

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA
MIAMI DIVISION

ANTHONY R. EDWARDS, *et al.*,

Case No.: 1:16-cv-21224-MORENO

Plaintiffs,

v.

PRICEWATERHOUSE, LLP,

Defendant.

**PLAINTIFFS' RESPONSE IN OPPOSITION TO THE FEDERAL HOUSING
FINANCE AGENCY'S RENEWED MOTION TO SUBSTITUTE AS
PLAINTIFF AND INCORPORATED MEMORANDUM OF LAW**

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Plaintiffs file their Response in Opposition to The Federal Housing Finance Agency's Renewed Motion to Substitute as Plaintiff and Incorporated Memorandum of Law ("Motion to Substitute") (Doc. 33) and state as follows:

Introduction

Plaintiffs are several of the private shareholders of the Federal Home Loan Mortgage Corporation ("Freddie") whose economic interests in the company were extracted and transferred to a single, dominant shareholder. As described below, the Court should thwart the Federal Housing Finance Agency's ("FHFA") effort to also take Plaintiffs' rights to pursue direct claims against Freddie's auditor, Pricewaterhousecoopers, LLP ("PwC"), by denying FHFA's Motion to Substitute.

Freddie, a publicly-traded, for-profit insurance company, insures trillions of dollars of mortgages and provides essential liquidity to the residential mortgage market. In July 2008, in the midst of a global financial crisis, the Office of Federal Housing Enterprise Oversight ("OFHEO") declared Freddie safe and well-capitalized. Nevertheless, that same month, Congress enacted the Housing and Economic Recovery Act of 2008 ("HERA"), Pub. L. No. 110-289, 122 Stat. 2654 (July 30, 2008). HERA established FHFA to replace OFHEO as "an independent agency of the Federal Government" to supervise and regulate Freddie. 12 U.S.C. § 4511.

On September 6, 2008, FHFA placed Freddie into conservatorship pursuant to its discretionary authority under 12 U.S.C. § 4617. As recognized by FHFA at the time, the purpose of the conservatorship was to restore confidence in and stabilize Freddie to return it to normal business operations. *See FHFA Fact Sheet, Questions and Answers on Conservatorship 3*, <https://goo.gl/G19z04>.

On September 7, 2008, FHFA entered into the Preferred Stock Purchase Agreement (“PSPA”) with the United States Department of Treasury (“Treasury”). Generally, the PSPA gave Treasury one million shares of a new class of senior preferred stock (the “Government Stock”) and warrants to purchase 79.9% of Freddie common stock, in exchange for a funding commitment that allowed Freddie to draw up to \$100 billion from Treasury, an amount increased by later amendments. The Government Stock entitled Treasury to dividends at an annualized rate of 10% if paid in cash or 12% if paid in kind.

Pursuant to the PSPA, FHFA reviewed Freddie’s financial statements each quarter to determine whether its liabilities exceeded its assets. If so, FHFA requested Treasury to draw on the funding commitment in an amount equal to Freddie’s net worth deficit. The greater the net worth deficit, the more Freddie was forced to borrow. FHFA always elected to have Freddie pay Treasury the 10% cash dividend rather than the in-kind dividend.

PwC, a purportedly independent accounting firm with “public watchdog” duties, was Freddie’s auditor throughout the conservatorship and continues to be so today. As alleged in the Complaint, PwC ignored its critical roles and obligations and assisted FHFA and Freddie to materially misstate Freddie’s financial statements, specifically grossly undervaluing deferred tax assets and overstating loan loss reserves, which increased Freddie’s paper net worth deficit and required it to borrow large sums from Treasury at enormous costs. Throughout the conservatorship, PwC falsely certified the accuracy of Freddie’s financial statements, in violation of accepted auditing and accounting standards.

By late 2011, it was clear that Freddie was returning to profitability, even by the punitive and incorrect accounting being applied by Freddie and certified by PwC. However, rather than allowing Plaintiffs to benefit from the reversal of the accounting misstatements, PwC continued

to write-off as worthless huge sums of deferred tax assets and otherwise hold on to its faulty assumptions until FHFA and Treasury could consummate the Third Amendment to the PSPA, the “Net Worth Sweep,” in August 2012.

Since the January 1, 2013 effective date of the Net Worth Sweep, Freddie has been forced to pay its entire net worth to Treasury every quarter, and, because these payments are considered dividends, not pay downs of principal, the face value of the Government Stock has not, and will not, decrease. Plaintiffs, by contrast, are guaranteed to never receive any return of their investments, such as in the form of dividends. To date, Treasury has already recouped approximately \$26.8 billion more than it invested in Freddie.

Procedural History

On March 9, 2016, Plaintiffs filed this lawsuit in the Circuit Court of the 11th Judicial Circuit in and for Miami-Dade County, Florida. Each Plaintiff brings a direct claim for Negligent Misrepresentation and Aiding and Abetting Breach of Fiduciary Duty. The claims *are not* brought derivatively on behalf of Freddie. Plaintiffs *do not* seek damages for Freddie.

On March 15, 2016, pursuant to 28 U.S.C. § 1407, FHFA filed a Motion for Transfer of Actions to the U.S. District Court for the District of Columbia (Initial Motion) before the United States Judicial Panel on Multidistrict Litigation (“JPML”). *See In re Federal Housing Finance Agency, et al., Preferred Stock Purchase Agreements Third Amendment Litigation, MDL No. 2713.*

On April 6, 2016, PwC filed its Notice of Removal (Doc. 1). On April 13, 2016, PwC filed its Motion to Stay Pending Action by the JPML (Doc. 8). On April 21, 2016, the Court entered its Order Granting Motion to Stay and administratively closed the case. (Doc. 11).

On June 2, 2016, the JPML entered its Order Denying Transfer. On August 17, 2016, FHFA filed its Renewed Motion to Substitute as Plaintiff. Because this Court does not have subject matter jurisdiction over Plaintiffs' state law claims that do not raise substantial federal issues, it should not consider FHFA's Motion to Substitute.¹ However, should the Court decide to consider the motion, as described below, it should be denied in its entirety because Plaintiffs have standing to bring their direct claims.

Argument

The Motion to Substitute should be denied for three primary reasons. First, Plaintiffs' claims for Aiding and Abetting Breach of Fiduciary Duty and Negligent Misrepresentation, premised upon Plaintiffs' personal economic rights, are direct claims. Courts construing the succession clauses in HERA and the materially-identical Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"),² including this Court, consistently find that shareholders retain their rights to bring direct claims. Second, FHFA only retains the ability to pursue shareholder derivative claims on behalf of Freddie when no manifest conflict of interest exists. If Plaintiffs' claims are deemed to be derivative (which they are not), FHFA still may not properly substitute for Plaintiffs in this action because of its manifest conflict of interest in prosecuting claims that require proving breaches of its own duties. Finally, Plaintiffs' claims

¹ Plaintiffs filed their Motion to Remand on August 15, 2016. (Doc. 28). The Court should resolve the remand motion before considering this motion. *See Edwards, et. al v. Deloitte & Touche, LLP*, Case No. 1:16-cv-21221 (S.D. Fla. Aug. 22, 2016), Order Granting Joint Motion to Extend Deadlines (Doc. 27) ("The Court notes, however, that it cannot rule on the motion to substitute until the Plaintiffs' attack on the Court's subject matter jurisdiction has been resolved.").

² Courts and the parties agree that FIRREA's provisions regarding the powers of conservators, including the succession clause, are materially identical to those of HERA. *Compare* 12 U.S.C. § 1821(d)(2)(A)(i) *with* 12 U.S.C. § 4617(b)(2)(A)(i); *see also In re Fed. Home Loan Morg. Corp. Derivative Litig.*, 643 F.Supp.2d 790, 795 (E.D. Va. 2009) (*In re Freddie Mac*), *aff'd sub nom La. Mun. Police Emples. Ret. Sys. v. Fed. Hous. Fin. Agency*, 434 Fed.Appx. 188 (4th Cir. 2011); FHFA Mot. 7-8.

for damages do not require the Court to restrain or affect FHFA's exercise of powers or functions as conservator.

I. HERA Does Not Strip Plaintiffs of Their Rights in Their Stock.

By imposing the Net Worth Sweep, FHFA expropriated the economic rights of Freddie's private shareholders, including Plaintiffs, and transferred them to the federal government. FHFA incorrectly argues that under HERA *only it* has the authority to challenge the accounting irregularities that made its destruction of minority shareholder rights possible. *See* FHFA Mot. 7–9, and 14–16. This argument is meritless for two independent reasons. First, HERA does not bar Plaintiffs from asserting direct claims, and all of the claims at issue here are direct. Second, even if Plaintiffs' claims were derivative, courts repeatedly have recognized that shareholders may bring derivative claims during conservatorship where, as here, the conservator has a manifest (and therefore disqualifying) conflict of interest.

A. Plaintiffs May Bring Direct Claims Arising from Their Ownership of Stock.

1. Section 4617(b)(2) Does Not Apply to Direct Claims.

HERA provides that FHFA as conservator succeeds to “all rights, titles, powers, and privileges of . . . any stockholder . . . of the regulated entity [i.e., Freddie] *with respect to the regulated entity and the assets of the regulated entity.*” 12 U.S.C. § 4617(b)(2)(A)(i) (emphasis added). Whatever implications this succession clause may have for shareholders seeking to bring derivative claims *on behalf of Freddie*, it does nothing to divest shareholders of their own, independent and personal economic rights in Freddie and, therefore, does nothing to prevent shareholders from maintaining direct claims *on behalf of themselves* to protect *their own rights* against any culpable party. This is why, upon imposition of the conservatorship, FHFA correctly insisted that Freddie's shares would “continue to trade” and that its shareholders would “retain all rights in the stock's financial worth.” *FHFA Fact Sheet, Questions and Answers on*

Conservatorship 3, <https://goo.gl/Gl9z04>. If FHFA's current litigating position were correct, these public assurances would have been demonstrably false.³

Consistent with the decisions of every other federal court to address this issue when interpreting HERA or FIRREA's succession clause, the Eleventh Circuit ruled in *Lubin v. Skow*, 382 F. App'x 866 (11th Cir. 2010), that as receiver the FDIC had succeeded to the plaintiff's derivative claims but made clear that "FIRREA would not be a bar to standing" if the plaintiff had brought a direct claim. As support for this conclusion, the *Lubin* Court cited the Eleventh Circuit's earlier decision in *FDIC v. Jenkins*, 888 F.2d 1537, 1545 (11th Cir. 1989), for the proposition that "FIRREA does not prohibit shareholders from proceeding against solvent third-parties in *non-derivative* shareholder suits." 382 F. App'x at 871 (emphasis added).

This Court accepted the Eleventh Circuit's position in *Official Committee of Unsecured Creditors of BankUnited Financial Corporation v. Federal Deposit Insurance Corporation*, Case No. 11-20305-CIV, 2011 WL 10653884, at *2 (S.D. Fla. Sept. 28, 2011), when it relied on *Lubin* while reviewing an order from the United States Bankruptcy Court for the Southern District of Florida and found: "Therefore, all derivative claims in the Appellant's proposed complaint belong to [FDIC], and all direct claims belong to [Stockholder]." *Id.*

FHFA's only answer is to characterize the *Lubin* Court's entire explanation for its decision as "dicta" because the receiver in that case was held to have succeeded to the plaintiff's

³ Adopting FHFA's position would also render numerous conservatorship decisions nonsensical. For example, FHFA expressly suspended payment of dividends to private shareholders like Plaintiffs during conservatorship. But if FHFA had in fact succeeded to the shareholders' contractual dividend rights, any payment of dividends would have been to FHFA itself, not to shareholders. FHFA then would have had no need to announce *to itself* that it was halting the payment of dividends. Moreover, FHFA entered into contractual agreements with Treasury—a *shareholder* in the Companies—that provided Treasury with dividend and liquidation rights, and FHFA has paid tens of billions of dollars in dividends under those agreements. If FHFA's assertion were correct, Treasury's dividend rights would belong to FHFA, and these payments should have been retained by FHFA rather than given to Treasury.

derivative claims. FHFA Mot. 15. But however characterized, this Court should not lightly cast aside a considered judgment of the Court of Appeals, especially where this Court has previously accepted the position and where, as here, it is confirmed by the decisions of numerous courts.

Consistent with *Lubin*, “[n]o federal court has read” Section 4617(b)(2) or the analogous provision of FIRREA to transfer direct shareholder claims to the conservator or receiver. *Levin v. Miller*, 763 F.3d 667, 672 (7th Cir. 2014); *see also Barnes v. Harris*, 783 F.3d 1185, 1193, 1195 (10th Cir. 2015); *In re Beach First Nat’l Bancshares, Inc.*, 702 F.3d 772, 778, 780 (4th Cir. 2012); *Plaintiffs in All Winstar-Related Cases v. United States*, 44 Fed. Cl. 3, 9–10 (1999).⁴ Even the district court’s decision in *Perry Capital*, which FHFA invokes, did not hold that Section 4617(b)(2) bars direct, as opposed to derivative claims, by shareholders—to the contrary, it implicitly recognized that this statute *does not* bar direct claims. *See, e.g.*, 70 F. Supp. 3d 208, 229 n.24 (D.D.C. 2014) (“[I]f such a determination were necessary, the Court notes that it would find that the *Fairholme* plaintiffs’ fiduciary duty claim is derivative in nature and, *therefore*, barred under § 4617(b)(2)(A)(i) as well.”) (emphasis added).

Indeed, FHFA itself took this position in the *Kellmer* litigation. In addition to derivative claims, a plaintiff in that litigation brought a claim asserting that Fannie Mae’s pre-conservatorship Board had violated shareholders’ rights under the Exchange Act and SEC regulations. FHFA expressly disclaimed any conservator interest in that claim:

Plaintiff in *Agnes v. Raines* . . . has sued both derivatively and in his individual capacity. . . FHFA moves to substitute only with respect to the derivative claims

⁴ The authorities cited by FHFA hold only that the succession provisions of HERA or FIRREA bar *derivative* claims by shareholders absent a manifest conflict of interest; they do not hold that those statutes bar *direct* shareholder claims. *See Kellmer*, 674 F.3d at 850–51; *Pareto v. FDIC*, 139 F.3d 696, 699–701 (9th Cir. 1998); *Gail C. Sweeney Estate Marital Trust*, 68 F. Supp. 3d at 119, 126 n.13; *Esther Sadowsky Testamentary Trust v. Syron*, 639 F. Supp. 2d 347, 350 (S.D.N.Y. 2009); *In re Fed. Home Loan Mortg. Corp. Derivative Litig.*, 643 F. Supp. 2d 790, 795 (E.D. Va. 2009).

asserted by Fannie Mae shareholders. Accordingly, FHFA seeks to substitute for plaintiff Agnes only insofar as he asserts derivative claims; Agnes's individual claims should be consolidated with the other non-derivative securities actions against Fannie Mae that are pending before this Court.

Motion of FHFA as Conservator for Fannie Mae to Substitute For Shareholder Derivative Plaintiffs at 1 n.1, *Kellmer v. Raines*, No. 07-1173 (D.D.C. Feb. 2, 2009), ECF No. 68.

In support of its new and inconsistent position, FHFA principally relies on Section 4617(b)(2)'s use of the word "all." See FHFA Mot. 14-16. But as discussed above, "all" this provision transfers is shareholder rights "*with respect to the regulated entity and the assets of the regulated entity.*" 12 U.S.C. § 4617(b)(2)(A) (emphasis added).

Recently, in *Pagliara v. Fed. Home Loan Mortgage Corp.*, No. 1:16-cv-337, 2016 WL 4441978, *7 (E.D. Va. Aug. 23, 2016), the court found the "*with respect to*" limiting language of the statute to be synonymous with "concerning" or "relating to." Relying on the ordinary definition of the plain language of the succession clause, the court held that "a stockholder's right to inspect corporate records is a stockholder right with respect to Freddie Mac or its assets," like the rights to elect directors, to seek removal of directors, to petition the court to force Freddie to hold an annual meeting, and to call a special meeting. *Id.* at *6-7.

The *Pagliara* court distinguished these rights with respect to Freddie or its assets from rights to bring direct claims, proclaiming that "standing to bring a lawsuit to remedy a personal injury is not easily categorized as a right with respect to the corporation." *Id.* at *6. The court emphasized in rejecting the plaintiff's constitutional avoidance argument, even if HERA deprives shareholders of their right to inspect Freddie's books and records, this "does not affect" their "right to bring a direct lawsuit"—a cognizable property interest. *Id.* at *7, n.16. As a result, *Pagliara* accepted the many judicial opinions that hold that during conservatorship, shareholders retain the right "to bring a lawsuit to remedy [their] own direct injuries." *Id.* at *6.

Nor does Plaintiffs' interpretation render the succession clause's reference to the "rights... of any stockholder" meaningless. *See* FHFA Mot. 10. To be sure, even without the shareholder rights language FHFA could "already pursue what would be a derivative claim because the claim really belongs to" Freddie itself. *Levin*, 763 F.3d at 673 (Hamilton, J., concurring). But the addition of that language clarifies that, absent a manifest conflict of interest, shareholders themselves generally cannot pursue the same claim derivatively. *See In re Freddie Mac*, 643 F. Supp. 2d at 796.

Further, established constitutional jurisprudence forecloses reading HERA to force Plaintiffs to accept FHFA as their representative in pursuing claims that it admits are "premised upon a litany of alleged wrongdoing by the Conservator" itself. FHFA Mot. 2. In a long line of cases under the Due Process Clause, the Supreme Court has held that a person cannot be relegated to representation by a party whose interests conflict with its own. For example, in the class action context, the Court has consistently held that due process requires adequate representation, free of significant potential for conflict of interest, for absent class members. *See generally Richards v. Jefferson Cty.*, 517 U.S. 793, 801 (1996) (holding that taxpayers could not be adequately represented by city finance director); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 812 (1985) ("the Due Process Clause of course requires that the named plaintiff at all times adequately represent the interests of the absent class members"). Likewise, the Court has held that the Due Process Clause is violated where a criminal defendant is represented by a lawyer who has a conflict of interest. *See Wood v. Georgia*, 450 U.S. 261, 271–72 (1981) (due process is violated where the party's attorney "may not have pursued [his clients'] interests single-mindedly"). Indeed, because the government cannot compel a litigant to press his case before a judge who has a stake in the outcome and an interest in seeing the litigant lose, *see Ward v.*

Village of Monroeville, 409 U.S. 57, 61–62 (1972); *Tumey v. Ohio*, 273 U.S. 510, 523 (1927), it necessarily must be an even clearer violation of the Due Process Clause for the government to compel a litigant to rely upon a government agency as his exclusive legal representative in a case that concerns misconduct by that very agency.

Straining to read HERA as transferring all shareholder rights to the conservator would improperly and unnecessarily raise additional constitutional concerns, because even a temporary governmental appropriation of private property is a taking that requires just compensation to the displaced owner. *See Waterview Mgmt. Co. v. FDIC*, 105 F.3d 696, 699 (D.C. Cir. 1997) (“[T]o hold that the federal government could simply vitiate the terms of existing assets, taking rights of value from private owners with no compensation in return, would raise serious constitutional issues.”). Thus, even if Plaintiffs’ interpretation *were not* the most natural reading of HERA—which, in fact, it is—it would still be improper to interpret HERA’s language as transferring *all* shareholder rights, including the ability to bring direct causes of action to protect those rights, to the conservator, because any such interpretation would raise serious constitutional difficulties. *See National Fed’n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2593–94 (2012) (opinion of Roberts, C.J.). Significantly, the Seventh Circuit relied on essentially this reasoning in holding that FIRREA grants the FDIC rights only to derivative shareholder claims, not direct shareholder claims:

Section 1821(d)(2)(A)(i) transfers to the FDIC only stockholders’ claims “with respect to . . . the assets of the institution”—in other words, those that investors . . . would pursue derivatively on behalf of the failed bank. This is why we have read § 1821(d)(2)(A)(i) as allocating claims between the FDIC and the failed bank’s shareholders rather than transferring to the FDIC every investor’s claims of every description. Any other reading of § 1821(d)(2)(A)(i) would pose the question whether . . . stockholders would be entitled to compensation for a taking; our reading of the statute . . . avoids the need to tackle that question.

Levin, 763 F.3d at 672 (first omission in original); *see also id.* at 673 (Hamilton, J., concurring)

(underscoring “our adoption of the direct/derivative dichotomy”).

Pursuant to precedent established in *Lubin* and *BankUnited*, and every other case that has interpreted these succession clauses, it is clear that direct claims do not belong to FHFA as conservator. This Court should not be the first to find otherwise.

2. Plaintiffs’ Claims are Direct, Not Derivative.

Plaintiffs’ aiding and abetting breach of fiduciary duty claims are direct because they seek to redress FHFA’s, with PwC’s assistance, improper expropriation of value and rights from the minority class of shareholders to Freddie’s controlling shareholder, Treasury. Plaintiffs’ negligent misrepresentation claims are direct because they are personal claims that could not possibly belong to the stock-issuing corporation, Freddie.

a. Plaintiffs’ aiding and abetting breach of fiduciary duty claims are direct.

When FHFA and Treasury effectuated the Net Worth Sweep, they guaranteed that Treasury would be the only Freddie shareholder to ever benefit from ownership of Freddie stock, in the form of dividends, liquidation preference, or otherwise. When Treasury takes Freddie’s entire net worth on a quarterly basis, it transfers these economic rights of the minority shareholders, including Plaintiffs, to Treasury.⁵

In the absence of a recognized test for determining whether a breach of fiduciary duty claim is direct or derivative, the Virginia Supreme Court has left open the possibility of adopting the leading test described in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004). *See Remora Invs., LLC v. Orr*, 277 Va. 316, 324 (Va. 2009). In fact, Virginia courts

⁵ Plaintiffs are all preferred stockholders who have historically been paid dividends and were entitled to a liquidation preference—two rights extinguished by the Net Worth Sweep.

regularly look to Delaware corporate law for guidance, especially regarding derivative litigation. *See Pagliara*, 2016 WL 4441978, at *8, n. 18.

While Delaware law permits stockholders to bring derivative suits “on behalf of the corporation for harm done to the corporation,” it also provides that “[a] stockholder who is directly injured . . . retain[s] the right to bring *an individual action* for injuries affecting his or her legal rights as a stockholder.” *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004), *Tooley*, 845 A.2d at 1036 (emphasis added). “[W]hether a stockholder’s claim is derivative or direct” turns “*solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually).” *Id.* at 1033.⁶ In analyzing the first question, the court considers “whether the stockholder has demonstrated that he or she has suffered an injury that is not dependent on an injury to the corporation”—that is, whether the plaintiff has “demonstrated that he or she can prevail without showing an injury to the corporation.” *Id.* at 1036. Once this first inquiry is conducted, “[t]he second prong of the analysis should logically follow.” *Id.*

Although FHFA argues otherwise, *see* FHFA Mot. 11–12, this analysis does not imply that a stockholder must show that the action which harmed his or her own interests did not also harm the corporation—to the contrary, some wrongs harm *both* the corporation and its stockholders directly and can be challenged through *either* derivative or direct actions. *See, e.g., Gatz v. Ponsoldt*, 925 A.2d 1265, 1278 (Del. 2007) (“claim could have been brought either as a direct or as a derivative claim”); *Gentile v. Rossette*, 906 A.2d 91, 99 (Del. 2006) (holding that

⁶ Virginia courts have followed the substance of the *Tooley* test. *See Keepe v. Shell Oil Co.*, 260 S.E. 2d 722, 724 (Va. 1979) (“a stockholder has no standing to sue in his own right for *an injury to the corporation*...”) (emphasis added).

claim “was both derivative and direct”); *see also Tooley*, 845 A.2d at 1036 (distinguishing “individual action for injuries affecting [stockholder’s] legal rights as a stockholder” from derivative action seeking redress for “an injury caused to the corporation *alone*”) (emphasis added). Rather, it means only that the stockholder must be able to prove his own injury *without regard to* whether the corporation was also harmed.

In this case, the gravamen of Plaintiffs’ Complaint is not that the Net Worth Sweep has diminished Freddie’s overall corporate profits and thus harmed all shareholders indirectly, but rather that it has improperly allocated to a single, dominant shareholder whatever profits Freddie makes *and* Plaintiffs’ previously-held rights to a earn dividend and a liquidation preference, thereby destroying Plaintiffs’ economic interest in Freddie to which they are entitled as owners of stock. The injuries Plaintiffs suffered are “not dependent on an injury to the corporation.” *Tooley*, 845 A.2d at 1036. In fact, Freddie has been immensely profitable since the Net Worth Sweep; however, only one shareholder enjoyed that profitability. It follows that Plaintiffs “can prevail without showing an injury” to Freddie, *Tooley*, 845 A.2d at 1036, and thus that Plaintiffs—not Freddie—suffered the specific injury complained of here.

Significantly, the Delaware Supreme Court has expressly approved direct stockholder suits to redress the “improper extraction or expropriation, by the controlling shareholder, of economic value and voting power that belonged to the minority stockholders.” *Rossette*, 906 A.2d at 102; *see also, e.g., Gatz*, 925 A.2d at 1278, 1280–81 (allowing direct suit in analogous circumstances raising the same policy concerns as *Rossette*); *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319, 330–32 (Del. 1993); *In re Activision Blizzard, Inc. Stockholder Litig.*, 124 A.3d 1025, 1052–54 (Del. Ch. 2015); *Gradient OC Master, Ltd. v. NBC Universal, Inc.*, 930 A.2d 104, 130 (Del. Ch. 2007). As the Delaware Supreme Court explained, although in such cases the

corporation may “suffer[] harm (in the form of a diminution of its net worth), the minority shareholders also suffer[] a harm that [is] unique to them and independent of any injury to the corporation.” *Rossette*, 906 A.2d at 103.

Indeed, in the recent AIG litigation, the Government “concede[d] that the *Gatz-Rossette* line of cases recognize the right of a plaintiff to bring a direct claim where a stockholder uses its majority or effective control to dilute minority shares,” but argued that these cases did not apply in that case “because the Government was not a stockholder, nor did it have majority or effective control of AIG, when the purported dilution occurred.” *Starr Int’l Co. v. United States*, 106 Fed. Cl. 50, 64 (2012) (quotation marks omitted), *appeal filed*, No. 15-5133 (Fed. Cir.); *see also id.* at 65 (rejecting Government’s argument and following *Gatz* and *Rossette* in upholding shareholder’s “right to maintain a direct claim”).

Further, direct “expropriation” claims are not limited to the factual scenario that was present in *Rossette*. As the Delaware Chancery Court recently explained,

Subsequent cases have recognized that the principle recognized in *Gentile* [*v. Rossette*] was not limited to dilutive issuances involving majority stockholders; it applies equally to stock transfers involving significant stockholders. Indeed, *Gentile*’s core insight applies to any insider stock issuance where the value transferred directly to the insider exceeds the share of the loss that the insider suffers through its stock ownership.

In re El Paso Pipeline Partners, LP, 2015 WL 7758609, at *28 (Del. Ch. Dec. 2, 2015) (footnotes omitted); *see also Gatz*, 925 A.2d at 1278, 1280–81 (looking beyond “transactional form” to “underlying concerns and substantive effects” and allowing direct suit in circumstances raising the same policy concerns as *Rossette*); *Gradient OC Master, Ltd. v. NBC Universal, Inc.*, 930 A.2d 104, 130 (Del. Ch. 2007) (“[W]hen a controlling shareholder extracts financial benefit from the shareholders and procures a financial benefit exclusive to himself, the non-controlling shareholders have a direct claim . . .”).

Here, also, the crux of Plaintiffs' claims is not that there has been "an equal dilution of the economic value . . . of each of [Freddie's] outstanding shares," *Rossette*, 906 A.2d at 100, due to mismanagement or waste. Rather, it is that accounting improprieties at Freddie facilitated an unlawful "extraction from [Plaintiffs], and a redistribution to [Treasury,] the controlling shareholder, of . . . the economic value" of their stock. *Id.* It is Plaintiffs, not Freddie, who have suffered this harm.

Given that Plaintiffs' claims easily qualify as direct under the first prong of *Tooley*, "[t]he second prong of the analysis should logically follow." *Tooley*, 845 A.2d at 1036. Despite FHFA's unsupported suggestions to the contrary, any damages awarded in this action would be paid to Plaintiffs, not Freddie. Because Plaintiffs seek relief that would flow directly to them, their claims are direct under *Tooley*'s second prong.

FHFA cites *Simmons v. Miller*, 261 Va. 561, 576 (Va. 2001) for the mistaken proposition that all breach of fiduciary duty claims are derivative. FHFA Mot. 10. In fact, *Simmons* deals with the narrow issue of whether Virginia law permits a minority shareholder to assert individual claims *on behalf of a corporation* against officers and directors based on breaches of fiduciary duties *owed to the corporation*. *Id.* at 565, 573. The court's analysis is restricted to "ordinary" breach of fiduciary duty claims where conduct such as "mismanagement, negligence or the like" causes damage "to the corporation." *Id.* citing 12B William M. Fletcher, *Cyclopedia of the law of Private Corporations* § 5924, at 497-99 (perm. ed. 2000 rev. vol.).

Remora extended the holding of *Simmons* to limited liability companies. *See Remora*, 277 Va. 323. Even if *Simmons* and *Remora* stand for the proposition that a minority shareholder cannot directly sue a corporate officer or director for breach of fiduciary duty, they do not limit a

minority shareholder's ability to sue a controlling shareholder.⁷ Under Virginia law, “[d]ominant or controlling shareholders also owe minority shareholders fiduciary duties.” *Parsch v. Massey*, 79 Va. Cir. 446, 459 (Va. Cir. 2009). Because the duty flows directly from controlling shareholder to minority shareholder, a minority shareholder has standing to directly sue the controlling shareholder for breaching that duty. Moreover, FHFA's cited cases do not apply where the dominant shareholder and officers of a corporation agree to destroy the value of the minority shareholders' stock and associated rights—a scenario Virginia courts have not contemplated. Accordingly, this Court should find that, presented with such a scenario, Virginia courts would follow the Delaware line of cases beginning with *Tooley* and *Rosette* and find that breach of fiduciary duty claims seeking to redress an expropriation of stockholders' economic rights may be directly asserted against both officers and controlling shareholders.

b. Plaintiffs' negligent misrepresentation claims are direct.

FHFA argues that Plaintiffs' negligent misrepresentation claims are derivative merely because they are “holder” claims. FHFA Mot. 12-13. However, *Stephenson v. PricewaterhouseCoopers, LLP*, 482 F. App'x 618, 621 (2d Cir. 2012) and *Ernst & Young Ltd. V. Quinn*, 2009 WL 3571573, at *6 (D. Conn. Oct. 26, 2009) involve harms suffered by plaintiffs due to accounting improprieties *that depended upon* underlying harms suffered by the companies in which they had invested. Here, PwC's misrepresentations harmed Plaintiffs but allowed Treasury to enjoy massive windfalls with respect to its own shares.

Moreover, in responding to the Second Circuit's certified question, the Delaware Supreme Court rejected *Stephenson* and held that stockholders' negligent misrepresentation claims in which they allege they continue to hold stock based on misrepresentations are direct

⁷ Plaintiffs allege that Treasury breached its fiduciary duties to Plaintiffs. Complaint, ¶ 97.

because “they belong to the holders and are ones that only the holders can assert, not claims that could possibly belong to the issuer corporation.” *Citigroup, Inc. v. AHW Inv. P’ship*, 140 A.3d 1125, 1140 (Del. 2016). Holder claims are “analytically indistinct from seller and purchaser claims,” which are “[q]uintessential examples of personal claims.” *Id.* at n. 76, citing *In re Activision Blizzard*, 124 A.3d at 1056. Accordingly, Plaintiffs’ negligent misrepresentation claims are personal, direct claims.⁸

B. Plaintiffs May Bring Derivative Claims Where, as Here, the Conservator Has a Manifest Conflict of Interest.

Even if HERA did make FHFA the successor to direct claims by shareholders of entities in conservatorship (or if Plaintiffs’ direct claims were construed to be derivative), HERA still would permit Plaintiffs to bring their claims here. While Section 4617(b)(2)(A) generally has been interpreted to bar derivative (but not direct) suits by shareholders during conservatorship or receivership, it does not follow that *all* shareholder derivative suits are barred without exception, including derivative suits involving misconduct by the conservator or receiver itself.

Two federal courts of appeals have squarely addressed this question, both in the context of 12 U.S.C. § 1821(d)(2)(A)(i), the provision of FIRREA on which Section 4617(b)(2)(A) was modeled. And both of those courts held that shareholders may maintain a derivative suit when the conservator or receiver has a manifest conflict of interest. *See First Hartford Corp. Pension Plan & Trust v. United States*, 194 F.3d 1279, 1283 (Fed. Cir. 1999) (finding standing to sue “because of the FDIC’s conflict of interest by which it is both alleged to have caused the breach and controls the depository institution”); *Delta Sav. Bank v. United States*, 265 F.3d 1017, 1024

⁸ Plaintiffs do not concede that their substantive negligent misrepresentation claims are governed by Virginia law, as they are not subject to the internal affairs doctrine. *Citigroup*, 140 A.3d at 1140. On the relevant question of whether the claims are direct or derivative, Virginia, having no established rule, would likely defer to Delaware’s analysis in *Citigroup*.

(9th Cir. 2001) (adopting “a common-sense, conflict of interest exception to the commands of FIRREA” and permitting a shareholder to bring a derivative suit against one of the FDIC’s “closely-related, sister agencies”). When Congress reenacted substantially the same language in HERA, it can be presumed to have accepted the consistent judicial construction of that language as including a conflict-of-interest exception. *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 85–86 (2006); *Lorillard v. Pons*, 434 U.S. 575, 580 (1978).

Further, a conflict-of-interest “exception would [not] swallow the rule” against shareholder derivative suits, *Perry Capital*, 70 F. Supp. 3d at 231, as reflected by cases denying shareholders the right to bring derivative claims despite acknowledging a conflict-of-interest exception. *See, e.g., Kellmer*, 674 F.3d at 850; *In re Fed. Home Loan Mortg. Corp. Derivative Litig.*, 643 F. Supp. 2d 790, 798 (E.D. Va. 2009); *Esther Sadowsky Testamentary Trust*, 639 F. Supp. 2d at 350. Indeed, a conflict-of-interest exception would do nothing to displace a conservator’s or receiver’s exclusive control over actions relating to corporate mismanagement leading to the appointment of the conservator or receiver in the first place, as it would not permit shareholders to bring derivative actions asserting such claims during conservatorship or receivership.

There is nothing “odd” about concluding that Congress intended shareholders to retain the right to bring derivative claims when the conservator is conflicted while also “grant[ing] immense discretionary power to the conservator . . . and prohibit[ing] courts from interfering with the exercise of such power.” *Perry Capital*, 70 F. Supp. 3d at 230–31. This right will only come into play when the conservator is alleged to have acted *outside* of the bounds of its power or in cases such as this one seeking damages—both situations in which Congress *has not* shielded the conservator’s actions from judicial scrutiny. *See* 12 U.S.C. § 4617(f). The “odd”

interpretation of HERA would be to strain to read it as shielding the conservator's actions from judicial review in situations not covered by the statute's provision directly addressing that subject.

In this case, Plaintiffs are suing the auditor that helped FHFA materially misstate Freddie's financial condition to justify excess draws on Treasury's funding commitment that ultimately enabled FHFA to impose the Net Worth Sweep. Plaintiffs allege that FHFA breached its fiduciary duty to Plaintiffs and, if substituted, FHFA would need to prove its own breach. As FHFA candidly acknowledges, this suit is "premised upon a litany of alleged wrongdoing by the Conservator." FHFA Mot. 2. FHFA plainly has a "manifest conflict of interest" within the meaning of *First Hartford*, 194 F.3d at 1295, and the numerous other authorities recognizing this common-sense exception, and Plaintiffs, rather than FHFA, are thus the proper parties to seek redress for the injury inflicted.

II. HERA's Anti-Injunction Provision Does Not Bar Plaintiffs' Suit for Damages.

Finally, FHFA argues that Plaintiffs' suit runs afoul of 12 U.S.C. § 4617(f), which says that "no court may take any action to restrain or affect the exercise of powers or functions of [FHFA] as conservator." *See* FHFA Mot. 16–18. FHFA's argument fails for two reasons.

First, by its plain terms Section 4617(f) only applies to suits that would "affect the exercise of powers or functions" of FHFA as conservator, and, as demonstrated above, pursuing direct claims on behalf of Freddie's shareholders and deciding whether to permit derivative claims when it is conflicted are not among those powers or functions. If accepted, FHFA's argument to the contrary would effectively overrule the numerous decisions that hold that shareholders may maintain suits like this one while a regulated entity is in conservatorship or receivership. *See, e.g., Levin v. Miller*, 763 F.3d 667, 672 (7th Cir. 2014) (shareholders may

press direct claims during receivership); *Delta Sav. Bank v. United States*, 265 F.3d 1017, 1024 (9th Cir. 2001) (federal receiver may not block shareholder derivative suit when it is conflicted).

Second, because Plaintiffs seek only *damages* from Freddie’s auditor for its role in past misconduct, this suit has no potential to “restrain or affect” FHFA’s exercise of its conservatorship powers in the future. *See* 12 U.S.C. § 4617(f). Consistent with this understanding of the statute, numerous courts—including FHFA’s own authorities—describe Section 4617(f) as an “anti-injunction” provision. *Sweeney Estate Marital Trust*, 68 F. Supp. 3d at 125; *accord Sadowsky*, 639 F. Supp. 2d at 350; *In re Fed. Nat’l Morg. Ass’n Sec., Deriv. & ERISA Litig.*, 629 F. Supp .2d 1, 2 n.1 (D.D.C. 2009). The Eleventh Circuit has likewise characterized the materially identical language in FIRREA, 12 U.S.C. § 1821(j), as an “anti-injunction provision,” *Bank of America v. Colonial Bank*, 604 F.3d 1239, 1241 (11th Cir. 2010), and numerous other courts have ruled that suits for money damages are “not affected” by that statute. *Sharpe v. FDIC*, 126 F.3d 1147, 1155 (9th Cir. 1997); *see also Dittmer Props., L.P. v. FDIC*, 708 F.3d 1011, 1016 (8th Cir. 2013) (observing that Section 1821(j) “constrain[s] the court’s equitable powers”); *Ambase Corp. v. United States*, 61 Fed. Cl. 794, 799 (2004) (Section 1821(j) “is not directed to the pursuit of money damages *ex post* as the result of FDIC actions. Instead, this section is intended to prevent injunctive relief against the FDIC’s actions as receiver.”). Because Plaintiffs seek only money damages in this suit, FHFA’s Section 4617(f) argument is without merit.

Conclusion

For the above reasons, this Court should deny FHFA’s Motion to Substitute.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on September 6, 2016, the foregoing document was filed with the Court's CM/ECF system, which will send electronic notice to all counsel of record.

/s/ Brad F. Barrios

Attorney