The Heritage Foundation

# ISSUE BRIEF

No. 4225 | MAY 19, 2014

# Taking Stock: Shareholder Lawsuits No Barrier to GSE Dissolution

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Fannie Mae and Freddie Mac, the two government-sponsored enterprises (GSEs) that were at the center of the financial collapse of 2008, have now been in federal conservatorship for nearly six years. Several bills are pending in Congress to end the conservatorships and dissolve the firms, although the proposals differ on what—if anything—should replace them.[1]

At the same time, a number of lawsuits have been filed against the federal government by disgruntled private shareholders of Fannie and Freddie. The most serious of these claims is that the current practice of "sweeping" all earnings by Fannie and Freddie to the U.S. Treasury is unconstitutional. While this claim is not without merit, it should not be allowed to impede needed efforts to dissolve the corporations.

## Background

Fannie and Freddie were at the center of the 2008 financial collapse—if not triggering it, exacerbating its effects.[2] Financially, the two were hit hard by the crisis, leading the Federal Housing Finance Agency (FHFA) to place them into conservatorship in September 2008.

This conservatorship, the authority for which was granted to FHFA by Congress only two months before the fact, was imposed with the consent of the Fannie and Freddie boards of directors. Immediately after taking control, FHFA—as conservator for Fannie and Freddie—entered into an agreement with the U.S. Treasury: In exchange for up to $200 billion in bailout money, Treasury would receive preferred stock valued at an equivalent amount, plus warrants to buy up to 79.9 percent of the common stock and a 10 percent dividend payment to the government for the money taxpayers invested. Over the next four years, Fannie and Freddie received some $188 billion in taxpayer funds under this agreement.

## The Earnings "Sweep"

Some of this capital, however, was only on paper. In quarter after quarter, the GSEs would find themselves short of the cash needed to pay the mandatory 10 percent dividend, so Treasury would advance them more cash in order to do it, creating a circular cash flow that changed nothing.

Saying it wanted to end the pointless circularity, FHFA and the U.S. Treasury agreed in August 2012 to revise the terms of their agreement. Instead of a 10 percent dividend, the Treasury would receive all net income earned by the two GSEs paid in a quarterly "sweep."

Not long afterward, Fannie and Freddie's financial situation changed for the better, and the two entities began to produce substantial profits. But due to the 2012 amendment of the agreement, all net income was turned over to the U.S. Treasury as dividends. None could be applied to a pay-down of the shareholders' debt. Thus, while Fannie and Freddie

This paper, in its entirety, can be found at **http://report.heritage.org/ib4225**

Produced by the Thomas A. Roe Institute for Economic Policy Studies

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have repaid a total of $185 billion to the Treasury to date, their debt has remained stuck at $188 billion.[3]

This lopsided arrangement was never actually agreed to by the GSEs' boards of directors or their shareholders (who are still the legal owners of the firms). Under a conservatorship, the conservator acts for the corporation. So the agreement to adopt the new dividend rules involved only FHFA (representing Fannie and Freddie) and the U.S. Treasury—two arms of the federal government.

## Ongoing Litigation

The legality of FHFA's action as conservator is now being challenged in court by stockholders, with almost 20 lawsuits having been filed. Some commentators have expressed doubt as to the merit of many of the lawsuits, many of which simply second-guess FHFA's initial judgment call about Fannie and Freddie's financial condition six years after the fact.[4]

Other claims, however, particularly those concerning the "earnings sweep" imposed in 2012 may be tougher to dismiss. Perhaps the leading challenge, filed by Fairholme Capital Management, a hedge fund with a sizable investment in the GSEs, argues that this was not only a breach of FHFA's fiduciary duty to shareholders but also an unconstitutional taking of private property. The earnings sweep has left the stock of Fannie Mae effectively worthless, Fairholme points out, leaving the GSEs with no way to ever pay down their debt to taxpayers or to end the conservatorship. Shareholders were cut off not only from any say in the management of the corporations but from any possible return on their investment.

The government has defended itself by arguing, among other things, that given the dire straits the GSEs were in when the conservatorship began, shareholders should not have had an expectation of recouping any of their investment. But that hardly justifies a taking of whatever remaining value existed. Moreover, if it were so clear that there was no chance of recovery, then FHFA should have moved the firms into receivership and liquidation rather than a conservatorship for the supposed benefit of the shareholders.[5]

Politically, the shareholders' property claims are certainly not popular. After all, they (or their predecessors) benefitted enormously over the years from Fannie and Freddie's government-sponsored status and from the bailout itself. But this is far more than a legal technicality. Protection of property rights is not only a fundamental principle of government but may also be key to establishing a market-based housing finance system. Ignoring property rights, argues University of Chicago law professor Richard Epstein, a consultant for Fairholme, works against efforts to

> rid housing markets of their past, massive irregularities in order to encourage more private investment. What private fund will invest in projects when their cash can be siphoned off by dubious contractual liberties and administrative shortcuts that make a mockery of the rule of law?[6]

1. For more information on the proposals being considered, see Norbert J. Michel and John L. Ligon, "Fannie and Freddie 2.0: The Senate Does Not Get the Government Out of the Market," Heritage Foundation *Issue Brief* No. 4201, March 11, 2014, http://www.heritage.org/research/reports/2014/04/fannie-and-freddie-20-the-senate-does-not-get-the-government-out-of-the-market, and John L. Ligon, "Hensarling Housing Finance Plan: A Welcome Step Toward Solving the Fannie and Freddie Mess," Heritage Foundation *Issue Brief* No. 3993, July 22, 2013, http://www.heritage.org/research/reports/2013/07/hensarling-housing-finance-plan-welcome-step-to-solve-the-fannie-and-freddie-mess.
2. See Peter Wallison, "Dissent from the Majority Report of the Financial Crisis Inquiry Commission," American Enterprise Institute, January 14, 2011, http://www.aei.org/files/2011/01/26/Wallisondissent.pdf (accessed May 15, 2014).
3. Nick Timiraos, "Fannie, Freddie Payments Nearly Match Aid," *The Wall Street Journal*, November 7, 2013, http://online.wsj.com/news/articles/SB10001424052702303763804579183454001715882 (accessed May 15, 2014).
4. For instance, see David J. Reiss, "An Overview of the Fannie and Freddie Conservatorship Litigation," Brooklyn Law School, March 2014, http://works.bepress.com/cgi/viewcontent.cgi?article=1096&context=david_reiss (accessed May 15, 2014).
5. Richard Epstein, "When Our Government Commits Fraud," Hoover Institution, Mach 3, 2014, http://www.hoover.org/publications/defining-ideas/article/169781 (accessed May 15, 2014).
6. Richard Epstein, "The Bipartisan Attack on Fannie and Freddie: How the Treasury and Congress Are Working Overtime to Strip These Corporate Cupboards Bare," PointofLaw.com, July 17, 2013, http://www.pointoflaw.com/archives/2013/07/the-bipartisan-attack-on-fannie-and-freddie-how-the-treasury-and-congress-are-working-overtime-to-st.php (accessed May 15, 2014).

## No Barrier to Dissolution

Whatever their outcome, the pending shareholder litigation should not impede efforts to liquidate the two firms. The congressionally granted charters explicitly reserve to Congress the power to dissolve the corporations. The Fannie Mae charter states: "The Corporation shall have succession until dissolved by Act of Congress."[7] The same language is included in the Freddie Mac charter.[8]

*Succession* in corporate law generally means continual existence. Ending that succession would mean ending the corporate existence of the two firms. Neither charter imposes any conditions on such dissolution: The firm need not be insolvent or even financially troubled for Congress to dissolve it.

After any such dissolution, creditors would be paid off, with any remaining assets divided among shareholders taking into account the priorities of different classes of shares. This process need not be delayed by the pending litigation. Because the United States is a defendant in the lawsuits, the litigation can proceed independently of the GSEs' dissolution. If shareholders prevail on their takings claim, or any other monetary claim, they would still be able to receive full restitution for any legitimate claims.[9]

## Not an Impediment

The pending shareholder litigation against the federal government regarding its nearly six-year-long conservatorship of Fannie Mae and Freddie Mac must be taken seriously. Most troubling is the allegation that the federal government violated the constitutionally protected property rights of the two corporations' stockholders.

Protecting property rights, however, does not mean that taxpayers and consumers must continue to be put at risk by these government-sponsored housing giants. The ongoing lawsuits need not impede and should not distract Congress from the critical task of dissolving these economically dangerous institutions.

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7. Federal National Mortgage Association Charter Act, 12 U.S. Code 1717(a)(1).
8. Federal Home Loan Corporation Act of 1970, 12 U.S. Code 145(c) (2).
9. Several of the pending bills include provisions prohibiting any changes in the current dividend agreement, in effect freezing the dividend "sweep" into place. Such a statutory provision, however, could not foreclose a constitutional challenge to the practice.