA may implement today under existing law," by contrast, "is to reconstitute [Fannie and Freddie] under their current charters." Letter from Edward J. DeMarco, Acting Director, FHFA, to Chairmen and Ranking Members of the Senate Committee on Banking, Housing, and Urban Affairs and to the House Committee on Financial Services 7 (Feb. 2, 2010). In other words, receivership is aimed at winding down a company's affairs and liquidating its assets, while conservatorship aims to rehabilitate it and return it to normal operation. This distinction between the purposes and authorities of a receiver and a conservator is a well-established tenet of financial regulation and common law. In our nation's history, there has *never* been an example of a regulator forcing a healthy, profitable company to remain captive in a perpetual conservatorship (in this instance, going on ten years) while facilitating the looting and plundering of the company's assets by another federal agency *and* simultaneously avoiding the organized claims process of a receivership.

43. In promulgating regulations governing its operations as conservator versus receiver of the Companies, FHFA specifically acknowledged the distinctions in its statutory responsibilities as conservator and as receiver: "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." 76 Fed. Reg. 35,724, 35,730. In contrast, when FHFA acts as a receiver, the regulation specifically provides that "[t]he Agency, as receiver, *shall* place the regulated entity in liquidation . . . ." 12 C.F.R. § 1237.3(b) (emphasis added). Consistent with this interpretation of HERA, a FHFA Advisory Bulletin describes "the conservator's or receiver's powers and responsibilities" as including "in the case of a conservator, to put the regulated entity in a sound

and solvent condition, and to carry on its business and preserve and conserve its assets, and in the case of a receiver, to liquidate the regulated entity."

44. During conservatorship FHFA has dual and potentially conflicting roles as the Companies' conservator and regulator. As conservator, FHFA's mission is to preserve and conserve the Companies' assets and restore them to soundness and solvency. In contrast, as regulator, FHFA is charged with the public mission of ensuring that the Companies "foster liquid, efficient, competitive, and resilient national housing finance markets (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities)" and conduct their operations in a manner "consistent with the public interest." 12 U.S.C. § 4513(a)(1)(B). The FDIC, which has similar dual roles, has in the past sought to manage this conflict by erecting a "firewall" between personnel tasked with working for the agency as conservator and other personnel tasked with working for the agency as regulator. *See Plaintiffs in All Winstar-Related Cases at Court v. United States*, 44 Fed. Cl. 3, 7 n.5 (1999). FHFA has not taken similar steps to protect the integrity of its conservatorship role and, as set forth in greater detail below, abandoned the traditional role of a conservator by disregarding the interests of the Companies when it took the actions that are the subject of this suit.

45. On September 6, 2008, FHFA and Treasury persuaded the Companies' boards to consent to 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, JR., ON THE BRINK 6 (2010). Given that the Companies were not in financial distress

and were in no danger of defaulting on their debts, the Companies' directors were confronted with 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 REPORT 320 (Jan. 2011). The Agencies ultimately obtained the Companies' consent by threatening to seize them if they did not acquiesce and by informing them that the Agencies had already selected new CEOs and had teams ready to move in and take control. In agreeing to the FHFA takeover, both Companies' boards understood that the "conservatorship" FHFA and Treasury proposed would be like all other federal conservatorships in American history and that the Companies would be operated by their regulator acting in a fiduciary capacity for the benefit of all stakeholders, including private shareholders.

46. In publicly announcing the conservatorship, FHFA acknowledged that the Companies' stock remains outstanding during conservatorship and "continue[s] to trade," *FHFA Fact Sheet, Questions and Answers on Conservatorship* 3, https://goo.gl/DV4nAt, and Fannie's and Freddie's stockholders "continue to retain all rights in the stock's financial worth," *id.* Director Lockhart testified before Congress that Fannie's and Freddie's "shareholders are still in place; both the preferred and common shareholders have an economic interest in the companies" and that "going forward there may be some value" in that interest. *Oversight Hearing to Examine Recent Treasury & FHFA Actions Regarding the Housing GSEs: Hearing Before the H. Comm. on Fin. Servs.,* 110th Cong. 29–30, 34 (2008).

47. FHFA also emphasized that the conservatorship was temporary: "Upon the Director's determination that the Conservator's plan to restore the [Companies] to a safe and solvent condition has been completed successfully, the Director will issue an order terminating

the conservatorship." *FHFA Fact Sheet, Questions and Answers on Conservatorship* 2. Investors were entitled to rely on these official statements of the purposes of the conservatorship, and public trading in Fannie's and Freddie's stock was permitted to, and did, continue.

48. In short, the Companies were not in financial distress when they were forced into conservatorship. The Companies' boards acquiesced to conservatorship based on the understanding that FHFA, like any other conservator, would operate the Companies as a fiduciary with the goal of preserving and conserving their assets and managing them in a safe and solvent manner. And in publicly announcing the conservatorships, FHFA confirmed that the Companies' private shareholders continued to hold an economic interest that could have value, particularly as the Companies generated profits in the future.

FHFA and Treasury Enter into the Purchase Agreements

49. On September 7, 2008, Treasury and FHFA, acting in its capacity as conservator of Fannie and Freddie, entered into the Preferred Stock Purchase Agreements.

50. In entering into the Purchase Agreements, Treasury exercised its temporary authority under HERA to purchase securities issued by the Companies. *See* 12 U.S.C. §§ 1455(*l*), 1719(g). To exercise that authority, the Secretary of the Treasury was required to determine that purchasing the Companies' securities was "necessary to. . .provide stability to the financial markets; . . . prevent disruptions in the availability of mortgage finance; and . . . protect the taxpayer." 12 U.S.C. §§ 1455(*l*)(1)(B), 1719(g)(1)(B). In making those determinations, the Secretary was required to consider six factors:

> (i) The need for preferences or priorities regarding payments to the Government.
> (ii) Limits on maturity or disposition of obligations or securities to be purchased.
> (iii) *The [Companies'] plan[s] for the orderly resumption of private market funding or capital market access.*

> (iv) The probability of the [Companies] fulfilling the terms of any such obligation or other security, including repayment.
> (v) *The need to maintain the [Companies'] status as . . . private shareholder-owned compan[ies]*.
> (vi) Restrictions on the use of [the Companies'] resources, including limitations on the payment of dividends and executive compensation and any such other terms and conditions as appropriate for those purposes.

Id. §§ 1455(*l*)(1)(C), 1719(g)(1)(C) (emphasis added).

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 (Sept. 7, 2008).

52. Treasury's authority under HERA to purchase the Companies' securities expired on December 31, 2009. *See* 12 U.S.C. §§ 1455(*l*)(4), 1719(g)(4). After that date, HERA authorized Treasury only "to hold, exercise any rights received in connection with, or sell" previously purchased securities. *Id.* §§ 1455(*l*)(2)(D), 1719(g)(2)(D).

53. Treasury's PSPAs with Fannie and Freddie are materially identical. Under the original agreements, Treasury committed to provide up to $100 billion to each Company to ensure that it maintained a positive net worth. In particular, for quarters in which either Company's liabilities exceed its assets under Generally Accepted Accounting Principles, the PSPAs authorize Fannie and Freddie to draw upon Treasury's commitment in an amount equal to the difference between its liabilities and assets.

54. In return for Treasury's funding commitment, Treasury received 1 million shares of Government Stock in each Company and warrants to purchase 79.9% of the common stock of

each Company at a nominal price. Exercising these warrants would entitle Treasury to up to 79.9% of all future profits of the Companies, subject to the Companies' obligation to satisfy their dividend obligations with respect to the Government Stock and Preferred Stock and to share the remaining 20.1% of those profits with private common shareholders. As Treasury noted in entering the PSPAs, the warrants "provide potential future upside to the taxpayers." Action Memorandum for Secretary Paulson (Sept. 7, 2008).

55. Treasury's Government Stock in each Company had an initial liquidation preference of $1 billion. In other words, Treasury took an upfront fee of $1 billion from each of the Companies before either Company received *any* funding from Treasury in return. This liquidation preference increases by one dollar for each dollar the Companies receive from Treasury pursuant to the PSPAs. In the event the Companies liquidate, Treasury is entitled to recover the full liquidation value of its shares before any other shareholder may recover anything.

56. While Treasury's commitment remains outstanding, Fannie and Freddie generally are prohibited from paying down amounts added to the liquidation preference due to draws from Treasury's commitment. *See* Fannie and Freddie Government Stock Certificates § 3(a). This extraordinary feature of the original PSPAs would play an important role in enabling the Government to permanently increase the size of the dividends on the Government Stock by artificially reducing the Companies' reported net worth through the accounting manipulations discussed below.

57. In addition to the liquidation preference, the original PSPAs provided for Treasury to receive either a cumulative cash dividend equal to 10% of the value of the outstanding liquidation preference or a stock dividend. If the Companies decided not to pay the dividend in cash, the value of the dividend would be added to the liquidation preference—effectively

amounting to an in-kind dividend payment of additional Government Stock. After an in-kind dividend payment, the dividend rate would increase to 12% until such time as full cumulative dividends were paid in cash, at which point the rate would return to 10%. The plain terms of the PSPAs thus make clear that Fannie and Freddie never were required to pay a cash dividend to Treasury but rather had the discretion to pay dividends in kind. In other words, the Companies were never under any obligation to pay a fixed 10% cash dividend to Treasury. Moreover, there was never any risk that payment of dividends would render the Companies insolvent since it would have been illegal under state law for either Company to pay a dividend that would render it insolvent.

58. Numerous materials prove beyond any reasonable doubt that the Agencies recognized that the PSPAs were designed, as their express terms plainly provide, to allow the payment of dividends in kind—in additional senior preferred stock—rather than in cash. In an internal October 2008 email to Mario Ugoletti—who was then a Treasury official, but later moved to FHFA and was a key point of contact with Treasury in the development of the Net Worth Sweep—another Treasury official indicated that Treasury's consultant wanted to know "whether we expect [Fannie and Freddie] to pay the preferred stock dividends in cash or to just accrue the payments." Mr. Ugoletti did not forget about this feature of the PSPAs when he moved to FHFA. Indeed, he acknowledged the option to pay dividends "in kind" in an email that he sent the very day the Net Worth Sweep was announced. In a similar vein, a document attached to a September 16, 2008, email between FHFA officials expressly states that PSPA dividends may be "paid in-kind." In an October 2008 email to Treasury and FHFA officials, a Treasury consultant sought to clarify whether Fannie and Freddie "intend[ed] to pay cash at 10 percent or accrue at 12 percent as a matter of policy." An internal Treasury document says that the dividend

rate "may increase to the rate of 12 percent if, in any quarter, the dividends are not paid in cash." And an internal FHFA document says that Treasury's senior stock pays "10 percent cash dividend (12 percent payment-in-kind)."

59. Documents that the Agencies placed in the public domain also support this understanding of the payment-in-kind option. Upon entering the PSPAs Treasury released a fact sheet stating that, "[t]he senior preferred stock shall accrue dividends at 10% per year. The rate shall increase to 12% if, in any quarter, the dividends are not paid in cash . . . ." U.S. TREASURY DEP'T OFFICE OF PUB. AFFAIRS, FACT SHEET: TREASURY SENIOR PREFERRED STOCK PURCHASE AGREEMENT (Sept. 7, 2008), https://goo.gl/ynb3TC. And a presentation Treasury included in the administrative record in a case in the District of the District of Columbia acknowledges that the dividend rate of the PSPAs would be 12% "if elected to be paid in kind." Treasury Presentation to SEC, GSE Preferred Stock Purchase Agreements (PSPA), Overview and Key Considerations at 9, June 13, 2012.

60. The Companies shared this understanding of the terms of their agreements with Treasury. Fannie's and Freddie's Chief Financial Officers ("CFOs") have testified that they were aware of the payment-in-kind option. Various Freddie documents say that "[t]he dividend becomes 12% if Freddie Mac is unable to pay the dividend through organic income," that "[t]he senior preferred stock will pay quarterly cumulative dividends at a rate of 10% per year or 12% in any quarter in which dividends are not paid in cash," that Treasury's stock "[p]ays quarterly cumulative dividend rate at 10% per year, or 12% in any quarter in which dividends are not paid in cash," and that Treasury's stock "will pay quarterly cumulative dividends at a rate of 10% per year, or 12% in any quarter in which dividends are not paid in cash." Similarly, Fannie documents say that "Treasury's preferred stock "has an annual dividend rate of 10%, which could

increase to 12% if not paid in cash," and that "[i]f at any time . . . the Company does not pay the cash dividends in a timely manner, . . . the annual dividend rate will be 12%."

61. An in-kind dividend payment would not decrease Treasury's funding commitment because only when the Companies receive "funding under the Commitment" does its size decrease. Fannie and Freddie Amended and Restated Senior Preferred Stock Purchase Agreements ("PSPA") § 1. Jeff Foster, one of the architects of the Net Worth Sweep at Treasury, accordingly has testified in a deposition that he could not identify any "problems of the circularity [in dividend payments that] would have remained had the [payment-in-kind] option been adopted." Thus, as the Congressional Research Service has acknowledged, under the PSPAs' original terms the Companies could "pay a 12% annual senior preferred stock dividend indefinitely." N. ERIC WEISS, CONG. RESEARCH SERV., RL34661, FANNIE MAE'S AND FREDDIE MAC'S FINANCIAL PROBLEMS (Aug. 10, 2012). In other words, because of the payment-in-kind option, there was no risk—none whatsoever—that the PSPAs would force Fannie and Freddie to exhaust Treasury's funding commitment to facilitate the payment of dividends.

62. The PSPAs also provided for the Companies to pay Treasury a quarterly periodic commitment fee "intended to fully compensate [Treasury] for the support provided by the ongoing Commitment." PSPA § 3.2(a). The periodic commitment fee was to be set for five-year periods by agreement of the Companies and Treasury, but Treasury had the option to waive it for up to a year at a time. Treasury has exercised this option and has never received a periodic commitment fee under the PSPAs. Even if the fee had been charged, the Companies were always free under the express terms of the PSPAs to pay the fee in-kind with additional senior preferred stock rather than in cash. *See* PSPA § 3.2(c) ("At the election of Seller, the Periodic Commitment Fee may be paid in cash or by adding the amount thereof ratably to the liquidation preference of

each outstanding share of Senior Preferred Stock . . . ."). This is a fact that Freddie's auditor recognized in a document produced in this case.

63. Finally, the PSPAs also grant Treasury substantial control over FHFA's operation of Fannie and Freddie and the conservatorships. In particular, from their inception through the adoption of the Net Worth Sweep the PSPAs provided as follows:

> From the Effective Date until such time as the Senior Preferred Stock shall have been repaid or redeemed in full in accordance with its terms:
>
> 5.1. *Restricted Payments.* Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, declare or pay any dividend (preferred or otherwise) or make any other distribution (by reduction of capital or otherwise), whether in cash, property, securities or a combination thereof, with respect to any of Seller's Equity Interests (other than with respect to the Senior Preferred Stock or the Warrant) or directly or indirectly redeem, purchase, retire or otherwise acquire for value any of Seller's Equity Interests (other than the Senior Preferred Stock or the Warrant), or set aside any amount for any such purpose.
>
> 5.2. *Issuance of Capital Stock*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, sell or issue Equity Interests of Seller or any of its subsidiaries of any kind or nature, in any amount, other than the sale and issuance of the Senior Preferred Stock and Warrant on the Effective Date and the common stock subject to the Warrant upon exercise thereof, and other than as required by (and pursuant to) the terms of any binding agreement as in effect on the date hereof.
>
> 5.3. *Conservatorship*. Seller shall not (and Conservator, by its signature below, agrees that it shall not), without the prior written consent of Purchaser, terminate, seek termination of or permit to be terminated the conservatorship of Seller pursuant to Section 1367 of the FHE Act, other than in connection with a receivership pursuant to Section 1367 of the FHE Act.
>
> 5.4. *Transfer of Assets*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, sell, transfer, lease or otherwise dispose of (in one transaction or a series of related transactions) all or any portion of its assets (including Equity Interests in other persons, including subsidiaries), whether now owned or hereafter acquired (any such sale, transfer, lease or disposition, a "Disposition"), other than Dispositions for fair market value:
>
> (a) to a limited life regulated entity ("LLRE") pursuant to Section

1367(i) of the FHE Act;

(b) of assets and properties in the ordinary course of business, consistent with past practice;

(c) in connection with a liquidation of Seller by a receiver appointed pursuant to Section 1367(a) of the FHE Act;

(d) of cash or cash equivalents for cash or cash equivalents; or

(e) to the extent necessary to comply with the covenant set forth in Section 5.7 below.[1]

5.5. *Indebtedness*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, incur, assume or otherwise become liable for (a) any indebtedness if, after giving effect to the incurrence thereof, the aggregate Indebtedness of Seller and its subsidiaries on a consolidated basis would exceed 110.0% of the aggregate Indebtedness of Seller and its subsidiaries on a consolidated basis as of June 30, 2008 or (b) any Indebtedness if such Indebtedness is subordinated by its terms to any other Indebtedness of Seller or the applicable subsidiary. For purposes of this covenant the acquisition of a subsidiary with Indebtedness will be deemed to be the incurrence of such Indebtedness at the time of such acquisition.

5.6. *Fundamental Changes*. Seller shall not, and shall not permit any of its subsidiaries to, in each case without the prior written consent of Purchaser, (i) merge into or consolidate or amalgamate with any other Person, or permit any other Person to merge into or consolidate or amalgamate with it, (ii) effect a reorganization or recapitalization involving the common stock of Seller, a reclassification of the common stock of Seller or similar corporate transaction or event or (iii) purchase, lease or otherwise acquire (in one transaction or a series of transactions) all or substantially all of the assets of any other Person or any division, unit or business of any Person.

. . .

5.8. *Transactions with Affiliates*. Seller shall not, and shall not permit any of its subsidiaries to, without the prior written consent of Purchaser, engage in any transaction of any kind or nature with an Affiliate of Seller unless such transaction is (i) Pursuant to this Agreement, the Senior Preferred Stock or the Warrant, (ii) upon terms no less favorable to Seller than would be obtained in a comparable arm's-length transaction with a Person that is not an Affiliate of Seller or (iii) a transaction undertaken in the ordinary course or pursuant to a contractual

[1] The Third Amendment, discussed below, added a provision to Section 5.4 permitting the Companies to sell up to $250,000,000 in assets in a single transaction without Treasury's consent.

obligation or customary employment arrangement in existence as of the date hereof.

PSPAs at 8–10.

64. As Freddie has observed, these covenants "restrict [the Companies'] business activities" and prevent them from taking certain actions even at the direction of FHFA "without prior written consent of Treasury."

65. On May 6, 2009, FHFA and Treasury amended the PSPAs to increase Treasury's funding commitment to each Company from $100 billion to $200 billion. On December 24, 2009—one week before Treasury's temporary statutory authority to purchase the Companies' securities expired—the agencies again amended the terms of Treasury's funding commitment. Instead of resetting the commitment at a specific dollar amount, the second amendment established a formula to allow Treasury's total commitment to each Company to exceed (but not fall below) $200 billion depending upon any net worth deficiencies experienced in 2010, 2011, and 2012, and any surplus existing as of December 31, 2012. In an action memorandum explaining the second of these two amendments, Treasury stated that the increased funding commitment was "a strong statement that the U.S. Government will make sure that the institutions continue to function" and that it was not expected that the Companies would require any additional increase because "[i]t is unlikely that either [Company] will reach the $200 billion existing cap unless the housing market worsens sharply from here." As Treasury acknowledged, in the same document, expiration of its authority to purchase the Companies' shares at the end of 2009 meant that its "ability to make further changes to the PSPAs . . . [was] constrained." Action Memorandum for Secretary Geithner at 3, 4 (Dec. 22, 2009).

The Agencies Force Accounting Changes To Increase the Companies' Draws From Treasury

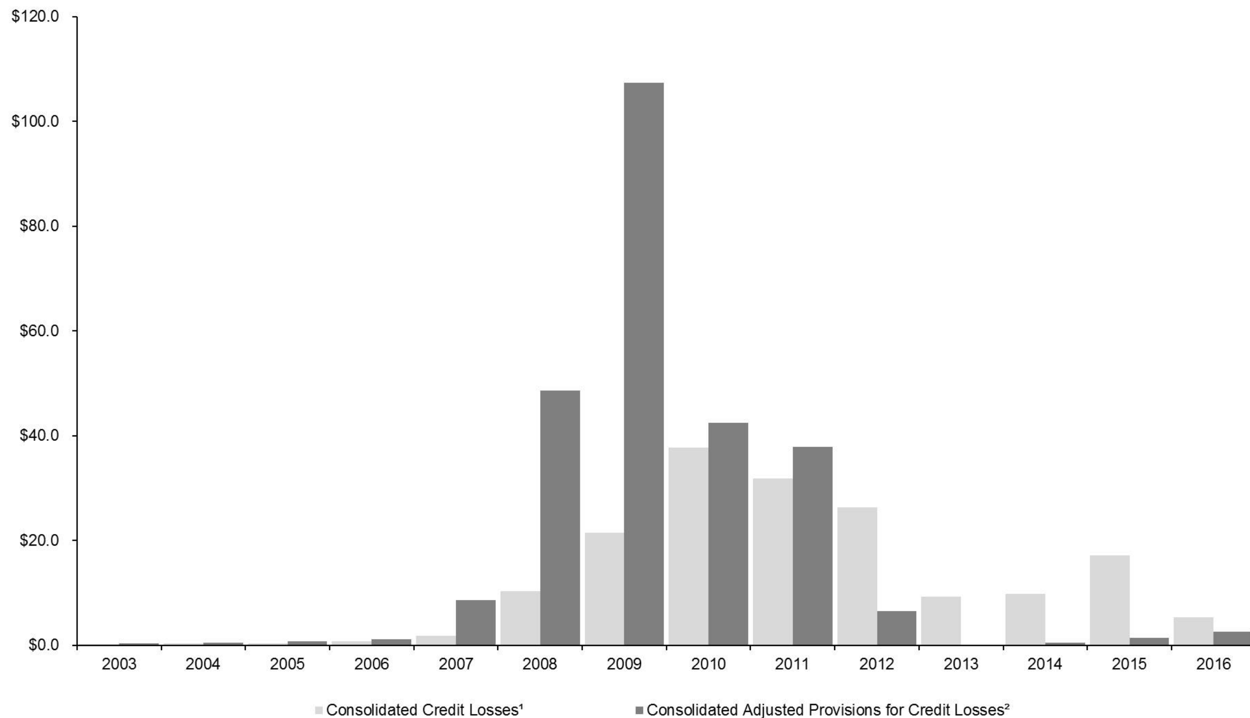
66. Beginning in the third quarter of 2008—when FHFA took control of the Companies as conservator—the Companies began to make wildly pessimistic and obviously unrealistic assumptions about their future financial prospects. Indeed, these assumptions would have only been accurate if the United States had suffered a catastrophic, multi-decade depression that no company, irrespective of its financial health, could have survived. These false assumptions triggered adjustments to the Companies' balance sheets, most notably write-downs of significant tax assets and the establishment of large loan loss reserves, which caused the Companies to report non-cash losses. Although reflecting nothing more than unjustifiable accounting assumptions about the Companies' future prospects and having no effect on the cash flow the Companies were generating, these non-cash losses temporarily and misleadingly decreased the Companies' reported net worth by in excess of a hundred billion dollars. For example, in the first year and a half after imposition of the conservatorship, Fannie reported $127 billion in losses, but only $16 billion of that amount reflected actual credit-related losses. These excessive non-cash losses resulted in excessive purchases of Government Stock by Treasury. Had the Companies' net worth been properly calculated under Generally Accepted Accounting Principles, their liabilities would never have exceeded their assets. In 2010, during the period when these improper accounting adjustments were being made, FHFA also decided to order the Companies to de-list their shares from the New York Stock Exchange, a decision that had no effect on the stock's underlying economic value but caused a precipitous decline in its market price.

67. By the end of 2011, the Companies' reported net worth had fallen by $100 billion as a result of the decision made shortly after imposition of the conservatorship to write down the value of their deferred tax assets. A deferred tax asset is an asset that may be used to offset future

tax liability. Under Generally Accepted Accounting Principles, if a company determines that it is unlikely that some or all of a deferred tax asset will be used, the company must establish a "valuation allowance" in the amount that is unlikely to be used. In other words, a company must write down a deferred tax asset if it is unlikely to be used to offset future taxable profits. Shortly after FHFA took control of the Companies, FHFA made the implausible assumption that the Companies would *never again* generate taxable income and that their deferred tax assets were therefore worthless. That incomprehensibly flawed decision dramatically reduced the Companies' reported net worth.

68. The decision to designate excessive loan loss reserves was another important factor in the artificial decline in the Companies' reported net worth during the early years of conservatorship. Loan loss reserves are an entry on the Companies' balance sheets that reduces their reported net worth to reflect anticipated losses on the mortgages they own. Beginning when FHFA took control of the Companies in the third quarter of 2008 and continuing through 2009, the Companies were forced to provision additional loan loss reserves far in excess of the credit losses they were actually experiencing. The extent to which excess loan loss reserve provisioning reduced the Companies' reported net worth is dramatically illustrated by the following chart, which compares the Companies' loan loss reserve provisioning to their actual credit losses. As the chart shows, FHFA caused the Companies to make grossly excessive loan loss reserve provisions in 2008 and 2009. The excessive nature of these loan loss provisions was readily apparent by 2012, and the inevitable reversals would appear as income on the Companies' balance sheet.

Loan Loss Reserve Provisions vs. Credit Expenses

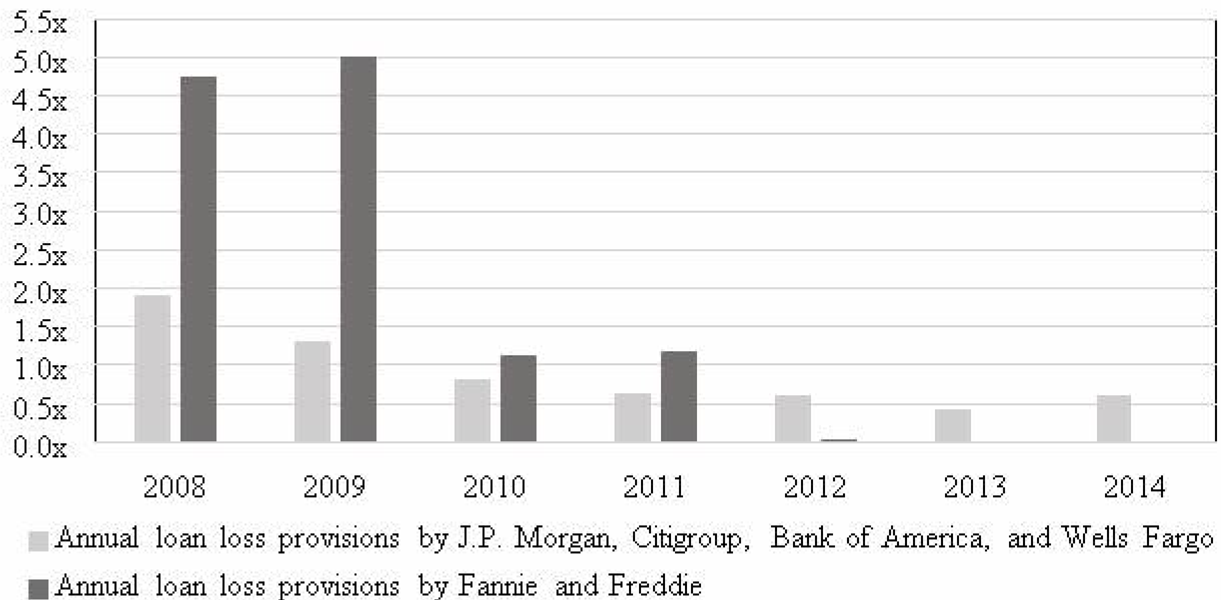


Source: Company Financials

(1) Credit losses based on net charge-offs (charge-offs less recoveries), plus foreclosed property expense. Charge-offs taken in relation to credit-impaired loans of Fannie Mae have been reversed, and replaced with ultimately realized

(2) Provisions shown include stated provisions, plus foreclosed property expense for Fannie Mae, and REO expense and Transfers for Freddie Mac. Note, stated provisions based on provisions only and excludes impact of provision reversals

69. Despite the fact that the Companies' mortgage portfolios were safer than the similar portfolios held by banks involved in the mortgage business, banks were much more accurate—and, with the consent of their regulators, far less aggressive—in reducing their net worth to reflect expected loan losses. The following chart illustrates this fact:



70. In June 2011, FHFA officials observed in an email exchange that Freddie was taking loan loss reserves in excess of what its own financial models supported but that Freddie would "face some hard questioning from FHFA" if it sought "to take down the reserves in the current clime." And in November 2011, a Treasury consultant that had reviewed Fannie financial projections previously used to justify loan loss reserve decisions observed that "actual net losses were typically lower than predicted in the optimistic and base cases . . . and far lower than forecasted in the stress cases."

71. By June of 2012, the Companies had drawn a total of $187 billion from Treasury, in large part to fill the holes in the Companies' balance sheets created by these artificial non-cash losses imposed under conservatorship. Approximately $26 billion of these combined amounts were drawn simply to pay the 10% dividend payments owed to Treasury. (In other words, FHFA

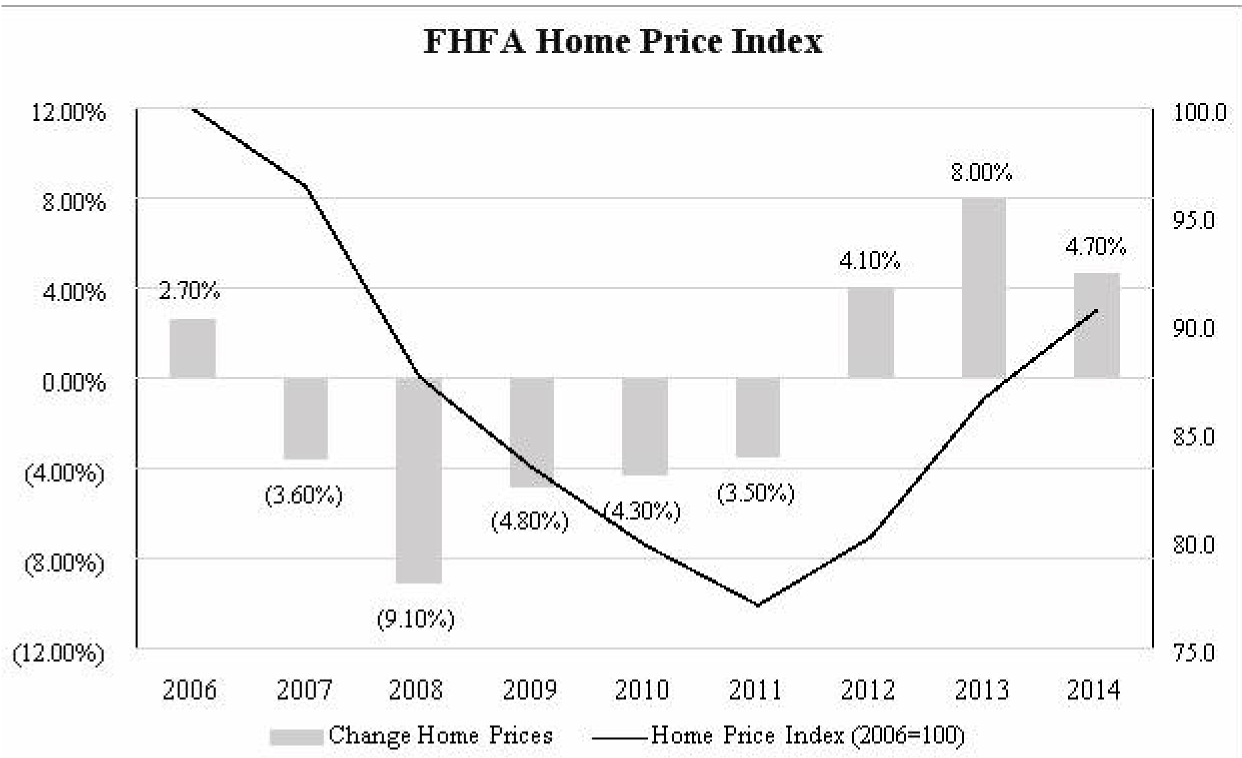
requested draws to pay Treasury this $26 billion in cash that was not otherwise available rather than electing to pay the dividends in kind. Had the dividends been paid in kind, FHFA would not have had to draw from—and, consequently, reduce the remaining size of—Treasury's commitment to pay them.) Thus, Treasury actually disbursed approximately $161 billion to the Companies, primarily reflecting temporary changes in the valuation estimates of assets and liabilities.

72. From the outset of the conservatorship through the imposition of the Net Worth Sweep, the Companies' net operating revenue exceeded their net operating expenses, and their actual losses were never so severe that they would have had a negative net worth but for the excessively pessimistic and unjustified treatment of deferred tax assets and loan loss reserves. In other words, despite manipulations made to the Companies' balance sheets while they were under the Government's control, they never had any difficulty paying their debts and other obligations. Over time, the Companies' cash receipts have consistently exceeded their expenses.

The Companies Return to Profitability and Stability

73. By 2012, Fannie and Freddie began generating consistent profits notwithstanding their overstated loss reserves and the write-down of their deferred tax assets. In fact, in the first two quarters of 2012, the Companies posted sizable profits totaling more than $11 billion. What is more, the Companies were well-positioned to continue generating robust profits for the foreseeable future.

74. Fannie's and Freddie's financial results are strongly influenced by home prices. And as FHFA's own Home Price Index shows, the market reached its bottom in 2011:



75. The improving housing market was coupled with stricter underwriting standards at Fannie and Freddie. As a result—and as the Agencies knew—Fannie- and Freddie-backed loans issued after 2008 had dramatically lower serious delinquency rates than loans issued between 2005 and 2008. To appreciate the significance of this point, it is useful to understand that the mortgages the Companies purchase and securitize in a given year are sometimes collectively referred to as that year's "vintage." Some vintages are more profitable than others; the Companies make more money from mortgages purchased in years when borrowers were on the whole more creditworthy and overall home prices were lower (factors that reduce the rate at which borrowers default). Although each vintage generates income for the Companies for many years (the Companies mostly purchase 30-year mortgages), it is possible to make an early assessment of how profitable a given vintage will be by examining the vintage's default rate in its first few years. In this manner, the Companies and the Agencies were able to examine the quality

of the mortgage vintages from after 2008, and by 2012 they fully understood that those newer vintages would be highly profitable.

76. The strong quality of these newer vintages of mortgages boded well for Fannie's and Freddie's future financial prospects. Indeed, as early as June 2011, a Treasury official observed that "[a]s Fannie and Freddie continue to work through their legacy book of business, —i.e., vintages from before 2009—" the actual realized losses are expected to decline significantly." And an internal Treasury document similarly observed that the Companies' losses during the early years of conservatorship "are almost entirely attributable to loans that were originated and guaranteed before conservatorship" and that "[t]he 2006, 2007, and 2008 vintages account for over 70% of all credit losses."

77. Together, the Companies' return to robust profitability and the stable recovery of the housing market showed in early 2012 that the Companies could in time redeem Treasury's Government Stock and that value remained in their Preferred Stock and Common Stock. Indeed, a presentation sent to senior Treasury officials in February 2012 indicated that "Fannie and Freddie could have the earnings power to provide taxpayers with enough value to repay Treasury's net cash investments in the two entities." The Companies' financial performance and outlook only further improved in the ensuing months. In the weeks leading up to the Net Worth Sweep, one Treasury official observed that Freddie's second quarter 2012 results were "very positive," and a report circulated among senior FHFA officials said that the agency deserved a "high five" for the Companies' strong financial outlook.

78. As a result of Fannie's and Freddie's return to sustained profitability, it was clear that the overly pessimistic accounting decisions weighing down the Companies' balance sheets would have to be reversed. Indeed, by early August 2012, the Agencies knew that Fannie and

Freddie were poised to generate massive profits well in excess of the Companies' dividend obligations to Treasury—profits that would make the $11 billion the Companies generated in the first half of 2012 look small by comparison.

79. By August 2012, the Agencies knew that the Companies' reserves for loan losses far exceeded their actual losses. These excess loss reserves artificially depressed the Companies' net worth, and reversing them would increase the Companies' net worth accordingly. Indeed, on July 19, 2012, a Treasury official observed that the release of loan loss reserves could "increase the [Companies'] net [worth] substantially." A Treasury document from early August 2012 likewise stated that the Companies were about to report "[r]ecord earnings" that would be "driven by [a] large credit loss reserve release." And the Agencies were focused on this issue. An internal briefing memorandum prepared for Under Secretary Miller in advance of August 9, 2012 meetings with Fannie and Freddie executives reveals that the number one question Treasury had for the Companies was "how quickly they forecast releasing credit reserves." And a handwritten note on a presentation from the August 9 meeting with Freddie says to "expect material release of loan loss reserves in the future." FHFA also knew that loan loss reserve releases would boost the Companies' profits going forward, as FHFA officials attended a meeting of Freddie's Loan Loss Reserve Governance Committee on August 8, 2012. FHFA's knowledge of the status of the Companies' loan loss reserves is also dramatically illustrated by a July 2012 FHFA presentation showing that starting in 2008 the Companies had set aside loan loss reserves far in excess of their actual losses.

80. Another principal driver of the outsized profits that the Companies would inevitably generate was the mandated release of the Companies' deferred tax assets valuation allowances. By mid-2012, Fannie and Freddie had combined deferred tax assets valuation

allowances of nearly $100 billion. Under relevant accounting rules, those valuation allowances would have to be reversed if the Companies determined that it was more likely than not that they would generate taxable income and therefore be able to use their deferred tax assets. The Treasury Department was intimately familiar with these issues, having seen such a reversal in February 2012 in connection with its massive investment in AIG. In 2011, it was also known within Fannie that the valuation allowance would be reversed; the only question was the timing.

81. The Companies' improved prospects came into even sharper focus on August 9, 2012, when Under Secretary Miller and other senior Treasury officials had meetings with the senior executives of both Fannie and Freddie. During the meeting with Fannie's management, Treasury was presented with ten-year projections showing the Company earning an average of more than $11 billion per year from 2012 through 2022 and having over $116 billion left of Treasury's funding commitment at the end of that time period. Those projections are reproduced below:

Annual Detail of Cumulative Dividends and SPSPA Draws

Fannie Mae

($ in Billions)	2008-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Comprehensive Income		11.6	7.5	11.0	12.5	13.9	13.2	12.2	11.4	10.9	10.5	10.5
Preferred Dividend Payment	19.8	11.6	11.8	12.1	12.2	12.2	12.2	12.2	12.2	12.2	12.3	12.5
Residual Equity	0.0	0.0	0.0	0.0	0.2	1.8	2.8	2.7	1.9	0.5	0.0	0.0
Cumulative Dividends	19.8	31.4	43.2	55.3	67.6	79.8	92.1	104.3	116.6	128.8	141.1	153.6
Cumulative SPSPA Draws	(116.1)	(116.1)	(119.0)	(121.2)	(121.5)	(121.5)	(121.5)	(121.5)	(121.5)	(121.5)	(122.9)	(124.8)
Cumulative Dividends Less Draws	*(96.3)*	*(84.7)*	*(75.8)*	*(65.9)*	*(53.9)*	*(41.7)*	*(29.4)*	*(17.2)*	*(4.9)*	*7.3*	*18.3*	*28.8*
SPSPA Funding Cap	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9
Remaining Funding under SPSPA	124.8	124.8	122.0	119.7	119.5	119.5	119.5	119.5	119.5	119.5	118.1	116.1

Note: 2012-2016 figures from Fannie Mae July BOD corporate forecast. 2017-2022 figures are based on simplifying assumptions derived from trends observed within the 2012-2016 horizon.

Freddie Mac

($ in Billions)	2008-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Comprehensive Income		11.6	7.5	8.2	8.6	9.0	8.7	8.3	7.7	7.1	6.7	6.5
Preferred Dividend Payment	16.3	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4	7.4
Residual Equity	0.0	0.0	0.4	1.7	3.5	5.6	6.9	7.9	8.1	7.9	7.2	6.3
Cumulative Dividends	16.3	23.7	31.1	38.4	45.8	53.2	60.6	68.0	75.4	82.8	90.2	97.6
Cumulative SPSPA Draws	(72.2)	(116.1)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)
Cumulative Dividends Less Draws	*(55.9)*	*(92.4)*	*(41.9)*	*(34.5)*	*(27.1)*	*(19.7)*	*(12.3)*	*(4.9)*	*2.5*	*9.9*	*17.3*	*24.7*
SPSPA Funding Cap	220.5	221.3	221.3	221.3	221.3	221.3	221.3	221.3	221.3	221.3	221.3	221.3
Remaining Funding under SPSPA	148.3	105.2	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3

Note: 2012-2022 figures are based on simplifying assumptions derived from Fannie Mae forecast trends and observed relationships between key Fannie Mae and Freddie Mac performance metrics. Reported 2011 results re-aligned as necessary to correspond to Fannie Mae management reporting.

Note: Numbers may not foot due to rounding

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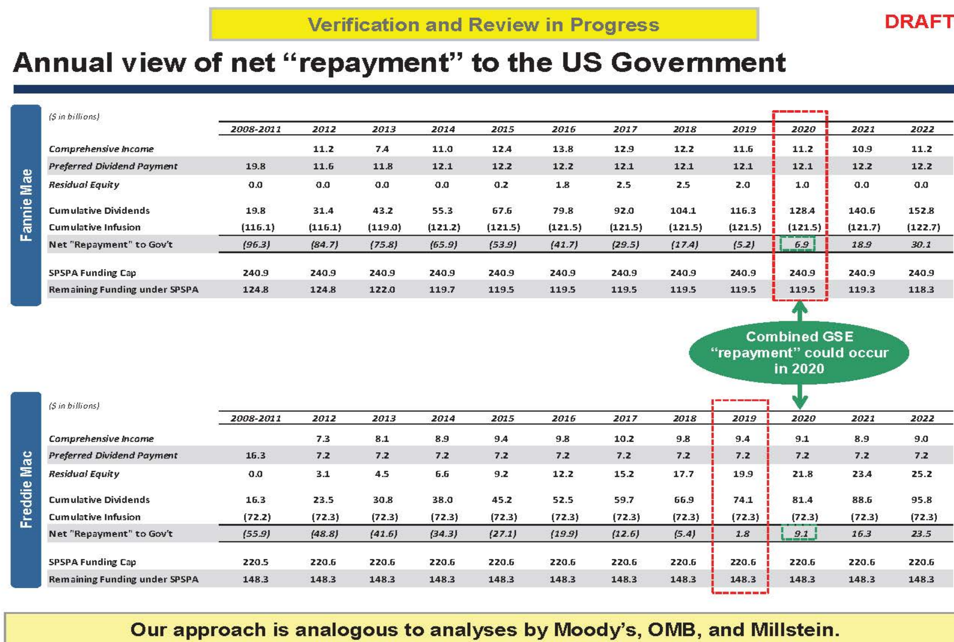
82. Furthermore, Treasury learned that Fannie's near-term earnings likely would be even higher than those in the projections due to the release of the Companies' deferred tax assets valuation allowance. During the August 9 meeting, Fannie CFO Susan McFarland informed Treasury that the criteria for reversing the deferred tax assets valuation allowance could be met in the not-so-distant future. And when asked for more specifics by Under Secretary Miller, Ms. McFarland stated that the reversal would be probably in the $50-billion range and probably sometime mid-2013, an assessment that proved remarkably accurate.

83. Like Treasury, FHFA was in possession of information showing that the Companies would soon generate substantial profits, thus making it inevitable that they would release their deferred tax asset valuation allowances. On July 13, 2012, Bradford Martin, Principal Advisor in FHFA's Office of Conservatorship Operations, broadly circulated within FHFA minutes from a July 9, 2012 Fannie executive management meeting. The recipients of the email included Acting Director DeMarco and Mr. Ugoletti. The minutes stated that Fannie Treasurer David Benson "referred to the next 8 years as likely to be 'the golden years of GSE earnings.' " Projections substantially similar to those shared with Treasury on August 9 were attached to the email containing the following slide:


Verification and Review in Progress

DRAFT

Annual view of net "repayment" to the US Government

Fannie Mae

($ in billions)	2008-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Comprehensive Income		11.2	7.4	11.0	12.4	13.8	12.9	12.2	11.6	11.2	10.9	11.2
Preferred Dividend Payment	19.8	11.6	11.8	12.1	12.2	12.2	12.1	12.1	12.1	12.1	12.2	12.2
Residual Equity	0.0	0.0	0.0	0.0	0.2	1.8	2.5	2.5	2.0	1.0	0.0	0.0
Cumulative Dividends	19.8	31.4	43.2	55.3	67.6	79.8	92.0	104.1	116.3	128.4	140.6	152.8
Cumulative Infusion	(116.1)	(116.1)	(119.0)	(121.2)	(121.5)	(121.5)	(121.5)	(121.5)	(121.5)	(121.5)	(121.7)	(122.7)
Net "Repayment" to Gov't	*(96.3)*	*(84.7)*	*(75.8)*	*(65.9)*	*(53.9)*	*(41.7)*	*(29.5)*	*(17.4)*	*(5.2)*	*6.9*	*18.9*	*30.1*
SPSPA Funding Cap	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9	240.9
Remaining Funding under SPSPA	124.8	124.8	122.0	119.7	119.5	119.5	119.5	119.5	119.5	119.5	119.3	118.3

Freddie Mac

($ in billions)	2008-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Comprehensive Income		7.3	8.1	8.9	9.4	9.8	10.2	9.8	9.4	9.1	8.9	9.0
Preferred Dividend Payment	16.3	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2
Residual Equity	0.0	3.1	4.5	6.6	9.2	12.2	15.2	17.7	19.9	21.8	23.4	25.2
Cumulative Dividends	16.3	23.5	30.8	38.0	45.2	52.5	59.7	66.9	74.1	81.4	88.6	95.8
Cumulative Infusion	(72.2)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)	(72.3)
Net "Repayment" to Gov't	*(55.9)*	*(48.8)*	*(41.6)*	*(34.3)*	*(27.1)*	*(19.9)*	*(12.6)*	*(5.4)*	*1.8*	*9.1*	*16.3*	*23.5*
SPSPA Funding Cap	220.5	220.6	220.6	220.6	220.6	220.6	220.6	220.6	220.6	220.6	220.6	220.6
Remaining Funding under SPSPA	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3	148.3

Our approach is analogous to analyses by Moody's, OMB, and Millstein.

Note: Numbers may not foot due to rounding

Confidential – Restricted 14

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84. Those projections expressly stated the assumption that Fannie would not be paying taxes because it would be using its deferred tax assets—and if Fannie was expecting to use its deferred tax assets, it would have to release the valuation allowance it had established for them. FHFA knew this; indeed, FHFA accountants were monitoring the Companies' deferred tax

assets situation, and FHFA knew that the Companies' audit committees were assessing the status of the valuation allowances on a quarterly basis. Indeed, in an August 14, 2012 email, an FHFA official indicated that both Companies had discussed the issue of "re-recording certain deferred tax assets that had been written off" during their most recent Board meetings "based on the view that they were going to be profitable going forward." In addition, Ms. McFarland testified that in July 2012 she would have mentioned the potential release of the valuation allowance at a Fannie executive committee meeting attended by at least one FHFA official, and she also testified that FHFA was on notice of the statement she made to Under Secretary Miller on August 9, 2012 regarding the potential release of the valuation allowance.

85. Rather than acknowledging the projections just discussed, the Government has instead sought to support the Net Worth Sweep by pointing to other financial projections that its own documents show were outdated and unreliable by August 2012. In other litigation, the Government has relied on a set of "June 13, 2012" projections that discovery in this case revealed were taken verbatim from projections prepared by Treasury consultant Grant Thornton in November 2011 using data from September 2011. Although not as positive as the more updated projections discussed above, the Grant Thornton analysis projected combined profits at the Companies of over $20 billion in 2014, with annual profits then gradually declining to a long-term figure of about $13.5 billion. Profits of this magnitude necessarily would have led to the reversal of the valuation allowances. And Treasury took notice. Hand-written notes on a Grant Thornton document produced by Treasury displaying Freddie's results through the first quarter of 2012 anticipate that Freddie could release its valuation allowance "probably [in] 2013, 2014." The agenda for a meeting indicates that by May 2012 Treasury and Grant Thornton were discussing "[r]eturning the deferred tax asset to the GSE balance sheets" and that Treasury

planned to discuss this issue with FHFA and the Companies in early June. And a Grant Thornton document sent to Treasury on June 29, 2012 recognizes that two "key issues" for determining the value of Treasury's investment in 2012 were "whether and when the GSEs will return their deferred tax assets to their balance sheets" and "whether and when the GSEs will become taxpaying entities."

86. By August 2012, it was apparent that the Grant Thornton projections based on data from September 2011 drastically underestimated Fannie's and Freddie's earning capacity. The manager of Grant Thornton's valuation services to Treasury, Anne Eberhardt, admitted in a deposition that the projections based on September 2011 data were no longer valid 11 months later, and Fannie's Chief Financial Officer, the highest ranking and responsible financial expert at the Company, Susan McFarland, has testified that it was particularly important to have fresh financial forecasts at that time. Mr. Ugoletti and Ms. Eberhardt likewise have testified to the importance of using up-to-date financial information, and Mr. DeMarco testified that FHFA as conservator was "constantly responding to a changing economic environment." And as Mr. DeMarco also testified, one change that took place between September 2011 and mid-August 2012 "was strengthening in the housing market." Mr. Ugoletti also has admitted that FHFA's own projections consistently were overly pessimistic leading up to August 2012. Treasury and FHFA therefore knew that Fannie and Freddie were poised to be even more profitable than Grant Thornton had projected in 2011.

87. In other litigation, the Government has also relied on a set of financial projections sent to Secretary Geithner on June 6, 2012, that showed that starting in 2018 Fannie would report only $4.1 billion in comprehensive income per year.

88. In sum, by August 2012 the Agencies knew that Fannie and Freddie were poised to add tens of billions of dollars of deferred tax assets to their balance sheets and to reverse billions of dollars of loan loss reserves. Thanks to these inevitable accounting decisions, coupled with Fannie's and Freddie's strong earnings from their day-to-day operations, the Companies anticipated that they would be able to pay their 10% dividends to Treasury without drawing on Treasury's funding commitment in the future, and dividend payments on the Government Stock did not threaten to erode Treasury's unused funding commitment.

89. In addition to the release of loan loss reserves and deferred tax assets valuation allowances, Fannie and Freddie also had sizeable assets in the form of claims and suits brought by FHFA as conservator relating to securities law violations and fraud in the sale of private-label securities to Fannie and Freddie between 2005 and 2007. In 2013 and 2014, the Companies recovered over $18 billion from financial institutions via settlements of such claims and suits. The Companies, FHFA, and Treasury knew in August 2012 that the Companies would reap substantial profits from such settlements.

FHFA and Treasury Amend the PSPAs To Expropriate Private Shareholders' Investment and Ensure Fannie and Freddie Cannot Exit Conservatorship

90. With Fannie's and Freddie's return to consistent and indeed record profitability, the holders of the Companies' Preferred Stock and Common Stock had reason to believe and expect that they would in time receive a return on their investment. Moreover, the Companies' return to profitability led to a reasonable expectation that they would eventually be healthy enough to redeem Treasury's Government Stock, exit conservatorship, and be "return[ed] to normal business operations," as FHFA's Director had vowed when the conservatorship was created.

91. These reasonable and realistic expectations were short-lived, however, not because of any change in the outlook for the housing market or broader economy, nor because of any change in the financial performance of Fannie or Freddie, but rather because of the Government's own self-dealing.

92. On August 17, 2012, within days after the Companies had announced their return to profitability and just as it was becoming clear that they had regained the earnings power to redeem Treasury's Government Stock and exit conservatorship, the Agencies unilaterally amended the PSPAs for a third time.

93. The centerpiece of this "Third Amendment" was the Net Worth Sweep. The Net Worth Sweep fundamentally changed the nature of Treasury's investment in the Companies. Instead of quarterly dividend payments at an annual rate of 10% (if paid in cash) or 12% (if paid in kind) of the total amount of Treasury's liquidation preference, the Net Worth Sweep entitles Treasury to *all—100%*—of the Companies' existing net worth and future profits. Beginning January 1, 2013, the Companies have been required to pay Treasury a quarterly dividend equal to their *entire net worth*, minus a capital reserve amount that starts at $3 billion and decreases to $0 by January 1, 2018. (In December 2017, FHFA and Treasury amended the PSPAs a fourth time to reset the capital reserve amount to $3 billion beginning in the first quarter of 2018. This change does not materially affect the claims in this litigation.)

94. The Companies did not receive any meaningful consideration for the imposition of the Net Worth Sweep. Because the Companies always had the option to pay dividends "in kind" at a 12% interest rate, the Net Worth Sweep did not provide the Companies with any additional flexibility or benefit.

95. To be sure, the Net Worth Sweep provides that the Companies will not have to pay a periodic commitment fee under the PSPAs while the Net Worth Sweep is in effect. But Treasury had consistently waived the periodic commitment fee before the Net Worth Sweep, and it could only set the amount of such a fee with the agreement of the Companies and at a market rate. And that rate likely would have been, at most, a small fraction of the outstanding amount of Treasury's commitment. Freddie forecasted its "sensitivity" to imposition of a periodic commitment fee as follows: "Our sensitivity to a commitment fee based on remaining commitment available beginning in 2013 of $149 billion shows that a 25 bps fee results in a $0.4 billion annual impact on Stockholders' Equity." Further, the purpose of the fee was to compensate Treasury for its ongoing support in the form of the commitment to invest in the Companies' Government Stock. By the time of the Net Worth Sweep, the 10% return on the Government Stock and the warrants for 79.9% of the common stock provided a more than adequate return on the government's stand-by commitment, and thus any additional fee would have been inappropriate. In August of 2012, the Companies had returned to stable profitability and were no longer drawing from Treasury's commitment. Given the Companies' return to profitability, the market rate for the periodic commitment fee in 2012 and after would have been zero. Finally, even if a market-rate fee had been agreed between Treasury and FHFA and imposed pursuant to the 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 profitability or the value of the Companies' equity securities.

96. The Net Worth Sweep has had far-reaching effects. These effects were intended and anticipated by FHFA and Treasury, and the Agencies adopted the Net Worth Sweep in furtherance of their policy objectives as agencies of the federal government.

97. First, the Net Worth Sweep eliminated entirely the economic interests in Fannie and Freddie held by the Companies' private shareholders. The quarterly sweep of the Companies' net worth ensures that there never will be sufficient funds for the Companies to pay a dividend to private shareholders. It also ensures that private shareholders will receive nothing in the event of liquidation, as Treasury's Government Stock entitles it to an additional dividend payment *plus* its liquidation preference in the event of liquidation. Government Stock Certificate § 8. The dividend payment will leave Fannie and Freddie with negligible capital well shy of the Government's nearly $200 billion liquidation preference, guaranteeing that there will be nothing left for private shareholders. In light of this reality, it is not surprising that, as FHFA's Mr. Ugoletti observed, "the preferred stock got hammered the day the Net Worth Sweep was announced." Similarly, after the imposition of the Net Worth Sweep, Mr. Lockhart—FHFA's former Director—told a reporter that the Companies' privately-owned stock "is worthless and should be worthless."

98. Upon its announcement, Treasury emphasized that the Net Worth Sweep would ensure that "every dollar of earnings that Fannie Mae and Freddie Mac generate will be used to benefit 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). https://goo.gl/NDAKhQ. The necessary corollary to this, of course, is that nothing would be left for private shareholders. Unbeknownst to the public, this was a long-term Treasury goal. Indeed, as early as December 2010, an internal Treasury memorandum acknowledged 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 (Dec. 20, 2010).

99. FHFA shared Treasury's goal of advancing the Government's interests and ensuring that private shareholders would not benefit from their stock ownership. In its 2012 report to Congress, for example, FHFA explained that the Net Worth Sweep "ensures all the [Companies'] earnings are used to benefit taxpayers." FHFA, REPORT TO CONGRESS: 2012 at 1 (June 13, 2013), https://goo.gl/ocyB9J. And while FHFA had earlier resolved to operate Fannie and Freddie with a view toward "minimiz[ing] losses on behalf of taxpayers," A STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIPS: at 7, the Net Worth Sweep indicates that the agency in fact is operating them to maximize taxpayer profits at the expense of private shareholders. Director Watt summed up the situation succinctly when stating that he does not "lay awake at night worrying about what's fair to the shareholders" but rather focuses on "what is responsible for the taxpayers." C-SPAN, Newsmakers with Mel Watt, at 9:00-9:27 (May 16, 2014), http://goo.gl/s3XWqi. Consistent with this understanding of FHFA's goals, it stated that the Net Worth Sweep was intended to "fully capture financial benefits for taxpayers.".

100. Second, the Net Worth Sweep not only destroyed the economic interests of Fannie's and Freddie's private shareholders but also transferred their interests to the federal government, resulting in Fannie and Freddie being wholly nationalized entities. As a Staff Report from the Federal Reserve Bank of New York acknowledged, the Net Worth Sweep "effectively narrows the difference between conservatorship and nationalization, by transferring essentially all profits and losses from the firms to the Treasury." W. Scott Frame, et al., *The Rescue of Fannie Mae and Freddie Mac* at 21, FED. RES. BANK OF N.Y. STAFF REP., no. 719 (Mar. 2015) https://goo.gl/DKBlQ1. Fortune similarly has reported that the Net Worth Sweep "effectively nationalized" the Companies. Indeed, the Government itself has stated in a brief in another case that an "interest in residual profits is the defining feature of an equity interest in a corporation."

Reply Brief of the United States at 24, *Starr Int'l.Co. v. United States*, No. 15-5103 (Fed. Cir. June 1, 2016). After the Net Worth Sweep, Treasury has the right to all residual profits, and it hence owns all the equity. All other equity interests have been eliminated.

101. Third, the nationalization effected by the Net Worth Sweep has enriched the federal government to the tune of ***$124 billion*** to date. As the Agencies anticipated, Fannie and Freddie have been extraordinarily profitable since the imposition of the Net Worth Sweep. From the third quarter of 2012 through the fourth quarter of 2017, Fannie and Freddie have reported total comprehensive income of $134 billion and $91 billion, respectively—numbers that include the release of the Companies' deferred tax assets valuation allowances, which in 2013 added over $50 billion and $20 billion to Fannie's and Freddie's earnings, respectively. The Companies' staggering net worth in 2013, 2014, and all subsequent years has been no higher than the Agencies anticipated when they imposed the Net Worth Sweep in August 2012.

102. Because of Fannie's and Freddie's tremendous profitability, the Net Worth Sweep dividend payments to Treasury have been enormous, as the following chart demonstrates:

Dividend Payments Under the Net Worth Sweep
(in billions)

		Fannie	Freddie	Combined
2013	Q1	**$4.2**	**$5.8**	**$10.0**
	Q2	**$59.4**	**$7.0**	**$66.4**
	Q3	**$10.2**	**$4.4**	**$14.6**
	Q4	**$8.6**	**$30.4**	**$39.0**
2014	Q1	**$7.2**	**$10.4**	**$17.6**
	Q2	**$5.7**	**$4.5**	**$10.2**
	Q3	**$3.7**	**$1.9**	**$5.6**
	Q4	**$4.0**	**$2.8**	**$6.8**

2015	Q1	**$1.9**	**$0.9**	**$2.8**
	Q2	**$1.8**	**$0.7**	**$2.5**
	Q3	**$4.4**	**$3.9**	**$8.3**
	Q4	**$2.2**	**$0.0**	**$2.2**
2016	Q1	**$2.9**	**$1.7**	**$4.6**
	Q2	**$0.9**	**$0.0**	**$0.9**
	Q3	**$2.9**	**$0.9**	**$3.8**
	Q4	**$3.0**	**$2.3**	**$5.3**
2017	Q1	**$5.5**	**$4.5**	**$10.0**
	Q2	**$2.8**	**$2.2**	**$5.0**
	Q3	**$3.1**	**$2.0**	**$5.1**
	Q4	**$0.7**	**$2.3**	**$3.0**
2018	Q1	**$0.0**	**$0.0**	**$0.0**
Total		**$135.1**	**$88.6**	**$223.7**

103. As the above chart shows, the Companies have paid Treasury $223.7 billion in "dividends" under the Net Worth Sweep. Had they instead been paying 10% cash dividends, they would have paid Treasury $99.5 billion by the end of the first quarter of 2018. The Government has thus profited from the Net Worth Sweep by $124 billion.

104. The chart above also shows that the Companies' dividend obligations in the fourth quarter of 2017 and first quarter of 2018 totaled $3.0 billion. But this is not in any way a sign that the Companies are in distress or that they are no longer positioned to generate large profits. In the third quarter of 2017, the Companies generated $7.7 billion of comprehensive income, and under the Net Worth Sweep that total was the dividend due in the fourth quarter. Before that dividend was paid, however, Treasury and FHFA agreed that the Companies could each retain $2.4 billion, and, as noted above, that moving forward the capital buffer under the sweep would be $3 billion, rather than decreasing to $0 in 2018. This "Fourth Amendment" does not affect the substance of

Plaintiffs' claims in this litigation. Indeed, FHFA and Treasury specified that the liquidation preference of Treasury's stock in each company would be increased by $3.0 billion, making clear that the capital buffer ultimately would benefit Treasury, not private shareholders.

105. In the fourth quarter of 2017, Fannie and Freddie were required to write down the value of their deferred tax assets to account for the recent decrease in the corporate income tax rate. This write-down decreased their comprehensive income for the quarter by $15.3 billion. Thus, instead of reporting comprehensive income of $5.3 billion, the Companies reported a comprehensive loss of $10 billion, and they announced that they will be requesting a $4 billion draw from Treasury's commitment. This one-time event does not change the Companies' underlying profitability and, in fact, moving forward the decrease in the tax rate enhances the Companies' outlook.

106. Another way to gauge the financial impact of the Net Worth Sweep is to compare it to what would have happened had the Companies instead been allowed to use their quarterly profits above Treasury's 10% dividend to partially retire Treasury's senior preferred stock. In that alternative scenario, Treasury's remaining investment in Freddie would have been fully redeemed in 2017. Indeed, Freddie has paid Treasury $6.3 billion *more* than the amount needed to redeem the Government Stock completely. Similarly, had Fannie been allowed to use its profits in excess of Treasury's original 10% dividend to partially redeem the Government Stock, the remaining liquidation preference on that stock would today stand at only $2.1 billion. Furthermore, given the Companies' strong financial condition when the Net Worth Sweep was announced and the very low interest rates that prevailed at the time, the Companies could have used debt and equity markets to obtain additional capital at a rate far lower than the 10% cash or 12% in kind rate mandated by the original terms of the Government Stock.

107. The Net Worth Sweep has become a major revenue source for the United States Government. Indeed, the federal government's record-breaking $53.2 billion surplus for the month of December 2013 was driven in large part by the $39 billion swept from Fannie and Freddie.

108. These massive influxes of cash began to arrive just when the government was confronting the statutory debt ceiling and accompanying political deadlock. *See* Jody Shenn & Ian Katz, *Fannie Mae Profit May Swell Treasury Coffers as Debt Limit Looms*, Bloomberg (Apr. 8, 2013), http://www.bloomberg.com/news/articles/2013-04-08/fannie-mae-profit-may-swell-treasury-coffers-as-debt-limit-looms. And because they were characterized as "dividends," and not a redemption of Treasury's Stock, the Pay It Back Act allowed the cash to be used for the government's general operating expenses rather than only for debt reduction. *See* 12 U.S.C. § 1719(g)(2); 12 U.S.C. § 1455(*l*)(2); 12 U.S.C. § 1455 note.

109. All told, Fannie has requested $119.8 billion in draws from Treasury under the PSPAs, and Treasury has recouped a total of $166.4 billion from Fannie in the form of purported "dividends." Freddie has requested $71.6 in draws from Treasury under the PSPAs and Treasury has recouped a total of $112.4 billion from Freddie in the form of purported "dividends." Combined, Fannie and Freddie have paid Treasury approximately $87 billion more than they have received.

110. As explained above, when entering the Net Worth Sweep FHFA and Treasury knew that the Companies were poised to generate earnings well in excess of 10% dividend payments, and they therefore knew that the Net Worth Sweep would be profitable for the federal government. It is thus not surprising that a document prepared for internal Treasury consumption

and dated August 16, 2012 listed the Companies' "improving operating performance" and the "potential for near-term earnings to exceed the 10% dividend" as reasons for "putting in place a better deal for taxpayers" by promptly adopting the Net Worth Sweep. Another Treasury document emphasized that the Net Worth Sweep would put the taxpayer "in a better position" because rather than having "Treasury's upside . . . capped at the 10% dividend, now the taxpayer will be the beneficiary of any future earnings produced by the GSEs." Additional Treasury communications indicate that the Agency anticipated that Treasury's receipts under the Net Worth Sweep "will likely exceed the amount that would have been paid if the 10% was still in effect" and that the Net Worth Sweep would lead to "a better outcome" for Treasury.

111. Fourth, the Net Worth Sweep guarantees that Fannie and Freddie can never be rehabilitated to a sound and solvent condition, and it positions them to be wound down and eliminated. The Net Worth Sweep makes the Companies unique in financial regulation. All other financial institutions are required to retain minimum levels of capital that ensure that they can withstand the vicissitudes of the economic cycle and are prohibited from paying dividends when they are not adequately capitalized. The FDIC's Risk Management Manual of Examination Policies explains why capital is critical to any financial institution: "It absorbs losses, promotes public confidence, helps restrict excessive asset growth, and provides protection to [market participants]." For this reason, in all other contexts financial regulators work to ensure that financial institutions maintain minimum capital levels.

112. The Companies, in contrast, are not allowed to retain capital but instead must pay nearly their entire net worth over to Treasury as a quarterly dividend. In other words, whereas other financial institutions are subject to *minimum* capital standards, the Net Worth Sweep makes the Companies subject to a capital *maximum*—any amount of retained capital that they hold in

excess of a small capital buffer is swept to Treasury on a quarterly basis. The effect of the Net Worth Sweep is thus to force the Companies to operate in perpetuity on the brink of insolvency and to prohibit them from operating in a safe and sound manner. Indeed, HERA itself recognizes that a fundamental aspect of the Companies' soundness is the "maintenance of adequate capital." 12 U.S.C. § 4513(a)(1)(B)(i). Director Watt has expressed the same view, describing the Companies' inability to build capital reserves under the Net Worth Sweep as a "serious risk" that erodes investor confidence in the Companies because they have "no ability to weather quarterly losses." Indeed, the fact that the Companies were required to take a draw because of a tax cut demonstrates the perversity of the Government's decision to strip the Companies of their capital.

113. The timing of the Net Worth Sweep was driven by the Companies' return to profitability. Notwithstanding the Agencies' statutory duties, the Administration had decided that Fannie and Freddie would be wound down and would *not* be allowed to exit conservatorship in their current form. Allowing Fannie and Freddie to rebuild their capital levels, however, would make that political decision more difficult to explain and sustain. The Economist stated the obvious in reporting that the Net Worth Sweep "squashe[d] hopes that [Fannie and Freddie] may ever be private again." *Back to Black*, THE ECONOMIST, (Aug. 25, 2012 http:goo.gl/1PHMs.

114. Treasury openly proclaimed that the Net Worth Sweep would "expedite the wind down of Fannie Mae and Freddie Mac. 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). https://goo.gl/NDAKhQ. Indeed, Treasury emphasized that the Net Worth Sweep would ensure that the Companies "will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form." *Id.*

115. FHFA Acting Director Edward DeMarco similarly informed a Senate Committee that the "recent changes to the PSPAs, replacing the 10 percent dividend with a net worth sweep, reinforce the notion that the [Companies] will not be building capital as a potential step to regaining their former corporate status." Edward J. DeMarco, Acting Director, FHFA, Statement Before the U.S. Sen. Comm. on Banking, Housing & Urban Affairs (Apr. 18, 2013), https://goo.gl/oxdMc6.. And in its 2012 report to Congress, FHFA explained that it had begun "prioritizing [its] actions to move the housing industry to a new state, one without Fannie Mae and Freddie Mac." FHFA, FHFA, REPORT TO CONGRESS: 2012 at 13 (June 13, 2013), https://goo.gl/ocyB9J. The Net Worth Sweep thus "reinforces the fact that the [Companies] will not be building capital." *Id.* at 1, 13.

116. As a result of the Net Worth Sweep, it is clear that FHFA will not allow Fannie and Freddie to exit conservatorship but rather will continue to operate them essentially as wards of the state, unless and until Congress takes action. Indeed, FHFA's website states that "FHFA will continue to carry out its responsibilities as Conservator" until "Congress determines the future of Fannie Mae and Freddie Mac and the housing finance market." *FHFA as Conservator of Fannie Mae and Freddie Mac,* FHFA, http://goo.gl/PjyPZb. This is consistent with the testimony of former Acting Director DeMarco, who stated that he had no intention of returning Fannie and Freddie to private control under charters he perceived to be "flawed." Mr. Ugoletti also testified that FHFA's objective "was not for Fannie and Freddie Mac to emerge from conservatorship."

117. This understanding of the purpose of the Net Worth Sweep is further supported by the testimony of Ms. McFarland, Fannie's CFO at the time. She believed that the Agencies imposed the Net Worth Sweep in response to what she told Treasury on August 9, and she

thought its purpose "was probably a desire not to allow capital to build up within the enterprises and not to allow the enterprises to recapitalize themselves." According to Ms. McFarland, Fannie "didn't believe that Treasury would be too fond of a significant amount of capital buildup inside the enterprises."

118. Communications involving White House official Jim Parrott provide further proof that the Net Worth Sweep was intended to advance the policy objectives discussed above. At the time of the Net Worth Sweep, Mr. Parrott was a senior advisor at the National Economic Council, where he led a team of advisors charged with counseling President Obama and the cabinet on housing issues. He worked closely with Treasury in the development and rollout of the Net Worth Sweep. Indeed, the day after the Net Worth Sweep was announced, he emailed Treasury officials congratulating them on achieving an important policy goal: "Team Tsy, You guys did a remarkable job on the PSPAs this week. You delivered on a policy change of enormous importance that's actually being recognized as such by the outside world . . . , and as a credit to the Secretary and the President. It was a very high risk exercise, which could have gone sideways on us any number of ways, but it didn't." What Treasury had accomplished, Mr. Parrott's emails make clear, was maximizing Treasury's profits and guaranteeing that Fannie and Freddie would be unable to rebuild capital and escape conservatorship:

- In an August 13, 2012 email, Parrott wrote that "[w]e are making sure that each of these entities pays the taxpayer back every dollar of profit that they make, not just a 10% dividend," and that "[t]he taxpayer will thus ultimately collect more money with the changes."

- In an email to a Treasury official on the day the Net Worth Sweep was announced, Mr. Parrott stated that "we've closed off [the] possibility that [Fannie and Freddie] ever[] go (pretend) private again."
- That same day, Mr. Parrott received an email from a market analyst stating that the Net Worth Sweep "should lay to rest permanently the idea that the outstanding privately held pref[ferred stock] will ever get turned back on." He forwarded the email to Treasury officials and commented that "all the investors will get this very quickly."
- At 8:30 a.m. on August 17, Mr. Parrott wrote an email to Alex Pollock, Peter Wallison, and Edward Pinto offering "to walk you through the changes we're announcing on the pspas today. Feel like fellow travelers at this point so I owe it to you." Pollock, Wallison, and Pinto had written a policy paper for the American Enterprise Institute in 2011 recommending that "Fannie Mae and Freddie Mac should be eliminated as government-sponsored enterprises (GSEs) over time."
- Also on August 17, Mr. Wallison was quoted in Bloomberg saying the following: "The most significant issue here is whether Fannie and Freddie will come back to life because their profits will enable them to re-capitalize themselves and then it will look as though it is feasible for them to return as private companies backed by the government. . . . What the Treasury Department seems to be doing here, and I think it's a really good idea, is to deprive them of all their capital so that doesn't happen." In an email to Wallison that evening, Mr. Parrott stated, "Good comment in Bloomberg—**you are exactly right on substance and intent.**"

- In another email to Wallison that evening, Mr. Parrott wrote that, "[d]ividend is variable, set at whatever profit for quarter is, eliminating ability to pay down principal (so they can't repay their debt and escape as it were)."
- Mr. Parrott also wrote on August 17 that, "we're not reducing their dividend but including in it every dime these guys make going forward and ensuring they can't recapitalize."

119. Mr. Parrott, who has left the White House and is now with the Urban Institute, told The Economist that "[i]n the aftermath of the crisis there was widespread agreement that [Fannie and Freddie] needed to be replaced or overhauled." *A Funny Form of Conservation*, THE ECONOMIST, (Nov. 21, 2015), http:goo.gl/gJVJrN. The Net Worth Sweep ensured that the Companies' return to profitability did not threaten this goal.

120. In short, the Government's Net Worth Sweep is designed to raise general revenue and further the policy goals of the Agencies at the expense of the Companies and their shareholders, and it thereby imposes on the Companies and their shareholders a disproportionate burden that, in all fairness, should be borne by the public as a whole.

121. The Government has advanced an alternative explanation for the Net Worth Sweep—that it was intended to stave off the risk of a "death spiral" caused by drawing from Treasury's commitment to pay Treasury's dividends. But this "death spiral" explanation is belied by the following facts, in addition to those discussed above regarding the Net Worth Sweep's true purposes.

122. First, given Fannie and Freddie's return to profitability, there was no imminent risk that the Companies would be depleting Treasury's funding commitment—that risk was at its lowest point since the start of the conservatorships. Indeed, a memo prepared by Treasury staff

indicates that on June 25, 2012, FHFA Acting Director DeMarco informed Treasury Secretary Geithner and Under Secretary Miller that he saw no "urgency of amending the PSPAs this year" because Fannie and Freddie "will be generating large revenues over the coming years, thereby enabling them to pay the 10% annual dividend well into the future." Communications within both FHFA and Treasury in the months leading up to the Net Worth Sweep indicate that the Companies' bond investors regarded Treasury's funding commitment as sufficient. And on August 13, 2012, a Treasury official observed that an explanation that the Net Worth Sweep was needed because "the 10 percent dividend was likely to be unstable" was one that "[d]oesn't hold water."

123. Second, as explained above, the original terms of the PSPAs entitled the Companies to pay Treasury's dividends in kind with additional stock, thus avoiding the need to make draws on Treasury's funding commitment to finance cash dividends they could not otherwise afford. Furthermore, an internal Treasury memorandum from 2011 acknowledged that any threat to Treasury's funding commitment from dividend payments potentially could be addressed by "converting [Treasury's] preferred stock into common or cutting or deferring payment of the dividend (under legal review)." Memorandum from Jeffery A. Goldstein, Undersecretary, Domestic Finance, to Timothy Geithner, Secretary, United States Treasury, 3 (Jan. 4, 2011). In other words, the problem the Government was purportedly trying to solve with the Net Worth Sweep, a cash dividend too high to be serviced by earnings, could be addressed by other means already known to Treasury, such as cutting or deferring payment of the dividend. Of course, given the payment-in-kind option, the purported problem was wholly illusory. An internal Treasury document explicitly recognized this point: "To the extent that required dividend payments exceed net income, FHFA, as conservator, could consider not declaring dividends

pursuant to the certificates of designation for the preferred shares, so that draws on the PSPAs are not used to pay dividends, preserving as much funding as possible to cover any unanticipated losses at Fannie Mae and Freddie Mac."

124. Third, the Agencies actually considered an alternative to the arrangement they ultimately adopted that would have had the Net Worth Sweep only kick in if Treasury's remaining funding commitment fell below $100 billion. The only plausible explanation for the Agencies' decision not to embrace that alternative is that they knew it would allow the Companies to rebuild capital in contravention of the Administration's commitment to wipe out private shareholders and prevent the Companies from exiting conservatorship.

125. Fourth, the structure and timing of the Net Worth Sweep—coming when the Companies were about to add tens of billions of dollars to their balance sheets—had the effect of *reducing* the amount of money available to guarantee that the Companies would maintain a positive net worth. If the Agencies were genuinely concerned about reassuring the Companies' bond investors that they would be repaid, the Agencies would have delayed imposing the Net Worth Sweep so long as the Companies maintained a substantial positive net worth. Instead, they adopted the Net Worth Sweep at a time when they knew that its near-term effect would be to transfer to Treasury massive profits that the Companies could have otherwise retained as a capital buffer and used to avoid making draws on Treasury's funding commitment in any subsequent unprofitable quarters. Indeed, FHFA has acknowledged how the Net Worth Sweep increases the chances of further draws on Treasury's funding commitment, observing that the Companies "are constrained by the PSPAs from building capital" and that the lack of retained capital combined with "mark-to-market volatility from the [Companies'] derivatives portfolio" has the effect of increasing "the likelihood of negative net worth in future quarters." Thus, even if the Agencies

believed that the Companies could not generate enough profits in the long term to finance a 10% dividend on Treasury's investment, they would not have imposed the Net Worth Sweep when they did if their goal was to preserve Treasury's funding commitment. Doing so only increased the likelihood of future draws. Accordingly, the Net Worth Sweep has not ensured continued access to capital for the Companies or preserved their financial stability and solvency.

126. Fifth, the Net Worth Sweep, announced on the heels of Fannie and Freddie announcing earnings allowing them to begin rebuilding capital, was adopted when it was not because the Companies would be earning too little, but rather because they would be earning too much in light of the Agencies' policy goals of keeping Fannie and Freddie under government control and prohibiting their private shareholders from realizing any value from their investments. An internal Treasury document prepared on July 30, 2012, stated that the Net Worth Sweep should be announced shortly after August 7, when Treasury anticipated the Companies would "report very strong earnings . . . that will be in excess of the 10% dividend." On August 1, a Treasury official similarly emphasized that the Net Worth Sweep should be announced in mid-August because the Companies' "[e]arnings will be in excess of current 10% dividend." FHFA's Mr. Ugoletti reported a "renewed push" from Treasury to implement the Net Worth Sweep on August 9, 2012—the same day that Fannie's CFO told Treasury that it was likely that her company would soon be in a position to make an accounting decision that would add tens of billions of dollars to its earnings. And on August 17, 2012, Mr. Ugoletti wrote to Mr. DeMarco and other FHFA officials that "other than a transitory buffer," the Net Worth Sweep "does not allow the Enterprises to build up a retained surplus, which may give the impression that they are healthy institutions."

127. That the Net Worth Sweep was not intended to advance any legitimate interest of FHFA as conservator is further demonstrated by the fact Treasury was the driving force behind the initiative. Indeed, FHFA agreed to the Net Worth Sweep only at the insistence and under the direction and supervision of Treasury. The Net Worth Sweep was a Treasury initiative and reflected the culmination of Treasury's long-term plan to seize the Companies and see that they were operated for the exclusive benefit of the federal government. Indeed, Mr. Parrott has testified that the Net Worth Sweep was imposed through a "Treasury-driven process." It was Treasury that informed the Companies just days before the Net Worth Sweep that it was forthcoming, and a meeting addressing the Net Worth Sweep was held at Treasury during which a senior Treasury official announced the changes. Secretary Geithner apparently believed that even before the Net Worth Sweep was imposed, "we had already effectively nationalized the GSEs . . ., and could decide how to carve up, dismember, sell or restructure those institutions." Plaintiff's Corrected Post-Trial Proposed Findings of Fact 26.2.1(a), *Starr Int'l Co. v. United States*, No. 1:11-cv-779-TCW (Fed. Cl. Mar. 2, 2015), ECF No. 430. And Treasury officials intimately involved in the development of the Net Worth Sweep testified that they could not recall Treasury making any backup or contingency plans to prepare for any possibility that FHFA would reject the Net Worth Sweep proposal.

128. The Net Worth Sweep is just one example of the significant influence Treasury has exerted over FHFA from the beginning of the conservatorship. Secretary Paulson has written that "seizing control" of Fannie and Freddie, an action that is statutorily reserved to FHFA, was an action "I took." HENRY M. PAULSON, JR., ON THE BRINK xiv (2010). Secretary Geithner, who was president of the Federal Reserve Bank of New York at the time, understood the federal takeover of Fannie and Freddie to be a "Treasury operation," and then-Chairman of the Federal

Reserve Ben Bernanke has said that "Treasury took over Fannie and Freddie." Similarly, Congressional Budget Office Assistant Director for Financial Analysis Deborah Lucas told Congress that the Companies are subject to "ownership and control by the Treasury." *Fannie Mae, Freddie Mac & FHA: Taxpayer Exposure in the Housing Markets: Hearing Before the H. Comm. on the Budget*, 112th Cong. 15 (2011). When asked whether Fannie had ever considered paying Treasury's dividends in-kind, rather than a cash dividend, Ms. McFarland testified that "in my mind, what form of payment we would make and what we were able to do was what Treasury would allow us to do." In its SEC filings, Freddie has said that it and Treasury are "related parties," as defined by Statement of Financial Accounting Standards 57.

129. The Net Worth Sweep was merely one element of a broader Treasury plan to transform the housing finance market and to eliminate Fannie and Freddie. Indeed, a housing finance reform plan drafted by Treasury in early 2012 listed "restructur[ing] the PSPAs to allow for variable dividend payment based on positive net worth"—i.e., implementing a net worth sweep—as among the first steps to take in transitioning to Treasury's desired outcome. Other elements of that plan included the development of a single securitization utility to be used by both Fannie and Freddie—and by other entities once Fannie and Freddie are eliminated. FHFA has made the development of such a utility a key initiative of the conservatorships, providing further evidence that FHFA is operating according to Treasury's playbook.

COUNT I

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

130. Plaintiffs incorporate by reference and reallege each allegation set forth above, as though fully set forth herein.

131. 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."

132. In the August 2012 Net Worth Sweep amendment to the Purchase Agreements, the Federal Government entered into an agreement with itself to take "every dollar of earnings each firm generates . . . to benefit taxpayers." One federal agency—FHFA, supposedly acting as conservator for the Companies—struck a deal with a second federal agency—Treasury—to effectively confiscate the Common and Preferred Stock held by the Plaintiffs and other private investors in Fannie and Freddie.

133. At the outset of conservatorship, FHFA's Director confirmed that both the preferred and common shareholders of Fannie and Freddie retained an economic interest in the Companies. As equity shareholders, that economic interest took the form of a claim on the Companies' equity that could be paid out in the form of dividends or a liquidation payment. Plaintiffs had both a property interest and a reasonable, investment-backed expectation in the economic interest in the Companies they held due to their ownership of Common and Preferred Stock. The Net Worth Sweep expropriated this economic interest by assigning the right to all of Fannie's and Freddie's equity to Treasury.

134. Treasury was the driving force behind the Net Worth Sweep, and both FHFA and Treasury entered the Net Worth Sweep to advance the interests of the United States Government. The policy interests the Agencies sought to advance through the Net Worth Sweep included: prohibiting Fannie and Freddie from recapitalizing and positioning themselves to exit conservatorship; ensuring that Fannie and Freddie would be wound down and, eventually,

eliminated; enriching the Federal Government; and expropriating the economic interests of Fannie's and Freddie's common and preferred shareholders.

135. Plaintiffs who are holders of Preferred Stock had both a property interest and a reasonable, investment-backed expectation in their Preferred Stock and in the share of the Companies' future earnings to which they and other holders of Preferred Stock were contractually entitled. Such Plaintiffs also had both a property interest and a reasonable, investment-backed expectation in the liquidation preference to which such Preferred Stock was contractually entitled in the event that Fannie and Freddie were dissolved or liquidated.

136. The Government, by operation of the Net Worth Sweep, has expropriated Plaintiffs' property interests in theirPreferred Stock and has destroyed Plaintiffs' reasonable, investment-backed expectations without paying just compensation.

137. As a result of the Net Worth Sweep, Plaintiffs have been deprived of all economically beneficial uses of their Preferred Stock in Fannie and Freddie.

138. Plaintiffs are entitled to just compensation for the Government's taking of their property.

COUNT II

Illegal Exaction Under the Fifth Amendment

(Alternative Claim)

139. Plaintiffs incorporate by reference and reallege each allegation set forth above, as though fully set forth herein.

140. In the August 2012 Net Worth Sweep amendment to the Purchase Agreements, the Federal Government entered into an agreement with itself to take "every dollar of earnings each firm generates . . . to benefit taxpayers." One federal agency—FHFA, supposedly acting as conservator for the Companies—struck a deal with a second federal agency—Treasury—to

effectively confiscate the Preferred Stock held by the Plaintiffs and other private investors in Fannie and Freddie.

141. At the outset of conservatorship, FHFA's Director confirmed that both the preferred and common shareholders of Fannie and Freddie retained an economic interest in the Companies. As equity shareholders, that economic interest took the form of a claim on the Companies' equity that could be paid out in the form of dividends or a liquidation payment. Plaintiffs had both a property interest and a reasonable, investment-backed expectation in the economic interest in the Companies they held due to their ownership of Preferred Stock. The Net Worth Sweep expropriated this economic interest by assigning the right to all of Fannie's and Freddie's equity to Treasury.

142. Treasury was the driving force behind the Net Worth Sweep, and both FHFA and Treasury entered the Net Worth Sweep to advance the interests of the United States Government. The policy interests the Agencies sought to advance through the Net Worth Sweep included: prohibiting Fannie and Freddie from recapitalizing and positioning themselves to exit conservatorship; ensuring that Fannie and Freddie would be wound down and, eventually, eliminated; enriching the Federal Government; and expropriating the economic interests of Fannie's and Freddie's common and preferred shareholders.

143. In agreeing to the Net Worth Sweep, FHFA purportedly acted pursuant to its authority as conservator of Fannie and Freddie under 12 U.S.C. § 4617, and Treasury purportedly acted pursuant to authority granted to it under 12 U.S.C. §§ 1455 and 1719. These statutes, however, did not authorize either FHFA or Treasury to expropriate Plaintiffs' economic interest in Fannie and Freddie for the benefit of the Federal Government.

144. In addition, FHFA acted unlawfully because it is an unconstitutional "independent" agency whose Director was removable only for cause in violation of the Appointments Clause.

145. The Constitution provides that the "executive Power shall be vested in a President," U.S. Const. art. II, § 1, and that "he shall take Care that the Laws be faithfully executed," U.S. Const. art. II, § 3. Those provisions vest all executive power in the President of the United States.

146. By making FHFA's head a single Director rather than a multi-member Board and eliminating the President's power to remove the Director at will, HERA violates the Constitution's separation of powers. An independent agency headed by a single Director is virtually unprecedented in our Nation's history, and this structure impermissibly concentrates power in a single person who is not the President.

147. Neither Congress nor the President can negate the constitution's structural requirements by signing or enacting (and thereby acceding to) HERA. "Perhaps an individual President"—or Congress—"might find advantages in tying his own hands," the Supreme Court has noted, "[b]ut the separation of powers does not depend on the views of individual Presidents"—or particular Congresses. *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 130 S. Ct. 3138, 3155 (2010). The Constitution's separation of powers does not depend "on whether 'the encroached-upon branch approves the encroachment.'" *Id.* (quoting *New York v. United States*, 505 U.S. 144, 182 (1992)).

148. "The diffusion of power" away from Congress and the President, to the independent FHFA, "carries with it a diffusion of accountability. . . . Without a clear and effective chain of command, the public cannot 'determine on whom the blame or the punishment

of a pernicious measure, or series of pernicious measures ought really to fall." *Id.* (quoting The Federalist No. 70, p. 476 (J. Cooke ed. 1961) (A. Hamilton)).

149. ~~144.~~ FHFA and Treasury therefore have illegally exacted Plaintiffs' economic interest in Fannie and Freddie without due process.

COUNT III

Breach of Fiduciary Duty

150. ~~145.~~ Plaintiffs incorporate by reference and reallege each allegation set forth above, as though fully set forth herein.

151. ~~146.~~ The conservatorship provisions of HERA create a fiduciary relationship between the United States Government, on the one hand, and the Companies' shareholders, on the other hand. *See United States v. Mitchell*, 463 U.S. 206 (1983). FHFA therefore has a fiduciary responsibility to manage the conservatorships of Fannie and Freddie for the benefit of the Companies' shareholders.

152. ~~147.~~ As conservator, FHFA is given elaborate control over Fannie and Freddie. As conservator, the Agency is vested with "all rights, titles, powers, and privileges of [Fannie and Freddie], and of any stockholder, officer, or director of [Fannie and Freddie] with respect to [Fannie and Freddie] and [their] assets." 12 U.S.C. § 4617(b)(2)(A). As conservator, FHFA accordingly has the authority to "take over the assets of and operate [Fannie and Freddie] with all the powers of the shareholders, the directors, and the officers of [Fannie and Freddie] and conduct all business of [Fannie and Freddie]." *Id.* § 4617(b)(2)(B).

153. ~~148.~~ The term "conservator" has long been understood to denote a position of fiduciary responsibility. HERA accordingly makes clear that FHFA is to exercise its conservatorship authorities for the benefit of the Companies' shareholders, and that the overriding purpose of the conservatorship is "rehabilitating" Fannie and Freddie. 12 U.S.C. §

4617(a)(2). For example, FHFA is authorized to "take such action as may be—(i) necessary to put [Fannie and Freddie] in a sound and solvent condition; and (ii) appropriate to carry on the business of [Fannie and Freddie] and preserve and conserve [their] assets and property." *Id.* § 4617(b)(2)(D). And when taking any action involving the disposition of Fannie's and Freddie's assets, FHFA is required to "conduct its operations in a manner which . . . maximizes the net present value return from the sale or disposition of such assets." *Id.* § 4617(b)(2)(E)(i).

154. ~~149.~~ In promulgating regulations implementing its conservator authorities, FHFA has recognized that "[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." 76 Fed. Reg. 35724, 35730.

155. ~~150.~~ Given the existence of a fiduciary relationship between FHFA and the Companies' shareholders, it naturally follows that the Government should be liable in damages for the breach of its fiduciary duties.

156. ~~151.~~ The Net Worth Sweep is a self-dealing transaction with a sister agency of the Federal Government, and it improperly expropriates the economic interest in Fannie and Freddie held by holders of the Companies' Common and Preferred Stock for the benefit of the Federal Government.

157. ~~152.~~ The Net Worth Sweep was neither entirely nor intrinsically fair.

158. ~~153.~~ The Net Worth Sweep constituted waste, gross and palpable overreaching, and a gross abuse of discretion.

159. ~~154.~~ The Net Worth Sweep did not further any valid business purpose or reasonable business objective of Fannie and Freddie, did not reflect FHFA's good faith business judgment of what was in the best interest of Fannie and Freddie, and was unfair to the Companies' common and preferred shareholders.

160. ~~155.~~ Thus, by entering the Net Worth Sweep, FHFA violated its fiduciary duty to Plaintiffs and the other holders of Preferred Stock.

COUNT IV

Breach of Implied-in-Fact Contract Between the United States and the Companies

161. ~~156.~~ Plaintiffs incorporate by reference and reallege each allegation set forth above, as though fully set forth herein.

162. ~~157.~~ Prior to appointing itself conservator on September 6, 2008, FHFA, along with Treasury, unambiguously offered to place Fannie Mae and Freddie Mac into conservatorship by consent, under § 4617(a)(3)(I), with certain conditions described below, and the boards of directors of the Companies accepted this offer. The Government made no finding of insolvency, undercapitalization, or any other ground to impose conservatorship under § 4617(a)(3)(A)-(H) or (J)-(L).

163. ~~158.~~ FHFA, with the urging of Treasury, offered, and the boards of Fannie Mae and Freddie Mac accepted, a conservatorship that would aim to "preserve and conserve the [Companies'] assets and property" and restore the Companies to a "sound and solvent condition." See § 4617(b)(2)(D). The offer was also of a conservatorship that would end when that goal was achieved. Neither of these conditions was ambiguous.

164. ~~159.~~ Underlying the offer was its promise that FHFA would not, as conservator, wind down or liquidate the Companies. When it publicly announced the conservatorship, FHFA stated that it could not, as conservator, place the Companies into liquidation. FHFA stated at the time, and for several years into the conservatorship, that its goal was instead to "restore the [Companies'] assets and property to a sound and solvent condition," which continued course of

performance constitutes evidence of the offer's original terms. The Companies' boards shared this understanding of conservatorship when they consented.

165. ~~160.~~ When consenting to the conservatorship, the boards of the Companies furnished good and valuable consideration to the Government by agreeing to forbear from a judicial or legislative challenge that the United States feared. See § 4617(a)(5). This forbearance was unambiguously furnished in exchange for the Agencies' promises to act to restore the Companies to a safe and solvent condition.

166. ~~161.~~ The United States and the Companies, through the acts described above, entered into an implied-in-fact contract. The terms of that contract, as relevant here, were that FHFA if made conservator would "preserve and conserve the [Companies'] assets and property," that its conservatorship would continue only until the Companies were placed in a safe and solvent condition, and that, in exchange, the boards of the Companies would consent to, and not challenge or litigate, such a course of action. Both the Government and the Companies intended that an implied contract would exist. That contract required FHFA to preserve the Companies' assets and property, and forbade it from diminishing or expropriating the Companies' assets and property. This intent was demonstrated through the offer and acceptance detailed above. The Government's offer was not ambiguous in its terms, and the boards' acceptance was manifested in its subsequent imposition of conservatorship based on the boards' consent.

167. ~~162.~~ Each Agency had actual authority, as an agency of the United States Government, to bind the United States.

168. ~~163.~~ The imposition of the Net Worth Sweep breached the contract by rendering it impossible for the Companies to build and retain the capital necessary to exit conservatorship and return to normal business operations.

169. ~~164.~~ Each subsequent Net Worth Sweep payment independently breaches that contract by depleting the Companies of capital (rather than "preserv[ing] and conserv[ing]" it), in a manner that FHFA has expressly recognized undermines the goals of conservatorship.

170. ~~165.~~ The Net Worth Sweep, thus, directly harmed Plaintiffs, by preventing the termination of the conservatorship; stripping the Companies of their ability to generate and retain funds to ever distribute as dividends to holders of the Preferred and Common Stock; and nullifying Plaintiffs' contractual right as shareholders to ever receive a liquidation preference upon the dissolution, liquidation, or winding up of the Companies. Plaintiffs are accordingly entitled to damages.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs seek a judgment as follows:

A. Awarding Plaintiffs just compensation under the Fifth Amendment for the Government's taking of their property;

B. Awarding Plaintiffs damages for the Government's illegal exaction of their stock;

C. Awarding Plaintiffs damages for the Government's breach of fiduciary duty;

D. Awarding Plaintiffs damages for the Government's breach of implied-in-fact contract;

E. Awarding Plaintiffs pre-judgment interest, the costs and disbursements of this action, including reasonable attorneys' and experts' fees, costs and expenses; and

F. Granting such other and further relief as the Court deems just and proper.

Respectfully submitted,

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