Government Perfidy and Mismanagement of the GSEs in Conservatorship

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PART ONE

Perfidy

I. Introduction

In September 2008, the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac were directed into government-controlled conservatorship by the U.S. Treasury and the Federal Housing Finance Administration (FHFA). With identical missions at inception—to support liquidity and stability in secondary mortgage markets—the GSEs continued to function perfectly in that capacity after being relegated to public ownership, operating as quasi-governmental publicly owned companies. The quasi-governmental nature of the companies' operations was instrumental in allowing a general market perception to develop of the GSEs' debt and preferred shares being risk-free by virtue of an implicit government guaranty of repayment.

In *On the Brink*, former Treasury Secretary Henry M. Paulson Jr. cites foreign government unease over the safety of their holdings of in excess of $1 trillion of Fannie/Freddie debt. Recounting a trip to Beijing in April 2008, he describes Chinese Vice Premier Wang Qishan as being "most interested in the problems in the U.S. capital markets." Paulson adds, "I was candid about our difficulties. . . . *I stressed that we understood our responsibilities*" (*Brink*, 128; emphasis added).

The announcement of the GSEs' having been placed into conservatorship was made at a press conference on Sunday, September 7. Secretary Paulson cited the government's tolerance in

allowing the market's perception of an implicit guaranty to gain adherence. The period of tolerance had gone on "too long," he said, and was central to the Treasury's decision to support and finance GSE operations in conservatorship.

Under the terms of a stock purchase agreement, Secretary Paulson said, "common and preferred shareholders bear losses ahead of the new government senior preferred shares." He noted that "conservatorship does not eliminate the outstanding preferred stock, but does place preferred shareholders second after the common shareholders in absorbing losses."

FHFA director James Lockhart, appearing with Paulson, said that "in order to conserve over $2 billion in capital every year, the common stock and preferred stock dividends will be eliminated, but the common and all preferred stocks will continue to remain outstanding. Subordinated debt interest and principal payments will continue to be made."[1]

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This paper examines the following issues:

(1) Did the GSE preferred shares enjoy an implicit guaranty of government repayment on and prior to September 7th, and, if so:

a. was the government's implicit guaranty of the preferred shares materially different from its implicit guaranty of GSE debt obligations;

b. was the government's implicit guaranty of the preferred shares terminated on September 7th;

c. was the government's implicit guaranty of the preferred shares terminated at any time after September 7th, or is it still extant?

[1] Hereinafter, the above-referenced September 7th statements by Secretary Paulson and Director Lockhart are collectively referred to as the Risk of Loss and Dividend Suspension Announcement.

II. The Federal Government's Implicit Guaranty of GSE Preferred Shares

A. Financial Obligations

In an April 2009 working paper entitled "The 2008 Federal Intervention to Stabilize Fannie Mae and Freddie Mac" ("Frame"), financial economist W. Scott Frame of the Federal Reserve Bank of Atlanta summarized the government's implicit guaranty of GSE securities: "The features of Fannie Mae's and Freddie Mac's federal charters, coupled with some past government actions, [have] long served to create a perception in financial markets that the federal government '*implicitly guarantees*' the GSEs' financial obligations [emphasis added]." Frame notes that this is so "despite explicit language on . . . the GSEs' securities that they are not obligations of the federal government." He also notes that the GSEs issue "'government securities' as classified under the Securities Exchange Act of 1934" (Frame, 6).

The question of whether or not preferred shares issued by Fannie Mae or Freddie Mac qualify as government securities is addressed and answered squarely in Comptroller of the Currency Administrator of National Banks Interpretive Letter #931 (hereinafter IL #931), dated March 15, 2002. Employing 12 U.S.C. 24(7) as its authority, IL #931 states as follows:

> Section 24(Seventh) permits national banks to hold "mortgages, obligations, or other securities which are or even have been sold by [Freddie Mac] pursuant to section 305 or section 306 of the Federal Home Loan Mortgage Corporation Act."[2] Section 306(g) of the Federal Home Loan Mortgage Corporation Act empowers Freddie Mac to issue "preferred stock on such terms and conditions as the Board of Directors shall prescribe."[3] Freddie Mac preferred

[2] Indeed, the OCC [Office of the Comptroller of the Currency] previously relied on this same language in Section 24(Seventh) in concluding that national banks may purchase and hold preferred stock of Freddie Mac. Interpretive Letter No. 577, reprinted in [1991–1992 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 83,347 (April 6, 1992).

[3] 12 U.S.C. 1455(f). [Notes 2–5 are reproduced from IL #931.]

stock is a "security"[4] that national banks may hold under section 24(Seventh).

Section 24(Seventh) also authorizes bans to purchase and hold Fannie Mae perpetual preferred stock. Section 24(Seventh) permits national banks to hold "obligations, participations, or other instruments of or issued by" Fannie Mae. Since the term "instrument" is commonly defined to include securities,[5] we believe this language affords a basis for national banks to purchase and hold Fannie Mae perpetual preferred stock.

Section 24(Seventh) generally restricts national banks' dealing, underwriting, purchasing and selling securities. Section 24(Seventh) exempts Freddie Mac "securities" and Fannie Mae "instruments" from these restrictions. Thus, banks' holdings of Freddie Mac and Fannie Mae preferred securities are not subject to quantitative limits, other than safety and soundness considerations. Examples of the prudential controls the OCC would expect to see in a bank investing in these instruments include: implementation of appropriate diversification principles, adoption of concentration limits on the securities of any one issuer and consideration of the impact on the bank's overall interest rate and liquidity risk profiles.

III. Conclusion

Accordingly, a national bank may invest in perpetual preferred stock issued by Fannie Mae and by Freddie Max. This investment is not subject to quantitative limits on the amount of such stock that the bank may hold, but the amount is subject to safety and soundness considerations, including the prudential controls noted above." (Comptroller of The Currency Interpretive Letter #931, p. 2)

B. Preferred Shares

The question of whether or not preferred shares issued by Fannie Mae or Freddie Mac were implicitly guaranteed by the federal government on or before September 7th is addressed and answered squarely in a Board of Governors of the Federal Reserve System Internal Discussion Paper dated March 2012 (hereinafter Federal Reserve Paper 1045), which deals with

[4] Interpretive Letter No. 577, *supra*.
[5] *Black's Law Dictionary*, 5th ed. (West 1979).

the effect on community bank solvency and lending practices emanating from the Risk of Loss and Dividend Suspension Announcement.

Federal Reserve Paper 1045 conclusively establishes the existence of the government's implicit guaranty of GSE preferred shares as being indisputable, central to the issuance of the shares, and patently responsible for their outsized inclusion in bank and thrift portfolios through September 7, 2008. The report is illuminating in its outline of the general accord that existed among Congress, Treasury, rating agencies, and bank regulators—that is, the Federal Reserve, the OCC, the Federal Deposit Insurance Corporation (FDIC), and so forth—in their recognition of an implicit guaranty. Ownership of the shares was promoted as being nearly risk-free and suitable for bank and thrift portfolios. Congressionally bestowed statutory benefits allowed banks and thrifts to hold GSE preferred securities as approved capital, and favorable tax treatment allowed these institutions to avoid income taxes on 70 percent of the dividends. Institutional trust in the government's implicit guaranty blindsided bank and thrift institutions into holding, as Tier 1 capital, a total of more than $8 billion of the $34 billion of the shares outstanding on September 7th.

The Aa3 credit rating (that is, high quality, very low credit risk) assigned by Moody's and others to GSE preferred shares contributed to banks', thrifts', and conservative investors' purchasing and holding them. The rating, which rested on the federal government's implicit guaranty of repayment, was downgraded first on July 15, 2008, and then on August 22, 2008, in reaction to the expected enactment of the Housing and Economic Recovery Act of 2008 (HERA) and related *New York Times* articles alluding to a possible government takeover of the companies.

After September 2008, various regulatory agencies explored conservatorship's effects on banks and thrifts with respect to their ownership of GSE preferred shares. One Treasury

investigation cited in Federal Reserve Paper 1045 quotes the Treasury Department's Inspector General as follows:

> One examiner stated that he would hesitate to tell a bank not to purchase GSE securities or raise a concentration concern because of the implied backing by the U.S. government. Two examiners told us that, in hindsight, it would have been a good idea to either mention the concentrations to management or require the bank to monitor its investment portfolio more closely. We accept that at the time NBC [National Bank of Commerce, described as "a small bank in Illinois with substantial GSE preferred stock investments"] made the purchases of the GSE securities, there would have been little basis to criticize the bank given the regulatory standards and perception of minimal risk associated with these holdings. Therefore, we do not fault OCC for not taking issue with NBC's investment practices. (Federal Reserve Paper 1045, 8)

Placing the GSEs into conservatorship resulted in their debt claim *financial obligations* being fully preserved, mortgage-backed securities *financial obligations* remaining intact, and dividends on common and preferred shares being wholly eliminated (absent explicit Treasury authorization). The government acquired nearly 80 percent equity *financial obligation* stake in each of the companies.

Financial markets interpreted the Risk of Loss and Dividend Suspension Announcement as an explicit repudiation of the federal government's implicit guaranty of its preferred share financial obligations—in turn resulting in near-total collapse of GSE preferred share market prices when the markets opened on Monday, September 8th. Prior to September 7th, despite widespread news coverage of the GSEs' financial stress (Fannie Mae, for example, reported a total loss of nearly $24 billion for the third quarter of 2007 through the first quarter of 2008), likely HERA enactment, and a rumored government takeover of the companies, preferred share prices had held up well. That wellness emanated almost wholly from the fact that the market continued to accept the government's implicit guaranty of repayment. In July and August, GSE

preferred shares consistently sold for between 45 percent and 60 percent of their stated face value.

Fannie Mae's common shares, which traded as high as $70.57 in 2007, closed at $28.12 on May 13, 2008, and traded as virtually worthless just prior to the September 7th announcement.

Fannie Mae Series T 8.25 Percent Preferred and Common Stock

Date	Event	Preferred Price	Common Price
2007–Summer 2008	At the urging of Treasury Secretary Paulson and Fed Chairman Ben Bernanke, the GSEs between year-end 2007 and summer 2008 collectively sold $22 billion of the $34 billion (that is, 65 percent) of the preferred shares outstanding on September 7th, 2008.		$70.57 (2007 high)
May 13, 2008	Citigroup, UBS, Merrill Lynch, Morgan Stanley, and Wachovia concluded an offering for the sale of 80 million shares of Fannie Mae 8.25 percent preferred T with stated face value of $25 (that is, $2 billion). The dividend rate of 8.25 percent was reflective of the changing market perception of risk attached to GSE debt, MBS, and preferred stock beginning late 2007. The Series T offering was preceded by a Fannie Mae 8.75 percent preferred share offering for 41,696,401 non-cumulative *mandatory convertible* shares with stated face value of $50 (that is, $2.1 billion).	$25	$28.12
July 10, 2008		$19.03	$13.11
July 11, 2008	*New York Times*, "U.S. Weighs Takeover of Two Mortgage Giants": "Alarmed by the growing financial stress at the nation's two largest mortgage finance companies, senior *Bush officials are considering a plan to have the government take over one or both of the companies and place them in conservatorship if their problems worsen*, people briefed about the plan said on Thursday. . . . "Under a conservatorship, the shares of Fannie and Freddie would be worth little or nothing. . . . "In the last week alone, Freddie has lost 45 percent of its value, and Fannie is off 30 percent. Expectations of default at the companies have also risen. . . .	$17.00	$10.18

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	"Shares of Freddie Mac plunged more than 30 percent and Fannie Mae's more than 20 percent in the first hour of trading on Thursday. By the close of trading, Fannie shares had fallen nearly 14 percent, and Freddie shares had dropped 22 percent. It was the second straight day of declines for the companies."		
July 14, 2008		$16.54	$9.67
July 15, 2008	Moody's downgrades the GSEs	$14.00	$7.02
August 11, 2008	Fannie declares a quarterly dividend of $0.5156 per share payable September 11, 2008, on Series T preferred shares	$16.35	$8.35
August 19, 2008		$13.78	$6.01
August 20, 2008	*New York Times*: "Shares of the mortgage finance giants, Fannie Mae and Freddie Mac, declined almost 25 percent on Wednesday on concerns that the companies will need a bailout from the federal government. "The decline almost matched the more than 24 percent drop on Monday and Tuesday. On Wednesday, Fannie Mae shares closed down 26.79 percent or $1.61 to $4.40."	$10.99	$4.40
August 21, 2008		$10.80	$4.85
August 22, 2008	Friday, 3:00 p.m. Wachtell, Lipton, Rosen & Katz hired by Secretary Paulson to put the GSEs into *receivership*. Moody's issues its 2nd downgrade of GSE preferred shares.	$10.90	$5.00
September 5, 2008	Friday pre-conservatorship closing price	$13.70	$7.04
September 8, 2008	Conservatorship announced Sunday, September 7, 2008	$3.00	$0.73
September 11, 2008	Fannie pays a dividend of $0.5156 on its T series preferred shares	$2.45	$0.78

As illustrated above, in the case of Fannie Mae's 8.25 percent preferred Series T shares, the market's perception of an implicit government guaranty for GSE preferred shares as a *financial obligation* was instrumental in the shares' market price holding up reasonably well from their May issuance through their September 8th collapse.

I was unable to find any evidence of Secretary Paulson's having focused on the implicit guaranty of GSE preferred shares at any time prior to September 7th. I have also been unable to find any direct mention of the implicit government guaranty in the memoirs of Secretary Paulson, Secretary Timothy Geithner, or Chairman Bernanke. Indirect examples of Secretary Paulson's and Treasury's knowledge of and exploitation of the government's implicit guaranty in promoting Fannie Mae's sale of $7.4 billion of its preferred and common shares in May 2008 are set forth in Appendix II, below. Regarding Wachtell, Lipton, Rosen & Katz ("Wachtell"), first employed to serve as outside conservatorship counsel to the government on August 22nd, I have been unable to ascertain their having any knowledge of the implicit guaranty at any time prior to September 7th.

As we have seen, market reaction to the Risk of Loss and Dividend Suspension Announcement was swift. On Monday, September 8, the Series T preferred share price collapsed by nearly 78 percent, a result of the market's interpreting Secretary Paulson's statement as an explicit government rejection of and abandonment of the guaranty of repayment.

C. Common Shares

Rather than revisit the legal road traversed in my conclusion that the GSE preferred shares are "*government securities*," let's simply employ basic logic in concluding that GSE common shares enjoy similar "government security" status. In May 2008 Fannie Mae sold 41,808,401 of $50 stated value 8.75 percent noncumulative mandatory convertible preferred shares, Series 2008-1 ($2.2 billion). While the transformation of the preferred shares into common shares would obviously change the extent of the government's implicit guaranty from the preferred shares' stated value to the converted shares' par value, it most certainly did not eliminate the shares' provenance as *government security obligations*. And while preferred shares

converted into common shares would then not qualify for inclusion in bank portfolios as Tier 1 capital, the common shares most certainly could be retained by bank owners as government securities acceptable for bank portfolio ownership at levels acceptable to the institution's regulators.

III. What Went Wrong

A. September 7, 2008

Prior to making the September 7th announcement, Secretary Paulson recounts that he called Chinese Vice Premier Wang Quishan: "'*I always said we'd live up to our obligations*,' I reminded Wang. '*We take them seriously*.'" (*Brink*, 15; emphasis added.) Secretary Paulson's belief in and personal allegiance to a heightened code of ethical conduct in dealings both governmental and private is well evidenced throughout *Brink*. Had he intended the Risk of Loss and Dividend Suspension Announcement to serve as the government's explicit abandonment and rejection of its prior implicit share guaranty, he would have said as much. A man who understands responsibility and takes it seriously does not employ equivocal or ambiguous language in announcing the abandonment of a responsibility. We thus need to examine Secretary Paulson's September 7th statement in order to form a clearer understanding of its intended reach and to understand what went wrong.

(1) Secretary Paulson's Statement	**Commentary**
Additionally, under the terms of the agreement,	Were the GSEs ordinary,

common and preferred shareholders bear losses ahead of the new government senior preferred shares.

rather than government-sponsored, entities, Secretary Paulson's prioritizing of common over preferred in loss incurrence would be correct. However, Fannie and Freddie were government-sponsored entities, and Secretary Paulson should have qualified his announcement to reflect that fact. What he should have said was that preferred share loss was limited to approximately $2 billion of annual passed dividends by reason of the implicit government guaranty.

These Preferred Stock Purchase Agreements were made necessary by the ambiguities in the GSE Congressional charters, which have been perceived to indicate government support for agency debt and guaranteed MBS. Our nation has tolerated these ambiguities for too long, and as a result GSE debt and MBS are held by central banks and investors throughout the United States and around the world who believe them to be virtually risk-free. Because the U.S. Government created these ambiguities, we have a responsibility to both avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings of GSE debt and MBS.

Secretary Paulson neither seeks to evade nor minimizes government responsibility for having allowed GSE debt and MBS implicit guaranty ambiguities to arise and continue. The absence of a similar ethical reference with regard to the GSE preferred shares as government security financial obligations speaks volumes!

Market discipline is best served when shareholders bear both the risk and the reward of their investment. While conservatorship does not eliminate the common stock, it does place common shareholders last in terms of claims on the assets of the enterprise.

The statement regarding common shares bearing first market risk in the event of conservatorship loss incurrence is correct for both traditional and government-sponsored entities.

Similarly, conservatorship does not eliminate the outstanding preferred stock, but *does place preferred shareholders second, after the common shareholders, in absorbing losses*.

Secretary Paulson's statement of preferred shares sitting in second place behind common shares in risk of loss

The federal banking agencies are assessing the exposures of banks and thrifts to Fannie Mae and Freddie Mac. The agencies believe that, while many institutions hold common or preferred shares of these two GSEs, *only a limited number of smaller institutions have holdings that are significant compared to their capital*. (Emphasis added.)

sufferance is inappropriate because it ignores the explicit federal government guaranty of repayment.

The agencies encourage depository institutions to contact their primary federal regulator if they believe that losses on their holdings of Fannie Mae or Freddie Mac common or preferred shares, whether realized or unrealized, are likely to reduce their regulatory capital below "well capitalized." The banking agencies are prepared to work with the affected institutions to develop capital restoration plans consistent with the capital regulations.

Secretary Paulson's comment with regard to federal banking agencies assessing bank and thrift exposure is indicative of a concern limited to dividend suspension rather than one that includes intentional explicit guaranty rejection. In short, his concern is for small banks no longer being able to claim preferred share ownership as risk-free capital by reason of the conservatorship-imposed suspension of preferred dividend payment.

(2) <u>FHFA Director James Lockhart's Statement</u>

. . . in order to conserve over $2 billion in capital every year, the common stock and preferred stock dividends will be eliminated, but the common and all preferred stocks will continue to remain outstanding. Subordinated debt interest and principal payments will continue to be made.

<u>Commentary</u>

Dividends on Freddie Mac common and preferred shares were passed following the second quarter of 2008. In August 2008 Fannie's board of directors reduced its common stock dividend to $.05 per share for the third quarter of 2008. Fannie's board of directors prior to September 7th had declared a dividend on its preferred shares of between $100 million and $300 million payable at the end of the company's third quarter.

B. Where Were the Regulators?

Sheila Bair served as chair of the FDIC from June 6, 2006, to July 8, 2011. Treasury Secretary Paulson, New York Federal Reserve President Geithner, and Federal Reserve Chairman Bernanke were unanimous in praise of her tenacious guarding of the FDIC's insurance fund and efforts to access Troubled Asset Relief Program (TARP) funds for besieged mortgage borrowers.

Prior to September 7th, Bair was fully aware of the implicit government guaranty of GSE preferred shares. As noted in Federal Reserve Paper 1045, "the FDIC explicitly authorized state banks to invest up to 15 percent of Tier 1 capital in such an investment without the FDIC's prior consent, stating that such an investment does not represent a significant risk to the Deposit Insurance Fund. In other cases, the FDIC consented to banks investing up to 100 percent of their Tier 1 capital in auction rate preferred stock" (10).

Why, then, didn't Bair or any other regulatory head issue a warning to either Secretary Paulson or government counsel Wachtell regarding the implicit guaranty? Answer: Until the Risk of Loss and Dividend Suspension Announcement was made, neither Bair nor any other regulator was consulted. The decision to enter conservatorship was treated as top secret. By the time the issue arose after September 7th, Bair had more immediate demons, such as WaMu, Wachovia, and Indie Mac, to focus upon.

From September 7, 2008, through year-end 2009, 139 banks and 26 other depository institutions under FDIC jurisdiction failed. The FDIC in the course of the liquidation of those institutions accumulated approximately 31 million shares of GSE preferred stock whose stated face value was in excess of $1 billion. The FDIC sold those shares in the open market shortly before the expiration of Bair's term in July 2011. I posit that the FDIC held onto the shares for

nearly two years in tacit expectation of renewed market appreciation for their implicit government guaranty. I further posit that the sale was likely a response to a February 2011 Treasury white paper entitled "Reforming America's Housing Finance Market," which, as discussed later, called for elimination of the GSEs under various wind-down scenarios, although without specific mention of the companies other than by implication.

C. Blowback, Advice of Counsel, the Law, and GSE Third-Quarter Dividend Payments

1. **Blowback**

Banking industry reaction after September 7th appears to have been muted—limited to letters to the Treasury and the Fed from the American Bankers Association and the Independent Community Bankers of America, complaining of the deleterious effect, on bank capital and lending policies, of suspending dividend payments. However, with the financial crisis mushrooming and nearly all eyes shifting from the GSEs to the banking sector, the issue never gained momentum.

Timothy Geithner served as the ninth president of the Federal Reserve Bank of New York between 2003 and 2009. Geithner and Fed Chairman Bernanke were instrumental in helping Secretary Paulson formulate and effectuate HERA's enactment, the GSE conservatorship, and TARP. In *Stress Test*, Secretary Geithner describes Washington's reaction to Secretary Paulson and the conservatorship announcement:

> Hank took a lot of grief for firing the bazooka so soon after telling Congress he wouldn't have to, and his reversal did give the impression that we were lurching from emergency to emergency

> without a comprehensive plan. But he did the right and courageous thing, heedless of the political costs. . . .
>
> The reaction to Fannie and Freddie quickly made the backlash over Bear look mild. Senator [Jim] Bunning, who had said the Bear deal's assault on free enterprise made him feel like he lived in France, now said he felt like he lived in China. Senator Obama and the Republican presidential nominee, John McCain, both expressed outrage about pubic rescues of private firms, although they didn't directly criticize what Hank had done. McCain and his running mate, Sarah Palin, wrote a *Wall Street Journal* op-ed titled "We'll Protect Taxpayers from More Bailouts." Obama's campaign put out word that he didn't want a taxpayer-financed rescue of Lehman, which was also the emphatic consensus of both parties in Congress.
>
> The economy was clearly deteriorating with unemployment up to 6.1 percent, and no politician wanted to get on the wrong side of rising populist anger. (*Stress Test*, 175)

In the expanding anti-bank, anti–Wall Street, post–September 7th Washington political climate, Secretary Paulson was in no position to address the unintended consequence of his having lumped common and preferred shares together as shock absorbers. In addition, the preferred share price collapse resulting from the market's response to the Risk of Loss and Dividend Suspension Announcement rendered corrective retraction meaningless.

With HERA's enactment likely and newspapers warning of possible GSE takeover by the government, the market had already priced a conservatorship dividend suspension into GSE preferred shares by July. What the market had not done prior to September 7th was to price a government rejection of the implicit guaranty into the shares' market price. Market-efficient pricing in response to the government's seeming rejection of the implicit guaranty took place on September 8th.

Secretary Paulson, for reasons both political and economic, could not publicly correct or amend the September 7th announcement. Treasury did introduce a bank-specific bespoke tax relief program, allowing bank owners to treat their GSE share losses as ordinary income losses

rather than capital losses, and qualified banks were permitted entry into the TARP program. However, no similar relief was afforded non-bank preferred share owners.

2. Advice of Counsel

a. Timeline

Employing *Brink* as my guide, I constructed the following timeline for events preceding the September 7th conservatorship announcement.

Timeline

August 1–15	Treasury retains Morgan Stanley to perform an in-depth review of the GSEs' cash flow, portfolio holdings, and debt obligations.
August 16	Secretary Paulson concludes that he needs to get FHFA to put the GSEs into receivership. Treasury provides the FHFA with Fed, OCC, and Morgan Stanley cash flow reviews of the GSEs' portfolio holdings and debt obligations.
August 22	Secretary Paulson hires Wachtell to serve as the government's outside conservatorship counsel, to guide it through the legal intricacies of law and corporate governance attendant to his decision to place the companies into receivership, or liquidation.
August 23	Wachtell advises Secretary Paulson that in order to avoid practical and technical

difficulties such as early derivative contract terminations, the government would need to pursue conservatorship (like Chapter 11) rather than receivership for the GSEs.

September 5 Treasury, Fed, and FHFA officials meet with GSE management to advise them of the government's decision to place the companies into conservatorship.

September 6 Treasury, Fed, and FHFA officials meet with GSE boards of directors and demand that they agree to the companies' being placed into conservatorship.

b. Wachtell

Wachtell, Lipton, Rosen & Katz was hired by Secretary Paulson at 3:00 p.m. on Friday, August 22, 2008, to guide the government through the intricacies of what Secretary Paulson initially believed was going to be a GSE *liquidating receivership*.

> By the next morning they [Wachtell] had torn through the GSEs' debt and preferred stock document, and concluded that going the receivership route would be perilous for a number of practical and technical reasons. That approach would be terribly disruptive to the GSEs' businesses and extremely difficult to implement successfully in a short time frame, especially without the active involvement and cooperation of the GSEs' management in the planning stages. It would also have posed risks of court challenges and the early termination of the GSEs' valuable derivatives contracts. Receivership, which is used to liquidate companies, might trigger consequences every bit as bad as those we were trying to avoid, Wachtell said. By contrast, conservatorship was more like a Chapter 11 bankruptcy, where companies kept their current forms; it would provide a stable time-out for the GSEs to avoid defaulting on their debs and could be accomplished quickly.

> We were in a race against time. The markets were fragile, and we knew that September was going to be even rockier. Lehman was going to announce a dreadful loss, and Washington Mutual and Wachovia both appeared headed for trouble. We needed to take care of Fannie and Freddie before then or we would have a real problem. (*Brink*, 164)

Operating in total secrecy from New York, Wachtell miraculously effected the companies' entrance into conservatorship without aid from company management, company counsel, or federal regulators. The only reasonable explanation for Wachtell's not having addressed and dealt with the preferred share implicit guaranty issue prior to September 7th lies in the firm's not having been told of it.

Neither the GSEs' debt nor preferred stock documents refer to an implicit guaranty of repayment. Had Wachtell been alerted to the implicit guaranty, it could easily have adjusted the Risk of Loss and Dividend Announcement as set forth below.

> Additionally, under the terms of the agreement common ~~and preferred~~ shareholders bear losses ahead of the new government senior preferred shares. In accordance with the Stock Purchase Agreement, and Conservatorship Law, *annual dividend payments on the companies' preferred and common shares of approximately $2 billion have been suspended*.
>
> These Preferred Stock Purchase Agreements were made necessary by the ambiguities in the GSE Congressional charters, which have been perceived to indicate government support for agency debt, ~~and~~ guaranteed MBS, *and preferred shares*. Our nation has tolerated these ambiguities for too long, and as a result GSE debt, ~~and~~ MBS*, and preferred shares* are held by central banks and investors throughout the United States and around the world who believe them to be virtually risk-free. Because the U.S. Government created these ambiguities, we have a responsibility to both avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings of GSE debt, MBS*, and preferred shares*. ~~Similarly, conservatorship does not eliminate the outstanding preferred stock, but does place preferred shareholders second, after the common shareholders, in absorbing losses~~.

3. The Law of Dividend Payment

Authority for the FHFA to place the GSEs into conservatorship and act as conservator stems from the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended by HERA in 2008. HERA replaced the act's conservatorship provisions with provisions based generally on federal bankruptcy law.

Under the United States Bankruptcy Code ("Bankruptcy Code"), the law dealing with dividend payments in insolvency is simple and unambiguous: A company while in bankruptcy has no legal power to reduce the insolvent estate by means of a dividend distribution to shareholders. That general rule persists in regard to both common and preferred share dividends, and it obtains even in the instance of preferred share dividends declared prior to, but unpaid as of, a company's entry into insolvency proceedings. The rule with regard to dividends payments by companies in conservatorship is in accord with that of the Bankruptcy Code.

The GSEs' preferred shares are redeemable at the companies' discretion at or after specified redemption dates. The shares are otherwise perpetual, noncumulative, and nonvoting. All of the foregoing is cited in support of my concluding that the government's implicit guaranty of the GSEs' preferred shares is not materially different from its implicit guaranty of GSE debt.

Absent conservatorship and Senior Preferred Stock Purchase Agreement (SPSPA) provisions, the dividends payable on every series of GSE preferred shares are noncumulative, declarable, and payable at the reasonable (good-faith) discretion of the companies' boards of directors. The GSEs' boards of directors' ability to eliminate dividend payments on the companies' noncumulative preferred shares is subject to discretionary review for reasonableness.

IV. Fannie Mae's Third-Quarter 2008 Multi-Million-Dollar Dividend Payments

A. Prohibition

Freddie Mac neither declared nor paid any share dividends in the third quarter of 2008 (Freddie Mac 10Q September 30, 2008, p. 138, note 8). However, Federal Reserve Report 1045 and Fannie Mae, in its 10K for 2008, admit to a Fannie Mae third-quarter preferred share dividend payment as follows:

> 1. The conservator announced on September 7, 2008, that we would not pay any dividends on the common stock or on any series of outstanding preferred stock. In addition, the senior preferred stock purchase agreement prohibits us from declaring or paying any dividends on Fannie Mae equity securities (other than the senior preferred stock) without the prior written consent of Treasury. *We were permitted to pay previously declared but unpaid dividends on our outstanding preferred stock for the third quarter*." (Fannie Mae 10K December 31, 2008, Part II, p. 76; emphasis added)
> 2. A last dividend payment was made at the end of the third quarter because it had been previously announced. *The Treasury believed it was legally obligated to make the payments given the prior announcement*." (Federal Reserve Paper 1045, p. 6, note 5; emphasis added)

Freddie Mac, in its 10K for 2008, discusses the restrictions of its payment of dividends:

> Our payment of dividends is subject to the following restrictions:
>
> *Restriction Relating to Conservatorship*
>
> As Conservator, FHFA announced on September 7, 2008 that we would not pay any dividends of the common stock or on any series of preferred stock (other than the senior preferred stock). FHFA has also instructed our Board of Directors that it should consult with and obtain the approval of FHFA before taking actions involving dividends.
>
> *Restrictions Under Purchase Agreement* [SPSPA]
>
> The Purchase Agreement prohibits us from declaring or paying any dividends on Freddie Mac equity securities (other than the senior

> preferred stock) without the prior written consent of Treasury. (Freddie Mac 10K December 31, 2008, Part II, pp. 60–61)

Dividend payments on GSE preferred shares after September 7th were strictly prohibited, singly and in combination, by HERA provision, FHFA direction, and SPSPA agreement. *Yet following the Risk of Loss and Dividend Suspension Announcement, Fannie Mae paid an absolutely prohibited, patently illegal dividend of between $100 million and $300 million to the holders of certain of its preferred shares prior to the third quarter's end.* How did it do so, and why did it do so?

B. How and Why: Random Thoughts

The legal and contractual restrictions on GSE preferred share dividend payments in conservatorship announced on September 7th are clear and straightforward. Nevertheless, Fannie Mae was "*permitted to pay previously declared but unpaid dividends on our [its] outstanding preferred stock for the third quarter*." One can imagine the following conversations taking place between Fannie Mae and Treasury officials on September 8th and 9th:

September 8th

Fannie: Hey, guys, thanks for taking our call, but we think we need to get some clarification with regard to yesterday's dividend suspension announcement. We are uncertain as to whether or not the dividend payment restriction announced yesterday applies to the $100 million which we deposited with our paying agent last Friday to fund the dividends payable on the $4.325 billion of preferred shares that we were able to sell in May, thanks to the bosses' ongoing implicit guaranty of our securities.

Treasury: When is the payment scheduled to be made?

Fannie: Thursday.

Treasury: Uh, thanks, we'll get back to you.

September 9th

Treasury: Hey, guys, thanks for taking our call. *We believe that you are legally obligated to make the payments because of their prior announcements*.

Fannie: That's a yes, no?

Treasury: Make the payment!!!

Fannie: Can we have it in writing?

(*Zzzz*. *Connection broken*.)

Other people get paid for making jokes. I don't. But given that there is so little documentation, we can only assume that on September 8, 2008, when Treasury directed Fannie Mae to make a third-quarter dividend payment, the payment directive was issued using language substantially in accord with that reported in 2012 by the authors of Federal Reserve Paper 1045: "The Treasury believed it was *legally obligated* to make the payments given the prior announcement" (Federal Reserve Paper 1045, p. 6, note 5; emphasis added). With prior declaration being legally irrelevant in the absence of an overriding legal directive, the sole justification for Fannie's September 2008 dividend payments can only be anticipatory breach. The payment was morally mandated rather than strictly legal-driven. Treasury wanted to avoid litigation claims.

What the government might have said to Fannie was:

> Payment of Fannie's declared but unpaid preferred share dividends were made necessary by the ambiguities in the GSE Congressional charters, which have been perceived to indicate government support for preferred shares' stated value in liquidation. Our nation has tolerated these ambiguities for too long, and as a result GSE preferred shares are held by central banks and investors throughout the United States and around the world who believe them to be virtually risk-free. Because the U.S. Government created these ambiguities, we have a responsibility to both avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings of GSE preferred shares.

Treasury, for political and economic reasons, could not have publicly made the statement set forth above in the period between September 8th and September 11th, 2008. However, it most certainly could have made the statement to Fannie Mae in confidential memorandum. Treasury's failure to do so marks the onset of the government's perfidious conduct in its treatment of GSE preferred share owners in conservatorship.

V. Omertà

Omertà is an intensely strict code of silence among persons in near-conspiratorial agreement. I don't intend to insult the government by using the term. Rather, I intend to fix September 8, 2008, as the onset of the federal government's silence on the subject of the implicit guaranty of payment of the GSE preferred shares.

In February 2011, Treasury issued a 32-page white paper to Congress entitled "Reforming America's Housing Finance Market." At its core, the paper sets forth as its objective "the orderly and deliberate wind down of Fannie Mae and Freddie Mac." Three wind-down options are laid out. The paper contains no mention of either GSE preferred shares or the federal government's implicit guaranty of the shares' repayment: it's sort of a no-harm, no-foul *erasure* of the government's implicit guaranty. Effectively, the government after September 7th converted Secretary Paulson's innocent conflation of common and preferred shares into an unspoken government policy of denying repayment to preferred shareholders absent GSE liquidation.

As luck would have it, the government till now has enjoyed a virtually litigation-free period with respect to the preferred share implicit guaranty issue. Adding to its good fortune is the silence of the press.

A. Litigation

1. In re Fannie Mae 2008 Securitas Litigation

By year-end 2008, several class-action lawsuits had been initiated against Fannie Mae in connection with preferred share and common security offerings made between November 2007 and May 2008. All of the suits alleged violation of the 1933 Securities Act (the "1933 Act"). None alleged breach of the implicit guaranty. The suits were dismissed in November 2009 by reason of Fannie Mae's status as a government instrumentality, which specifically exempts it from any 1933 Act liability.

2. The Third Amendment Lawsuits

Following the passage, in August 2012, of the Third Amendment to the SPSPA, which authorized a net-worth dividend sweep, a series of lawsuits were initiated alleging breach of contract and government taking. To date, none of the lawsuits have alleged either breach or anticipatory breach of the government's implicit guaranty of the GSE preferred shares' repayment. My guess is that allegations of implicit guaranty breach by reason of the government's bad faith in restricting preferred share dividend payments amid a cornucopia of positive earnings will not be long in coming.

B. The Press

Prior to a recent spate of articles questioning the government's direction and the financial management of the GSEs in conservatorship (discussed below in Part Two), the government has enjoyed near-universal favorable financial press coverage in connection with the Third Amendment sweep and attendant litigation. Two *Wall Street Journal* opinion pieces are

illustrative of the press's unquestioning acceptance. (Links to the full articles may be found in Appendix II, below.)

1. <u>Holman W. Jenkins Jr.</u>

In "Fannie and Freddie's Propaganda War," a *Wall Street Journal* article dated December 12, 2015, Holman Jenkins wrote:

> By far the loudest voice raised against Fannie and Freddie's long-discussed liquidation comes from big-time fund managers Bill Ackman of Pershing Capital, Richard Perry of Perry Capital, and Bruce Berkowitz of Fairholme Capital Management.
>
> Why? After noticing that the government's stated, bipartisan intention to wind them up had driven down their shares to penny-stock levels, these fund managers opportunistically began buying great gobs of their stock. These funds were able to score large, instant profits for their investors simply by mounting a visible campaign to suggest the government's intended outcome might be in doubt.

Ackman's fund owns mostly, if not entirely, GSE common shares, and Perry's fund and Berkowitz's fund own mostly, if not entirely, GSE preferred shares. I own GSE preferred shares, and since before September 7th, I have not owned any GSE common shares. One would expect a reporter of Mr. Jenkins's stature to ferret out the existence of possible divergence in motive and investment strategy among the three fund managers. With common and preferred firmly fixed as one in his mind, Jenkins thus mistakenly refers to the three fund managers in the singular as "the loudest voice."

Citing the government's "stated, bipartisan intention to wind them up" as the three fund managers' opportunistic buying point is of course ludicrous given Treasury's 2011 white paper wind-down announcement. I don't speak for any of the three fund managers. I do, however, speak for myself as owner of both Fannie Mae and Freddie Mac preferred shares. I believe that both Perry and Berkowitz, if asked, would have told Jenkins of their commitment to seeing the

GSEs being adequately recapitalized and responsibly reprivatized following the enactment of legislative reform. If asked, I believe the fund managers would tell Jenkins that their immediate objective is not recap and release but rather to compel the return of the $200 billion of Treasury-looted assets to the companies. If asked, I believe that they would implore Jenkins to employ his *Wall Street Journal* pulpit to urge the government to abandon asset looting, abandon its policy of omertà in regard to the GSE implicit guaranty, and issue something like the following:

> Directing the GSEs into conservatorship and restricting the payment of preferred share dividends was made necessary by the financial crisis of 2008. In the past, ambiguities in the GSE congressional charters were perceived to indicate government support for GSE preferred share stated value repayment. Our nation has tolerated these ambiguities for too long. GSE preferred shares were held by banks and investors throughout the United States and around the world who believed them to be virtually risk-free. Because the U.S. government created these ambiguities, we have a responsibility to both avert and ultimately address the issue of investor holdings of GSE preferred shares. Effective as of August 2012, the Third Amendment cash sweep is being retroactively terminated. Dividend payments on GSE preferred shares will be resumed as of that date.

2. John Carney

On December 18, 2015, the *Wall Street Journal* published John Carney's "Why Fannie Mae Revival Hopes Are Withering on Capitol Hill," in which Carney refers to the Jumpstart GSE Reform Act of 2015–16:

> The catalyst appears to be a small provision known as the Jumpstart GSE Act in the omnibus spending agreement reached on Capitol Hill. The provision prohibits Treasury from selling its preferred stakes in the mortgage-finance companies for at least two years.
>
> This effectively rules out any chance the companies could be recapitalized and released from conservatorship until 2018, something for which a coalition of investment firms and affordable-housing advocates have been pushing.

> At first blush, that shouldn't be cause for despair for Fannie and Freddie shareholders. After all, officials from the White House and Treasury Department have made clear they oppose recap and release.
>
> Despite this, some investors had held out hope. They should now let it go—the thing that wasn't going to happen really, really isn't going to happen.
>
> A bigger negative, though, may be the effect Jumpstart could have on lawsuits brought against the government by several shareholders. These ask courts to undo a 2012 deal that requires the companies to pay nearly all of the earnings in dividends to the Treasury.
>
> Jumpstart may hurt the shareholder cases because it suggests Congress agrees with Treasury that the profit sweep is legal.

One might reasonably expect a reporter of Mr. Carney's stature to at least question the supposed coalition's members as unified in an immediate "recap and release" agenda. One might reasonably expect a reporter of Mr. Carney's stature to have directly sought confirmation from one or more of the acknowledged GSE preferred share owners regarding the owner's Jumpstart enactment views. Had Mr. Carney contacted me, for example, I would have told him that the Jumpstart GSE Reform Act provisions contained in the federal budget specifically prohibit Treasury for two years from "selling, transferring, relinquishing, liquidating, divesting, or otherwise disposing of any outstanding shares of senior preferred stock acquired pursuant to a specified Senior Preferred Stock Purchase Agreement between Treasury and an enterprise until Congress has passed and the President has signed into law legislation that includes a specific transfer of the preferred stock so acquired." I would have said that to me, Jumpstart is little more than a feeble congressional finger in the dyke, seeking to blunt the tidal buildup of negative public reaction emanating from media exposés of Treasury asset looting. I would have pointed to two pieces—the December 12, 2015, *New York Times* article entitled "Fannie and Freddie Government Rescue Has Come with Claws ("Claws") and *Fortune* magazine's "Uncle Sam's

$130 Billion Money Grab," published on December 1, 2015—as the basis of my view. Finally, I would say, "Mr. Carney, you've been had by government omertà, and you really should read Federal Reserve System Internal Discussion Paper 1045." I am not a member of any coalition, and I don't know what other GSE preferred shareholders advocate or hold dear, but GSE preferred share owner Joshua Angel's GSE timetable does not include immediate GSE recap and release. Rather, Joshua Angel wants the federal government to immediately stop its GSE asset looting, abandon its policy of omertà in regard to the implicit guaranty, and restore GSE preferred share dividend payments.

For virtually all of the fifty-seven years following my graduation from Columbia Law School in 1959, I have labored as a practicing attorney specializing in commercial insolvency, initially as the founder and managing partner of Angel & Frankel, PC, and then for the past ten years as senior counsel to Herrick, Feinstein LLP. For me, the GSE conservatorship is just another bankruptcy, albeit one that has consumed me as an investor since late 2013. As an insolvency attorney, my habit has been to learn as much as I can about a case for which I am being engaged, even before the engagement's formal onset. As a self-directed nonprofessional investor I follow the same procedure, albeit with less success than I enjoyed in my more active professional life. My GSE implicit government guaranty epiphany did not come to me in an instant, or at the onset of making an investment in GSE preferred shares. Rather, it came to me, as in my active practice days, by dint of habitual, continuous case questioning and evidence examination. Holman Jenkins and John Carney are highly respected journalists. I fault them not because we have different opinions but rather because in voicing their opinions they stopped looking, while I did not.

PART TWO

Mismanagement

I. A Tale of Two Cases

A. <u>The GSE Fraud Recovery Case</u>

With apologies to Dickens, "the worst of times" for Fannie Mae and Freddie Mac was undoubtedly marked by their 2008 descent into government-directed conservatorship with a government federal agency as their administrator. The government's chief rationale for the action was the theoretical risk of depression that it was believed a GSE failure would pose. From the onset of their conservatorships, the companies were demonized as pervasive wrongdoers and blamed for the collapse of the housing mortgage market. In 2008 Secretary Paulson described conservatorship as a sort of beneficent "time-out" during which Congress and a new administration could address potential reform. A presumably benign conservatorship was in short order transformed into de facto nationalization. James Lockhart, employing HERA-endowed powers, (a) opted to appoint the FHFA, rather than an independent person, to serve as conservator, and (b) discharged the GSEs' independent boards of directors and replaced them with FHFA nominees whose sole fiduciary obligation and duty was to the GSE conservator (collectively hereinafter "Elimination of GSE Fiduciary Oversight"). The Elimination of GSE Fiduciary Oversight early on set the stage for the two companies to be drafted into government service in order to effect the Obama administration's off-budget housing assistance and

economic recovery programs. The Elimination of GSE Fiduciary Oversight marks the onset of Treasury's $200 billion asset looting, carried out with the blessing of the conservator and a captive GSE board of directors.

Attendant to the companies' de facto nationalization, the entire cost of the government's Home Affordable Refinance Program (HARP) and the administrative cost of its Home Affordable Modification Program (HAMP) were legislatively offloaded onto the GSEs without public comment and without resistance from the captive board of directors. Concurrent with de facto nationalization, owners of GSE common and preferred shares lulled themselves into complacency by accepting HERA's statutory admonition that the FHFA's management of the GSEs be conducted to "preserve and conserve" GSE assets and property in "sound and solvent condition."

A 2010 Treasury memorandum outlined "the administration's commitment to ensure existing *common equity owners* (emphasis added) will not have access to any positive earnings from the GSEs in the future." The memorandum did not surface publicly until March 2014. FHFA brought suit in September 2011 against eighteen financial institutions, alleging fraudulent misrepresentation and violation of the Securities Act of 1933 in connection with the pre-conservatorship sale of more than $200 billion of allegedly defective mortgage debt to the GSEs (collectively the "GSE Fraud Recovery Case"). By spring 2015, nearly $20 billion in settlement and trial judgment recoveries were obtained by the FHFA on behalf of the GSEs from seventeen of the eighteen case defendants. The eighteenth GSE Fraud Recovery Case is expected to go to trial this year. Based upon results obtained in the seventeen concluded actions, a recovery estimate of $5 billion from the eighteenth case would appear to be reasonable (collectively "Litigation Recoveries").

In “Claws,” Gretchen Morgenson, the *New York Times* assistant business and financial editor, cites an FHFA source for her fixing Treasury’s 2013/2014 GSE litigation haul at $38.5 billion. The proceeds obtained, together with case-revealed evidence of pervasive mortgage originator fraud, provide conclusive evidence of the GSEs as victims of, rather than perpetrators in, the mortgage market’s collapse. Despite overwhelming evidence to the contrary, the GSEs, rather than the truly responsible too-big-to-fail mortgage originators, continue to be vilified politically and by the media as public enemy number one in the great recession.

Fixated with a depression mentality, the Treasury directed that the GSEs’ financial statements be adjusted to reflect massive deferred tax asset write-offs and aggressive increases in securitized mortgage loss reserves totaling nearly $100 billion (the “Depression-Guess GSE Capital Losses”). Treasury-directed Depression-Guess GSE Capital Losses were a key both to Treasury’s obtaining the FHFA’s 2008 declaration of GSE insolvency and the resulting imposition of conservatorship. Ironically, seven years later, Litigation Recoveries obtained from the FHFA’s conduct of the GSE Fraud Recovery Case, together with the reversal of nearly $100 billion of Depression-Guess GSE Capital Losses, provided the vast majority of the real $130 billion GSE *cash* payment to Treasury in excess of the 10 percent dividend initially imposed by the 2008 SPSPA. That $130 billion payment was effected pursuant to the net-worth sweep imposed by the Third Amendment. It was wordlessly accompanied by the unannounced expansion of the 2010 Treasury memorandum policy into the unwritten policy of omertà and perpetual denial of shareholder access to positive GSE earnings.

As noted in “Claws,” “The timing of the 2012 profit sweep announcement was fortunate for the Obama administration: It followed a tumultuous period when government spending had come up against the debt ceiling, threatening to cause a federal default with potentially catastrophic consequences. Since then, the profits from Fannie and Freddie have helped the

Treasury Department manage its debt during showdowns with Congress." For the mathematically minded, adding approximately $46 billion of unreimbursed HARP/HAMP expenses to approximately $20 billion of Litigation Recoveries and then adding the $130 billion Third Amendment sweep adds up to nearly $200 billion of assets looted by the government.

***

My belief is that, while the money was great, Treasury's main purpose in effectuating the Third Amendment looting of assets did not originate in the administration's need to raise cash attendant to its dysfunctional budget relationship with Congress. Rather, I believe that the Third Amendment dividend sweep had its origin in anticipation of GSE profits likely leading to shareholder demand for dividend payments. When the SPSA was executed in September 2008, Treasury had little to fear that the dividend restriction provisions of the document would or could be complained of.

Federal Court of Claims' information recoveries revealed to date have already completely eviscerated the government's stated rational for the Third Amendment net-worth sweep. As litigation continues, the Treasury-imposed omertà-like silence will break, and truth in government will once again prevail.

A recurrent theme emanating from the government since 2012, and consistently echoed by the *Wall Street Journal* editorial staff and other financial media, has been that Fannie and Freddie do not earn enough to repay senior preferred and to recapitalize. We respectfully disagree. Jumpstart aside, for example, were the government to simply credit the $130 billion of its double-dealing Third Amendment cash takings against the SPSPA senior preferred balance of $189.5 billion and reimburse the GSEs for approximately $46 billion of offloaded government

HARP and HAMP expenses, the remaining SPSPA balance could be repaid out of petty cash. Recapitalization could easily be effected through simple reinstatement of junior preferred as dividend-paying as of August 2012, coupled with a public offering of the government's common share holdings. The assertion of inadequate earning capacity as excusing continued nationalization of the GSEs simply does not hold together when the companies' profitability is truthfully examined. Keep in mind that during seven years of conservatorship, the government, by imposing nearly $46 billion of unreimbursed HARP/HAMP expenses on the GSEs, effectively reduced their operating profits for the same period, in equal amount.

Based upon my conversations with significant preferred share owners, I can say with absolute confidence that any assertion of their demanding an immediate recap and release to public ownership is a total government fabrication—a smoke screen, designed to mask the looting of nearly $200 billion of assets.

Approximately 20 percent of Fannie and Freddie ownership was left in public hands following the conservatorship imposition in order to avoid a nationalization sticker's being imposed and the Treasury's having to put $5 trillion of the GSEs' guaranteed and direct debt obligations on the government balance sheet. As candidly acknowledged in deposition by Timothy Geithner, ongoing GSE public ownership was a government fiction, and the companies were from their conservatorship start "effectively nationalized." The issues now for preferred share owners are (a) reinstatement of dividends as of August 2012, or (b) resolution of their Fifth Amendment right to receive just compensation—with interest.

B. The GSE Preferred Share De Facto Nationalization Case

Starr International Company, Inc., v. The United States (the "AIG Case") had as its core issue whether or not the owners of an insolvent borrower retain the basic constitutional right to receive just compensation for property taken by governmental action. The judge's opinion in the case was clear in its condemnation of the government's heavy-handed bailout treatment of the AIG Company. That treatment, while an irritant, did not distract the court from recognizing the core case issue to be not one of good v. evil, or crisis expediency as an excuse for ignoring constitutional rights, but rather government obeisance to the rule of law as an absolute. In its opinion, the court said: "The Government's unduly harsh treatment of AIG in comparison to other institutions seemingly was misguided and had no legitimate purpose, even considering concerns about 'moral hazard.' *The question is not whether this treatment was inequitable or unfair, but whether the Government's actions created a legal right of recovery for AIG's shareholders*." (Emphasis added.)

I initially thought it strange that the court made no mention of the similarity between the initial basic treatment afforded AIG and the GSEs in rescue program dollar amounts, interest/dividend rates, and 80 percent common stock ownership dilution. On further thought, I realized that the court did not make the comparison because it could not. The government's mistreatment of the GSEs, commencing with the Elimination of GSE Fiduciary Oversight and followed by the 2012 Third Amendment profit sweep, separately and in combination were so over-the-top heavy-handed and punitive as to make comparison impossible except with other de facto and de jure nationalizations.

The government has steadfastly refused to acknowledge or address the preferred share dividend reinstatement, the implicit guaranty, or the de facto taking issues. Preferred share owners, relegated to nonperson status, were thus forced to seek redress from the government's heavy-handed treatment in the courts. By the simple device of continuing Secretary Paulson's

unintentional error of lumping together the GSEs' common and preferred share owners, the government has been able to avoid $2 billion of annual preferred share dividend payments for more than seven years.

A May 20, 2014, *Wall Street Journal* piece provides proof perfect of the government's insensitivity, quoting FHFA director Mel Watt as having said that "it isn't his job to worry about shareholders of the companies, for which the FHFA act as conservator." According to Watt, "'My responsibility in the conservatorship is not to the shareholders, really. So I don't lay awake at night worrying about what's fair to the shareholders.'" He is not alone in his indifference.

In late 2015, Senator Robert Corker pointedly ignored the anti-GSE equity owner bias of his own Corker-Weaver–sponsored bill when he was quoted as saying that he had nothing against GSE shareholders, adding: "They'll have their day in court." To that I respond, "Why, sir, do GSE preferred shareowners have to go to court to receive dividend payments on shares issued with a government's implicit guaranty of payment?"

In a well-reasoned December 2015 report entitled "GSE Reform: Something Old, Something New, and Something Borrowed," managing director Joshua Rosner of Graham Fisher & Co. reviews the historical web through various permutations, from Fannie Mae's New Deal inception through HERA. For GSE conservatorship guardians FHFA Director Watt, Treasury Secretary Jack Lew, and Senator Corker, I cite the report as a must-read.

I own both Fannie Mae and Freddie Mac preferred shares. I purchased my shares in recognition of the government's ongoing implicit guaranty. I purchased my shares because the companies' book and enterprise values have at all times exceeded the shares' $34 billion of combined stated value by multiples.

Secretary Paulson candidly admitted in testimony to Congress that the GSEs were drafted into government service as the "best engines" to get financial mortgage markets unfrozen and

moving again. The country was in crisis, and there is no shame in the government's nationalization of the GSEs. However, the government's bad faith refusal to reinstate preferred share dividend payments, its Third Amendment sweep of $130 billion of GSE cash, and its imposition of $46 billion of unreimbursed HARP/HAMP costs upon the GSEs are separately and in combination legally untenable and shameful.

Treasury currently owns 79.9 percent of the GSEs by virtue of common stock warrants obtained for nominal consideration in the form of a commitment fee for the 2008 rescue financing. The government's warrant interests represent the largest commitment fee ever paid to any recipient by any company in financial history, and the country's best investment since the Louisiana Purchase. In conservatorship, the government has come off very, very well in its offloading of expenses and dividend and warrant value receipts. In the face of that joint wellness, the government's seven-year refusal to restore approximately $2 billion of annual preferred dividends will prove to have been a bad faith anticipatory repudiation of its implicit guaranty of the preferred shares' contractual dividend entitlements when the courts rule, as they must, in favor of preferred shareowners on the implicit guaranty dividend reach and the GSEs' de facto nationalization. The Elimination of GSE Fiduciary Oversight was instrumental in allowing unhampered Treasury looting of nearly $200 billion of GSE assets. The same Elimination of GSE Fiduciary Oversight mandates a court finding of GSE de facto nationalization.

Without doubt, the government's treatment of GSE preferred shareowners, its preferred share hawking and ongoing post–August 2012 restricted dividend policy, and the Third Amendment money grab are individually and collectively immoral. The immorality of the government's repudiation of its implicit guaranty of preferred share payment is beyond shameful.

Only when the preferred dividend restitution and taking issue are disposed of can the debate legitimately move on to reform, and what to do with the government's ownership stakes. I believe that Fannie and Freddie should be responsibly reformed and reprivatized, with Treasury's de facto 100 percent ownership being sold over time to public investors.

The Congressional Budget Office (CBO) is a federal agency charged with providing budget and other economic information to Congress. In January 2010 the CBO, in a report to Congress, focused on the government's ownership and direction of GSE activities: "In the judgment of the CBO, those actions make Fannie Mae and Freddie Mac part of the government and imply that their operations should be reflected in the federal budget."

Rather than permit the economic absurdity of de facto nationalization, Treasury asset looting, and government anticipatory repudiation of its implicit guaranty of the GSEs' preferred share payments to continue and fester, the government should publicly own up to the charade of its conservatorship errors. At the same time, in the next federal budget, it should announce Treasury's acceptance and adoption of the CBO's suggested accounting treatment for GSE receipts and disbursements and lay out a plan: (a) to resume payment of GSE preferred dividends on a cumulative basis retroactive to August 2012 or (b) to redeem preferred shares at their stated face value with payment of taking interest from 2008.

In reasonable time thereafter, GSE common share owners should be offered ratable redemption payment, with the right to contest similar to that of a dissenting shareholder in any take private transaction.

Conclusion

I believe that the GSEs should be responsibly reprivatized, with proceeds being legislatively directed to finance public housing, education, healthcare, and other social programs. The worst option would be to throw the money obtainable from a GSE reprivatization away, and that is exactly what will happen if no action continues to be the government's chosen path. In the past, the government's stated reason for liquidating Fannie and Freddie was that they were flawed. Obviously—but keep in mind that more than seven years of conservatorship has now securely validated the GSE model as a worldwide housing finance best. Prudent owners fix flawed but valuable companies, just as prudent governments make use of the best available engines when the country is in crisis mode. American taxpayers were big-time losers in the financial crisis of 2008. Handled correctly, the responsible reformation and reprivatization of Fannie Mae and Freddie Mac could set the stage for a big come-from-behind American taxpayer win.

Joshua J. Angel, Esq.
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APPENDIX

I.

1. Comptroller of the Currency Administrator of National Banks Interpretive Letter #931, April 2002

   http://www.occ.gov/static/interpretations-and-precedents/apr02/int931.pdf

2. Board of Governors of the Federal Reserve System International Finance Discussion Papers—IFDP 1045, March 2012

   http://www.federalreserve.gov/pubs/ifdp/2012/1045/ifdp1045.pdf

3. *New York Times*, July 11, 2008, "U.S. Weighs Takeover of Two Mortgage Giants"

   http://www.nytimes.com/2008/07/11/business/11fannie.html

4. *New York Times*, August 19, 2008, "Some Investors Say U.S. Bailout of Housing Giants Is Inevitable"

   http://www.nytimes.com/2008/08/20/business/20fannie.html

5. U.S.D.C.S.D.N.Y. In re Fannie Mae 2008 Securities Litigation (08 Civil 7831 PAC) Order, November 24, 2009

   http://securities.stanford.edu/filings-documents/1040/FNM_01/20141024_r01x_08CV7831.pdf

6. *Wall Street Journal*, December 12, 2015, "Fannie and Freddie's Propaganda War"

   http://www.wsj.com/articles/fannie-and-freddies-propaganda-war-1449876249

7. *Wall Street Journal*, December 18, 2015, "Why Fannie Mae Revival Hopes Are Withering on Capitol Hill"

   http://www.wsj.com/articles/why-fannie-mae-revival-hopes-are-withering-on-capitol-hill-1450384375

II.

Fannie Mae Exploitation of the Federal Government's Implicit Guaranty of GSE Financial Obligations in the May 2008 Sale of $7.4 Billion of Its Preferred and Common Shares

Henry M. Paulson Jr., *On the Brink*:

Page 3

But Fannie and Freddie were congressionally chartered companies that already relied heavily on implicit government support . . .

Pages 112–13

Sunday, March 16, 2008

Meantime, as we raced to save Bear, we saw an opportunity to take a positive step with Fannie Mae and Freddie Mac. The market's weakness ultimately stemmed from housing troubles, and they were right in the center of that. A negative *Barron's* cover story the previous weekend had hit them hard.

Why not use the crisis to our advantage? Tim and I believed some positive news from Fannie and Freddie might help the market. I called [Treasury Undersecretary for Domestic Finance] Bob Steel and asked him to arrange a conference call with the GSEs and their regulator, OFHEO [the Office of Federal Housing Enterprise Oversight, which in 2008 was combined with the Federal Housing Finance Board to form the FHFA], to nail down an agreement he had been working on. Steel, on the fly, rounded up Fannie Mae CEO Dan Mudd, Freddie Mac CEO Richard Syron, and OFHEO chief Jim Lockhart, and we jumped on a conference call for about half an hour beginning at 3:00 p.m.

Fannie and Freddie were operating under a consent order temporarily requiring 30 percent more capital than mandated by federal statute. They were pressing to have this surcharge removed early. To get them to raise more capital—which we felt they sorely needed—Steel and Lockhart had for weeks been pushing a

deal: for every $1.50 to $2 of new capital the GSEs raised, OFHEO would reduce the surcharge by $1.

I had no time to waste, so I began the call by saying we were expecting to get a deal done on Bear Stearns and that we wanted an agreement from the GSEs to help calm the market. Steel had done his work well, and we quickly hammered out an agreement that, we estimated, would lead each firm to raise at least $6 billion. We calculated that this, in turn, would translate into $200 billion in much-needed financing for the sagging mortgage market. We agreed to make the announcement as soon as possible. (It was made on March 19.)

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While Congress dithered, the markets got jittery. I was at a meeting of finance ministers from the Americas and the Caribbean in Cancún, Mexico, on June 23, when I heard that Freddie Mac shares had dropped below $20. That was off more than $10 since they'd announced plans to raise capital in March. I'd been hoping all along that the GSEs would be able to raise capital. Fannie had done so in May and June, raising $7.4 billion in common and preferred stock. But Freddie had not done anything. Now they would not be able to access the market, and we did not have the legislation we needed to protect them or the taxpayers.

III.

Fannie Mae Capital Raise Roadshow, May 2008

Page 4

Recent actions on conforming jumbos, lifting the portfolio cap, and reduction in required capital surplus signal policy and regulatory support for Fannie Mae's liquidity mission.

http://www.fanniemae.com/resources/file/aboutus/media/05_2008_Roadshow_Presentation.pdf

Biography

Since graduating from Columbia Law School in 1959, Joshua (Josh) Angel has specialized in corporate reorganizations for nearly his entire legal career—first at Angel & Frankel, PC, which he founded, and where he served as managing partner for nearly forty-six years, and then from January 2007 as senior counsel to the firm of Herrick, Feinstein LLP, 2 Park Avenue, New York, NY 10016.

Acknowledgment

In the space of fifty-six years at the law, I have, without benefit of strict count, written briefs, affidavits, motions, articles, and other arguments numbering in the many thousands, but no pamphlets, not even a mini-one like "Government Perfidy and Management of the GESs in Conservatorship." Legal readability is one thing, normal discourse another. In writing "Government Perfidy," my hope was to translate a complex legal analysis of what I believe to be government abuse in connection with the GSEs' conservatorship into something readable—and understandable to non-lawyers. As a first-time author, how fortunate was I to have met Janet Byrne and convinced her to be my editor. I hope that she remains a friend for life. My admiration for and indebtedness to her are unbounded. Janet, thank you!