PANEL THREE: CONSERVATORSHIP AND THE TAKINGS CLAUSE

Panelists: Barry Adler, Richard Epstein, Arthur Gonzalez, Randall Guynn
Moderator: Steven Menashi

Mr. Steven Menashi: Welcome to Panel 3 on "Conservatorship and the Takings Clause." We heard earlier that there are a series of lawsuits brought by the Fannie and Freddie shareholders against the conservatorship and the conduct of the FHFA as Conservator. The lawsuits allege that the FHFA not only exceeded its statutory authority and violated its fiduciary duties, but also effectively took property from the shareholders without just compensation, in violation of the Fifth Amendment, and the lawsuits challenge both the 2008 decision to go into conservatorship and the 2012 net income sweep.

So to sort through the implications of the conservatorship, we have four distinguished panelists with us. I should say that Judge Gonzalez, who is teaching, is going to join us a little bit into the panel, so he is going to come and speak last, but I will follow the practice of the last panel, and introduce our speakers as they get up to talk.

Our first speaker is Randall Guynn. He is a partner and head of the Financial Institutions Group at Davis Polk & Wardwell, where his practice focuses on providing strategic bank regulatory advice, and advising on M&A and capital markets transactions involving financial institutions. Among the institutions he had advised are the securities industry and Financial Markets Association, and all of the 6th largest American banks. He's a graduate of UVA law school, and served as a law clerk to Justice Rehnquist. So with that, Randy?

Mr. Randall Guynn: Okay, so I'm going to try to provide a little bit of useful background and perspectives on the Fannie and Freddie conservatorships. As some of you know, I was actually in the room when Freddie, at least, was put into conservatorship. I worked on many of the rescues during the financial crisis that followed. I've represented SIFMA in commenting on what is known as the Orderly Liquidation Authority in Title 2 of Dodd-Frank, and sort of tried to help harmonize it with the Bankruptcy Code, and I played a role in developing what is known as the single point of entry recapitalization strategy that the FDIC says is its favorite approach for resolving the too-big-to-fail banks.

Now, although my law firm and I no longer have a client relationship with Freddie Mac, there are many things about the conservatorships that I still can't talk about because of attorney client privilege or because some of it is treated by the regulars as confidential supervisory information, but I think having had that experience will help me put some of the publicly available information in better light.

I'd like to structure my remarks around seven questions. The first one is that, let me start with—I'll just call it FHFA—did it have a statutory basis for putting Fannie and Freddie into conservatorship in the first place? So, as we know, their authority as conservator arises under Section 1145 of the Housing and Economic Recovery Act, which was passed July 30, 2008, just six weeks before they were put into conservatorship, and remember, this was the hearing which Hank Paulson said he needed to have a blank check for rescuing Fannie and Freddie, because if he had a blank check, that would be like a bazooka, and he would never need to use it, and if you gave him some limits, it would be a squirt gun, and he much have to use it. Unfortunately, he used his bazooka six weeks later.

Section 1145 is modeled on the bank resolution provisions in the Federal Deposit Insurance Act. In fact, it's almost a markup of those. Section 1145 gives the Director of FHFA the discretionary authority to put Fannie and Freddie into either conservatorship or receivership if any one of a long list of statutory grounds is satisfied. It also requires the Director to put Fannie and Freddie into receivership if it finds them to be insolvent or unable to pay their debts as they come due.

The difference between conservatorship and receivership is similar, but as I've stressed more now than I usually have, not identical to the difference between reorganization and liquidation. Receivership is very similar to liquidation, but there are some critical differences between conservatorship and reorganization. Under a conservatorship, a troubled institution is not closed, but remains open, subject to the control of its conservator. The conservator's duty is to operate, rehabilitate, reorganize, and restore the health of the troubled institution. When that is achieved, the conservatorship is terminated, and the institution is returned to the private sector.

Under a receivership, a troubled or failed institution is closed and liquidated. Its assets and liabilities, however, may first be transferred to a third party, or they may all be transferred temporarily to a bridge bank until the bridge bank can be either sold, recapitalized, and returned to the private sector, or liquidated itself. Before Section 1145 was enacted, the government's resolution authority over Fannie and Freddie was limited to conservatorship, with no statutory authority to place either of them into receivership. In addition, the only ground for doing so was the determination that the institution was critically undercapitalized. The conservator almost had no express statutory authorities. But then that was all changed, as I said, on July 30, 2008, in which basically, the bank resolution provisions were made effective and adapted to Freddie and Fannie.

The grounds in Section 1145 that would allow the Freddie and Fannie—and this is the same as in the FDIA—include being insolvent; being critically undercapitalized; being undercapitalized and having no reasonable prospect of becoming adequately capitalized—part of the reason we're going through this is to see how vague and inchoate they can actually be—being in an unsafe and unsound condition, whatever that is; experiencing a substantial dissipation of assets or earnings due to unsafe or unsound practices; being likely to be unable to pay its obligations or meet the demands of creditors in the normal course of business; being likely to become insolvent or experience a substantial dissipation and so forth; or the Board of Directors consents to their being put into conservatorship or receivership.

As is well known, the Boards of Fannie and Freddie consented to being put into conservatorship after listening to speeches that have been published, by Jim Lockhart, Treasury Secretary Hank Paulson, and Fed Chairman Ben Bernanke. Among the themes in those speeches were the following: reminders that Section 1145 insulated the Boards from liability if they consented; comments to the effect that the troubled conditions of Fannie and Freddie were primarily the fault of a flawed business model that had been imposed on them by Congress, rather than wrongful conduct by the managements or the boards; promises to inject up to $200 billion in new capital in Fannie and Freddie on terms and conditions outlined to the boards if they consented to the appointment of FHFA as conservator; expressions of an intent to continue running Fannie and Freddie as publicly traded companies with public shareholders, and a board of directors, presumably so that they could emerge from conservatorship with normal corporate governance structures; appeals to doing good for the country, since these conservatorships, at least so it was thought, which would help stabilize the financial system, which had been in a slow free-fall since the fall of 2007, and was about to—and they didn't quite know this at the time, and was about to face a genuine panic starting the next weekend, which has come to be known as Lehman Weekend—warnings about what, and this is important, what FHFA and Treasury might do if the boards failed to consent, including the possibility of putting the two entities into receivership and wiping out both the common and preferred shareholders, which included hundreds of banks across the country, and might have triggered even more contagion than the conservatorships actually turned out to trigger.

Finally, the boards of Fannie and Freddie—sorry, since the boards of Fannie and Freddie consented to the appointment, at least one of the statutory grounds obviously was satisfied. But what if the boards had not consented? Did FHFA indicate whether any other statutory grounds were satisfied? I'm afraid that the public may never know, unless FHFA discloses whether it ever issued an order to that effect, or makes any such order public, because as far as I can tell, whether that exists or what it contains has never been made public. Hint to Bloomberg: file a FOIA request.

But one thing is certain, FHFA must not have found that Fannie and Freddie were insolvent or unable to pay their debts when due, because if it had decided, if it had made that determination, it would have been required by the statue to put both of them into receivership rather than conservatorship. So, apparently, the grounds that might have satisfied if it weren't for the Board consent, would have been one of those vague and sort of woolly grounds that I mentioned.

This raises some very serious questions. Is it really good public policy, consistent with the rule of law, to allow a federal agency to wipe out or substantially dilute the interests of the shareholders of Fannie and Freddie by placing them into conservatorship or receivership for such vague and inchoate weaknesses? Since the same grounds exist in the bank resolution provisions of the FDIA, does this mean that the FDIC and the bank regulators have the power to nationalize virtually any bank at any time at their whim?

Now, history shows, as David Skeel knows, that the FDIC virtually never uses this power to shut down a bank too early. Rather, it generally waits until the bank is deeply insolvent, but is it really safe or consistent with the rule of law for them to have the potential power to actually move so early? Isn't this like creating a regulatory court or Star Chamber?

Interestingly, a lot has been said about the lack of due process and the orderly liquidation authority of Title 2 of the Dodd-Frank Act. In fact, the Hoover Institution has published a book on that. But compared to Section 1145 of HERA and the FDIA, Title 2 of Dodd-Frank is the model of due process.

PROFESSOR EPSTEIN: God.

[Laughter]

MR. GUYNN: Now, it's important to point out that to my knowledge, Fannie and Freddie are the first genuine conservatorships of any U.S. financial institution. What I mean by that is that there are virtually—well, sorry, this is important because it means that there are no relevant precedents under the Federal Deposit Insurance Act to help guide the interpretation of conservatorship for Fannie and Freddie. The FDIC has almost never been appointed as conservator, and when it has been appointed, it has been to basically mimic something called a bridge bank, and those are called pass-through receiverships or pass-through conservatorships.

The next question: if FHFA had the discretion to put Fannie and Freddie into either a conservatorship or a receivership, why did it choose conservatorship over receivership? I think the answer is pretty clear on that. I think there are probably two grounds. First, the Fed and Treasury generally thought at the time that putting them into conservatorship and announcing the rescue would actually stabilize the broader financial system. This, of course, turned out to be wrong, as we saw what followed.

They also did not want—we talked about this, they didn't want Fannie and Freddie's guarantees of mortgage laws or mortgage-backed securities to disappear into smoke, because in fact, under the law that was marked up for Fannie and Freddie, the way the FDIC has always interpreted it, guarantee and contingent claims against banks that are put into receivership or conservatorship are wiped out, and to the extent they're not wiped out, the FDIC says that under the statue, there are zero damages for having repudiated them. The reason I think there's evidence for this last claim is that later on, in fact, the government said, don't worry, the Treasury is actually standing behind these guarantees if we ever wind down Fannie and Freddie, but that happened to come after we raised the issue with SIFMA, and SIFMA raised the issue with the government and said—because the question a lot of banks were asking—what happens if Freddie and Fannie are actually converted from a conservatorship to a receivership? We said, the first thing that happens is their guarantees go poof, so that has now been corrected.

The third question, at the time of its appointment as conservator, did FHFA have a statutory duty to put Fannie and Freddie into receivership? We talked about that. I guess reasonable people will differ as to whether they were actually insolvent at the time they were put into conservatorship, but the at least the FHFA did not make a finding that they were insolvent, otherwise it would have—they would have been required to put them into a receivership.

Other important questions, does FHFA have any statutory duties to the stakeholders of Fannie and Freddie as conservator under Section 1145 of HERA? So, like Section 11 of the Federal Deposit Insurance Act, Section 1145 provides that upon FHFA's appointment as conservator, it succeeds by operation of law to all the rights, titles, powers, and privileges of Fannie and Freddie, and of any stockholder, officer, or director of Fannie and Freddie, with respect to the company and its assets. This language could be read, to me, that the property rights of the shareholders are entirely wiped out by operation of law, and they have no further claim over the companies or their assets, but this provision is actually qualified for two provisions that make it clear that it's not intended to wipe out these rights.

The first, and Chuck mentioned this, but it actually only expressly applies to FHFA in its capacity as receiver, is that notwithstanding any other provision of law, the appointment of the receiver would terminate their rights, but the stakeholders retain their right to payment resolution or other satisfaction of their claims.

There's a second provision which applies to FHFA, either as conservator or receiver, that provides that it shall, to the extent of proceeds, realize from the performance of contracts or sale of the assets of the institution, pay all valid obligations of the regulated entity that are due and payable at the time of the appointment of FHFA as conservator or receiver.

So, although the first provision I mentioned only applies to FHFA as receiver, it seems to me that it would be unreasonable to interpret these various provisions to mean that FHFA has a duty to satisfy the legitimate claims of the stockholders of Fannie and Freddie when they're being liquidated, but does not have any such obligation when they're merely put into conservatorship. The whole purpose of conservatorship compared to receivership would make that sort of interpretation absurd in my view.

While Section 1145 does not appear to have any express requirement that FHFA carry out its duties as conservator in a manner that maximizes the value of Fannie and Freddie for the benefit of its creditors and shareholders, there are some provisions that imply such a duty, and those similar provisions exist in the FDIA and the FDIC, at least, has interpreted those to mean that it has a duty to maximize the value of the failed banks or failed non-bank financial companies for the benefit of their stakeholders, including the Deposit Insurance Fund, subject, of course, to whatever discretion they have to help stabilize the system, that is kind of a countervailing power.

Next question: do those statutory duties include a duty to take steps to restore Fannie and Freddie's capital, or otherwise restore them to a safe and sound condition? I'm not aware of any provision that expressly requires FHFA, as conservator, to restore Fannie and Freddie's capital, or otherwise restore them to a safe and sound condition, but I think such a duty is strongly implied from the express purpose of conservatorship, which is stated to be reorganizing or rehabilitating the entity. To the extent the purpose of conservatorship—and then I think this is significant—since 1145 is just a markup of Sections 11 and 13 of the Federal Deposit Insurance Act, I think that the Supreme Court's decision on *O'Melveny & Myers v. FDIC* in 1994 is really significant and important.

In that decision, the FDIC was purporting to have some powers to do things beyond what the statute said, and what the Supreme Court said was no, under the statute, when you become conservator or receiver, you step into the shoes of, in this case, Fannie and Freddie, subject— you have all the powers and obligations that they had under existing state and federal law, except to the extent that the statute, the resolution statute expressly overrides those, and I don't think—obviously, Fannie and Freddie had duties to their shareholders under state and federal law, and there's nothing in 1145 that overrides those duties. So I think, under *O'Melveny & Myers v. FDIC*, I think those would survive.

Next question: what statutory rights do the stakeholders of Fannie and Freddie have under Section 1145 to protect their claims and interests. Again, they have whatever they would have under *O'Melveny & Myers v. FDIC*, and also, there's language that has been interpreted, at least in the FDIA, to say that they have a minimum recovery right equal to what they would have recovered in a liquidation.

Second to last question, what would have been different if FHFA had put, or had chosen to put Fannie and Freddie into receivership of the asset instead of conservatorship? I don't think that it would have meant that Fannie and Freddie would have been immediately liquidated. Instead, what would have happened is, they have something called a limited life regulated entity, which is the equivalent in the bank statute to what's called a bridge bank, so what they would have done is, they would have put them into receivership, and they almost certainly would have set up one of these bridge institutions, transferred all of the assets and liabilities to the bridge institution. My guess is that they would have dealt with the guarantee issue, instead of watching it go poof, they would have then directed the bridge institution to assume the guarantee obligations.

The capital injections then would have been made to these bridge institutions instead of the conservatorship. The common and preferred shareholders would have almost certainly been left behind in the receivership, and—this is really critical—but they would have been entitled to the residual value of this bridge institution, whenever it was sold or liquidated or whatever.

The other thing that's actually significant is that there would have been a termination date, because in the statute, you can only have one of these bridge institutions alive for two years, with possible extensions up to a maximum of five. So at this point, it's five years later, they would have been required to have been somehow either sold, sent out to the market, or otherwise restructured. It wouldn't be a permanent state like we seem to have with conservatorships.

And then lastly, given that Section 1145 and Title 2 of Dodd-Frank are both modeled—in fact, are markups of the bank resolution provisions in the FDI Act—are there any lessons from the Freddie and Fannie conservatorship that are applicable to the resolution of insured banks and systemically important bank holding companies and non-bank financial companies throughout the system? So this is where we get to the scary part. Yes, but they're really frightening.

First, one of the lessons is that there virtually no statutory constraints on the power of the federal banking regulators to put virtually any bank into conservatorship or receivership at any time. The statutory grounds for putting banks into conservatorship are sufficiently flimsy that they would justify putting almost any bank into conservatorship at any time. My own view is that this should be corrected by an amendment in the statutes that limit the grounds that allow the agency to put them into conservatorship or receivership.

Second, I think a lesson is, we need time limits on conservatorships, just as there are time limits on the bridge bank. Otherwise, the conservatorships can become permanent nationalizations.

And lastly, the FDIC, the Liquidation Authority, and Section 1145 should probably all be amended to insert an express statutory duty to maximize the value of the enterprises for the benefit of the stakeholders, subject only to any specified power to stabilize the financial system or some other specified federal interest. Thanks.

[Applause]

MR. MENASHI: Next up is Richard Epstein, to whom you were already introduced this morning, so suffice it to say that Richard is the Laurence A. Tisch Professor of Law at NYU, where he is the Co-Director of the Classical Liberal Institute, sponsoring this conference.

PROFESSOR EPSTEIN: Yeah, thank you very much. Randy has done a very useful job in reminding me—something I probably never knew, which is exactly what the detailed provisions are inside of the statute. What I'm going to try to do is see if I can place this in some kind of constitutional framework relative to the Takings Clause, or some version of the substantive due process provisions. You can't take property without just compensation, even if you're taking it for a public use. And it turns out that this is actually a rather tricky kind of inquiry, which depends at least in part on how you conceptualize mortgages within the framework of the Takings Clause, and in part on the way in which you actually understand the facts of a particular transaction.

To go back to the simplest basics with respect to this, the standard rule with respect to a mortgage is that somebody borrows money; you put a lien on the property for some fraction of its total value. The residual is the equity, which may just be kept as such, or it may be large enough to support a second mortgage, one way or another, and then the equity stays on top. So the question then is, if you're thinking about this in relationship to the Takings Clause, how do you decide what interest are protected, once you take a single piece of property, which is surely protected, and then divide it in this particularly way amongst two, three, or more interests, each of which has a separate legal status within the law?

My own view about this question is that in order to think about the way in which you think about this in connection with the government, what you do is, you think about the same question, in the way in which you think about it with respect to private property, dealing with other private individuals, so that what you first do is figure out what the relationships of a given situation are between private entities and private actors, and then you say, well, the government is in a very special position. It can force a taking upon payment of compensation, where a private party could be enjoined from that particular kind of action.

If you want to grow this thing a little bit further, what you do is assume you have a piece of property which is subject to a couple of mortgages, and the interloper comes in and simply occupies the property, and the question then is, what are the remedies that are going to be made available to that thing? The obvious point here is that surely, the equity holder who is sitting in possession has a remedy to try to recover the property. Butit would be foolish to say that when he recovers the property, he is rid of the liens they would surely continue to attach to it, and in addition, if for some reason, it turned out that the fellow who took the property over bought out the equity holders, he could not, on that particular transaction, simply white out the interests of the lienors. Each of these people has a separate and distinct property interest, which is itself subject to kinds of constitutional protection.

If, in fact, you say that this is the case, how do you then take one of these things? Well, there are many complications here, but the basic thing is, whenever you're doing takings law, you start with the total taking, and then what you have to do is to figure out how this applies and extends to various forms of partial takings with respect to the same kinds of interest. It turns out, if you actually look at the case law under the Takings doctrine, it is systematically underdeveloped with respect to liens as opposed to two other kinds of things: outright confiscation of fee interest on the one hand and land use regulations associated with zoning and similar activities on the other.

But the basic framework should carry over exactly to this, and here are a couple of observations about it. The first of the important takings cases on this sort is a case called *Armstrong v. United States*, and this involved a lien which a materialman was entitled to put on a United States Navy vessel which was harbored or burst somewhere in Maine, and the reason that the materialman was entitled to put a lien on the boat is that the general contractor did not claim, did not pay him in a timely fashion, and the standard rule with respect to property rights under these kinds of circumstances is that the lienor has an action in rem against the property for the amount of the lien in question, because otherwise, what happens, there's going to be a bit of unjust enrichment under these circumstances.

What the United States government decided to do in this particular case, was to defeat the lien by sailing the boat out into international waters, where the thing would now be dissolved upon its removal from the jurisdiction, and it was actually only a 5-4 decision in favor of the lienor, but the basic position was that the United States, by its unilateral action, can decide that it wants to be a debtor to a secured creditor, but the only way in which it could change that status is to make itself, how do we say, a general debtor, so that the guy can now have access against all the United States government, and since the credit there is relatively solid, the switch does no good whatsoever, which is exactly what you would want the be, because the efficient solution is to pay off the lien, and if you want to have efficient solutions, you'd rather not go through these complicated kinds of machinations in order to defeat them.

So, what this kind of does is, it says, look: there are really categorical, firm, per se obligations under this, and the sentence which has done more to rehabilitate takings law than any other in the history of the area, is one that roughly says that if there's a series of expenses, which in fairness and justice, ought to be on the public at large, the government, by its own unilateral action, cannot force a single individual to bear them, and as it applies to the case that I just gave, what that turns out to mean is, this ship is going to work for the United States Navy is not providing a disproportionate benefit to this poor lienor sitting there in Maine. And since it's a general public benefit of defense, the public ought to paid for it, and so therefore, what happens is the lienor gets discharged in full, gets paid in full, satisfied in full, and he bears, as a citizen, some tiny fraction of the total cost associated with its operation.

Now, if one accepts this as an appropriate type of situation, then it turns out that the partial Takings doctrine have to start to come into place, and the question is, well, how do you start working partial takings? We do it with respect to the occupation of land, by the government going on a corner of the property for a limited period of time, and saying, well, since you'll get it all back eventually and have some of the use intermediately, we don't have to worry about that stuff, and the basic maxim to keep the government honest all these cases is the more you take the more you pay, so you don't get a situation where taking a little allows you to get a public benefit at no government cost, it's just a continuous function, so that at each and every point when the government tries to take something, it's going to have to have the proportion and allegation to do it, and it will only take these properties where it makes sense. So if it needs a facility during wartime, it may well be able to lease the thing for the somewhat inflated market rates, but it's not going to be required to take the fee simple, and can, in fact, return the property to somebody else.

Exactly the same kind of thing applies when you start thinking about these liens, and so it is a taking for the following thing to happen. The government sees that it has got this lien on the boat against it, and what it decides to do is to manufacture its own lien, which is going to give priority to the other lien, and so it says, well, before we have to pay off your $5,000, we have this magic lien which we've imposed on the boat, we just have to pay that one off. And the answer is that it cannot, by its own devices, simply manufacture ways in which to force subordination of one lien to some other kind of action, so if it was to announce, for example, that we've owed money to Mr. Jones, and what we'd like to do is to give them a prior lien on this particular boat to us, and that lien is large enough to essentially make the lien worthless of the second guy, it's a take.

Basically, what the Takings doctrine does is, it says, in effect, you cannot manipulate the financial structure of any particular assets in a way which compromises the position of somebody who holds vested rights. The social justification for that is, it means that whenever the government finds that it's in its interest to change the current capital structure, it has to be able to generate a gain larger than the losses it's imposing upon the private party, which means that on average, it's only going to do so when you have some kind of social improvement.

Now, the argument with respect to partial takings under these circumstances also extends to the relationship between the holder of the equity on the one hand and the holder of the debt on the other hand. When you're worried about these strategies, suppose the United States government were to say, you know, we've got ourselves a lien on this particular asset, and the property is worth $1,500, we're going to cure our particular problem. We're going to go to Adler and Company and get ourselves an authoritative evaluation of $1,500 on the loan, on the property, it turns out there's zero equity, so we own the whole thing.

Essentially, you can't do that in this particular world. The valuation questions now become something which is absolutely subject to the same kind of constitutional constraint as the flipping over of priorities with respect to liens because otherwise, if there's free hand with respect to valuation, you can always wipe out any equity holder or any junior lienor by simply declaring that the value of the property is insufficient to cover the particular obligations in question.

What this means is that substantively, the question of whether or not you are or are not insolvent is, in fact, a justiciable issue of serious proportion which, in fact, is something which has to be litigated underneath the Takings Clause in order for the doctrine to make any expense, and the moment you start to say that, immediately, two kinds of protections start seep in.

On the one hand, and Randy mentioned this, you've got all of the procedural protections that are going to be needed under the circumstances, so as to make sure that you get a fair valuation, because *audi alteram partum*, you must hear the other side, is an old Roman mechanism, and the reason why people say it is, if you hear only one side, you're likely to come out with a one-sided verdict, and all of these procedural protections are going to be extremely important.

One of the noticeable features about the 2008 situation, and certainly with respect to the 2012 situation, is as best I can tell, there was no independent process which was directed towards the question of valuation, which was for itself, at that point, it seems to me, a question of constitutional fact, so that you cannot essentially get away from this thing by doing what Randy implicitly, reluctantly, unhappily, but inexorably did, which is, I think we ought to amend this statute, because this is a rather unfair procedure.

The basic argument is that the amendments that he suggested to the statue would be required independently by constitutional constraints, and so either you put them in as a constitutional matter or as a matter of statutory construction underneath the standard kinds of avoidance requirements, or the statute itself is unconstitutional. So if you get, for example, a bankruptcy budge who just happens to come onto the panel and so forth, we know there are all sorts of cases in which you have liens on the property, and the lienor wants to foreclose on the asset in question, it cannot be that you can do this simply by declaring values and wiping out equity holders, or you can't do the same thing to the lienor.

Essentially, you've got to get right values, and the right values have to go in both directions, which means this has to be a serious determination, which means you cannot rely on some soupy version of a rational basis test as a substitute for fair value. And this is perfectly consistent with the basic structure of the Takings law because as it's currently construed, when you're dealing with the rather wobbly question on what counts as a taking for a public use, there's sort of the siesta version of the *Kelo* case, we'll let you guys decide it, and frankly, although I'm a tough-minded litigator, I don't want to fight the Fannie and Freddie reorganizations on public use grounds. There are other ways to commit hari-kari which are a lot less painful than doing that, but the *quid pro quo* has always been, if the public use requirement is broadly construed, the just compensation requirement is subject to a much higher level of judicial scrutiny, and for that, you have to get the things right. And if the statute as written doesn't have these correlative duties, you have to read them in or face constitutional extermination, I think that what Randy says is probably correct. There is, in the law of contract and private transactions, all force of good faith obligations that are added into transactions, when the situation about opportunism becomes completely acute, and you would want to do that under these circumstances.

So then the next question is, at least if you're going back to the 2008 question, is whether or not this thing is going to be something that's going to be put into receivership on the one hand, or into conservatorship on the other.

This is absolutely a killer deal of a question, because the bankruptcy law, as it is currently construed, has, with respect to its receivership requirement, what has been called here, a number of times, the snapshot test. What you do is, a particular time of the firm, look at this particular firm, assume that if you had to put a value on this thing, so as to take a whole variety of future distributional episodes and reduce them to a single point, what would that point be? And if it turns out that that single point is less than the outstanding indebtedness, then the thing is insolvent, and all the equity holders get wiped out, and if it's above that level, then you have to have a procedure for orderly liquidation so that you don't dissipate the assets, and the residuals go to the remaining claimants under the absolute priority rule, at least in accordance with the priorities that they actually had.

The problem that one sees in this particular case is that the gods in Washington have not been kind to us because when you try to figure out how it is that you value this particular firm, it turns out that the assets of the firm are only a tiny fraction of the problems in terms of just looking at it in this step. What we do is, in effect, as I mentioned this morning, for those of you hearing the question, there are two elephants in the closet, and they move in opposite directions.

One of them is the question that they were obliged to take on—and I think obliged is the right kind of word to use for this—inferior loans, for which a very credible argument could be made that you had to do this to lend out money, which if there was no guarantee, would not give you a fair rate of return with respect to the individual transaction in question, and in my book, that becomes a taking, just the way, in fact, if I were to go over to Mario and say, Mario, I really like your house, and I'm going to buy it for 40 cents on the dollar, and you now sell it to me, and then when somebody comes back and says, you know, you took his property; I say, no, I didn't, I paid him 40 cents on the dollar.

The rule on compensation, all of these things, is a full and perfect equivalent to the property taken must be supplied in return, and essentially, what happens is, my 40 dollar payment, or 40 cents on the dollar, is a down payment, but I continue to owe the rest of the money with respect to the obligation in question. So there is, in fact, again, no wiggle room.

Randy mentioned a couple of very smart reasons why it is that the government didn't want to put this thing into receivership. They were worried, I gathered, as you said, that foreign creditors of the operation would be nervous, there was a question of whether contingent guarantees would survive against this situation. That seems to me to be completely right but I have another reason that I would add, which I think ultimately is even more important to the internal operation of the system.

The reason that I'm thinking about is this. If, in fact, you know you've got a situation where the variance is extremely high with respect to the valuation, then it follows from that

that the estimation of the median point at any given point in time is going to be exceedingly difficult to find out, and it follows further that if you, in fact, change the strike date from one date to the next, that the valuations that you're going to make are going to be extremely difficult to do so, and it's also going to be almost impossible to try to do this kind of thing in an objective fashion, because everybody but everybody is going to be influenced by the events that happen afterwards, and what you're going to do is have ex post cheating ex ante valuations that are supposed to be done at this particular time.

So, the advantage of the conservatorship, apart from basically preserving the interests of the underlings in this particular case, is what it does is, it allows you to essentially postpone the ultimate valuation question so that you can see the way that things start to play out. If you eventually want to put it into receivership later on when things are stabilized, the variance is going to be reduced so you'll get better estimates. And in fact, because this is the *quid pro quo,* it may well be, at that later time, what Chuck Cooper said this morning is that as of today, when you start looking at this stuff, putting it in receivership does not wipe out any of the equity holders, because it turns out now, you're pretty confident that you know what the value of the liens are, and there's going to be something left over, and the rule outside of bankruptcy, when you have a simple foreclosure, is that the creditors get principle interest in course, but they can't wipe out the residual equity, and there is a translation mechanism which says, when you go into bankruptcy it's roughly the same formula, otherwise it's a complete nightmare as to whether or not you go out, and this thing is solidified by a constitutional obligation, which essentially forces you to keep exactly these things in exactly that same kind of fashion.

So, I think in effect, that particular decision was a wise decision, and was not a foolish decision, because what it did is, it obviated a large number of challenges that could otherwise be made on both the process-like grounds, and also on the substantive grounds. Remember, the fact that the stop is in wild distress could be regarded as a form of joint temporary insanity, because the ultimate test is not what shareholders think in this kind of zany, unstable world, but first of all, have you been able to pay your debts as they've matured, and the answer is, there is no problem on that front, if I'm correct, Randy, at this particular point. You've got a very liquid pool of assets, and what happens is, you can make the perfectly good argument that the company is in fact solvent, unless you impose upon it a condition that no private owner would ever impose upon itself, namely that you've got to dump everything into the market on exactly the same day, and so, if you give people the option, as you should, in variable markets, to value the stuff as they think of it, rather than at market prices, it changes the entire dynamic of the situation.

Todd Henderson, a blessed memory, I don't see him—he may be in Hong Kong—he and I wrote this paper on the mark-to-market, mark to model kinds of rules, and mark to model, in effect, is relatively stable, because you can actually pick the point at which you want to go, but if you're marketing to market, and the market is very thin, and the market only consists of those individuals who are panicky and are willing to sell, the market price does not reflect the supermarginal value that are given to these assets by those people who want to stay out of the market. Therefore, when you start compressing to a point, what you do is, you engage in a systematic bias in this situation, where all the people who value it below that thing are in the market and selling, and all the people who value it above that thing are outside of the market, so that essentially, what happens is that the mark-to-market regime, not mark to model, but mark to market, creates a systematic bias, a potential cascade, and also, some really other kinds of stuff, and the way to understand this is to make the following very simple point.

If you forget about people who are fiduciaries, and simply take sole owners, trading on their own account, are they under some kind of moral imperative to sell at the lowest point in the market on the ground that it might yet go low? And the answer is, of course they're not obliged to do that. Some of them will sell, some of them will stay, and that the whole point about a market is it allows for consistency with respect to heterogeneous valuations by the exchange mechanism, and one of the most important features of a market is the decision not to sell at a given point in time, and that particular thing turns out to be lost under these kinds of equations. So, going into this particular situation, the Takings law, it seems to me, becomes pretty tough.

It also becomes tough in connection with fiduciary obligations, which rise to the same situation. Todd Henderson, this morning, chastised me for forgetting what the Business Judgment Rule was, and I do remember what the Business Judgment Rule is. It says, if you want a series of directors to basically make honest decisions, if you charge them with all the downside and you don't reward them for all the upside, essentially, this position is a guaranteed loss because you make a thousand decisions, 20 of them are wrong, you pay for all of those, and the shareholders walk away with everything else. It's quite clear that if you have fiduciaries that you choose, that's the correct rule, and if in fact, they decide that they have a conflict of interest between their common and their preferred shareholders, which makes this more complicated than it was, but at least we can understand why it is that they may be willing to trade away the guys at the bottom in the common in order to prefer the guys at the top.

Other people might prefer you have two kinds of fiduciaries to run this settlement, but we'll put that aside. But you don't have that here. What you did is, you had a situation in which the regular fiduciaries walked off the job, were protected from liability, and you have a government agency at this FHFA kind of operation dealing with the Treasury Department making a deal in which they announce that their stated interest is the protection of the taxpayers, which is a blatant disregard of their own fiduciary duty, at which point, you're not talking about the Business Judgment Rule, but you are talking about the Fair Value Rule, at which point you then have to go through the valuation, even in 2008, to see whether or not you had to have both the 10% coupon, the 12% override, the 79.9% conversion at nominal rates, and that's part of a package.

This, of course, is really tricky, because remember, he's the fiduciary only for the preferred shareholders. He's not a fiduciary for the common shareholders under these circumstances, and so it's a very difficult, inconsistent duty type situation.

Now, I'm going to go on for about two minutes more. When you get to the 2012 reorganization, all of a sudden, the world is a much cleaner place. We now know that the stock was allowed to trade after the September situation, that there were many people who bought it up at a very low price, thinking that it was likely to go up when the conditions changed. It's not clear when they bought this, whether they were entitled to think that the guarantee would remain in place, or that they were sure that it would continue to be subject to the other stuff. They basically, I think, took some degree of risk about that, and it's unconscionable to allow that to exist in the long term: too much instability on two sides of the arrangement. But they did this, and then when you get to not only the 2012 agreement, we did not mention the G-fee arrangement, guarantee fee arrangements in the interim, in which they just said, hey, you know guys, we want you to pay ten basis points on everything, into a fund which is going to basically replace the fund that we had from the payroll tax deduction. You're basically a substitute for that.

Well, that's obviously a diversion from primary uses. You're not asking to fund a guarantee, you're just—more diversion, so that's also in this, but when you get to this other thing, this is not—it can't be an arm's length transaction, because all the consideration runs in one direction, and that is, it runs from the preferred guys, the junior preferred to the senior preferred. Now, Tony and Adam make, as I finally understand it, a very complicated and sophisticated argument that you have to do something like this in order for to protect the higher level creditors who are sitting out there from the risk that the company will become insolvent, ultimately, by virtue of the fact that it continues to last for a very long period of time, and that strikes me as a concern, but I think the question here, who is robbing whom and for whom, becomes a very difficult one.

The way in which I would resolve this is to say, under technical private law grounds, what you've done is, you've taken basically what would be a return of capital and called it into a super dividend. What we do is, we treat it as though it's a return of capital, and so therefore, write down the debt by the amount above and beyond that which is needed to serve as the 10 percent obligation. That, in effect, means that the exposure of the senior guys is going to be somewhat reduced because there's a smaller underhang that's going to stop this thing up. You keep doing that, and not only do you do what—right by the senior creditors, but it also strikes me, and I suggest you modify your complaint on this—if, in fact, there is a duty to wind this down in the ordinary course of business, the federal government cannot insist on a perpetual senior preferred, because that, essentially, is trying to force things in exactly the opposite direction, and to create an additional credit risk for those people who are on the top.

So, all in all—and I'm going to stop at this particular point—I think that the level of irregularity you get on these cases is, in fact, a large measure of a function that there is a well-understood body of mortgage priorities and interactions that exist in the private law. There's a pretty good body dealing with business judgment and fair value moves in private law, and that what's at stake in this case is ultimately the following question: does the government get to play by its own rules, which is set for its own advantages, and in a constitutional democracy, the answer to that question is no. Thank you.

[Applause]

MR. MENASHI: Thanks very much. Next up is Barry Adler, who is the Bernard Patron Professor of Law and Business at NYU, where he teaches bankruptcy, commercial law, contracts, corporate finance, and corporations.

PROFESSOR BARRY ADLER: Thank you. Am I correct in assuming we're out of time now?

MR. MENASHI: No, [inaudible].

PROFESSOR ADLER: I think it's entirely possible that everything that Randy and Richard argued was exactly correct, and their conclusions were exactly wrong. I don't find any tension in that statement, and let me explain why. So, in September of 2008, there was an editorial in *The Wall Street Journal* entitled, "A Bailout for Billionaires." It was about the Fannie and Freddie bailouts, or maybe not bailouts, depending on your characterization.

The argument in the editorial was as follows: that the authors understood why it was that the government was making good on its implicit guarantee of those securities for which such a guarantee was well understood, but in bailing out the firms to the level that it did, leaving equity in place, at least in part, it was bailing out not only the debt that was implicitly guaranteed, but also subordinated debt, which had no guarantee, implicit or explicit. It made no sense for the government, who wanted to make good on its implicit guarantee, to save the firm because by saving the firm, they saved everybody else with it; the subordinated debt holders as well as, to a limited extent, the equity holders.

So, how is this possible? Now, Richard anticipated a lot of this in his remarks, and I understand that, but I'm going to go through this again with a simplified illustration, just in case that will help. So, imagine that you had a firm that has $200 in debt, $100 of which are debt that carries this implicit guarantee that I spoke of, and $100 in debt that is subordinated and carries no such guarantee. Imagine the assets at the time we're talking about are worth $80, so now you're the board of directors of this company with assets worth $80, subject to $200 in debt. Yes, you may have made all your payments to date, but there's a significant prospect that you won't be able to continue to service your debt.

And remember, this is 2008, the entire world is collapsing on everyone's head. It's a little bit through the looking glass to imagine that it was well understood or well believed that either Freddie or Fannie or any of the other large financial institutions were solvent in any sense, or would stay solvent in any sense, whether that meant an asset in excess of liabilities, or inability to pay debts as they became due. So you're the director of this firm, and someone comes along and offers you $200 for this firm worth $80, enough to satisfy the entire $200 of your obligations. You would be falling all over yourself to sign, I don't care who you represent, I don't care if you're self-dealing, not self-dealing, independent, the Pope, anybody else you can think of. 200 is a lot more than 80.

This was the popular perception of what happened back then. It may not have been correct, but I don't know that it's not correct, either. Now, Richard says, okay, we need a lot of process to determine whether it was or it wasn't, and that's an interesting question, and again, I don't disagree with the arguments made, that—to the decision of conservatorship, suggesting putting off the day of reckoning, and that even if there were a receivership, we don't know what the asset value should have been considered in that receivership—I understand that these were difficult questions.

My only point, and I can be really brief here, is, we need some perspective on the possibility that what happened was not a—that what happened was not a confiscation of shareholder value, but a windfall to the shareholders, because they were given the opportunity, at least temporarily in 2008, to continue with a stake in a firm that by all rights, they should have been out of, the way any firm, any insolvent firm with bankruptcy eliminates the claims that are out of the money.

So, again, this is not a defense of the process, and it's certainly not a defense of what happened in 2012, which as I understand it, and I think I probably don't, is a bit mysterious. That is, yes, we said that you still had a stake in 2008, now we changed our mind, we're taking back your stake. I could see that generating a lawsuit.

[Laughter]

PROFESSOR EPSTEIN: Generating a winning lawsuit.

PROFESSOR ADLER: However, if we're looking at what happened from a public policy perspective, it doesn't eliminate the possibility that what was done in 2008 was not a disservice to the low priority claims, but at least, potentially, a windfall to them.

I can go through this a little more specifically. So, Richard is concerned about this single point, this median of the distribution values and a day of reckoning, a phrase I used a moment ago, and how it's better to delay it. Well, there's a problem with this. As any bankruptcy lawyer, academic, or practitioner can tell you, when you take an asset on, let's say, the day of a bankruptcy filing, and estimate its value, and then wait a year or two—bankruptcies don't always take that long anymore, they used to routinely, and they used to—so you wait a year or two, and let's say you value the asset at $100 on day one. Two years later, it's valued at $180. You have no idea what that extra $80 came from.

What the senior claimant is going to say is that extra $80 represents the true value that has always been there, and that the judge made a mistake by putting a $100 value back then. That's one possibility. I'm not going to try to say whether a senior or junior would say that, back off of that, but one possibility is that the $80 increase in value was simply a valuation error, but there's another possibility.

The other possibility is that the assets appreciated between day one and the day two years later. If you would like to give the valuation its correct consideration, what you need to do is take the person who is going to benefit from the $100 valuation, given the possibility that $80 is an appreciation, and give the full $180 to the claimant who would have received it in the bankruptcy at the time, because that person is going to bear the possibility that instead of going up to 180, it might have gone to 20, so what you're going to have is a systematic undercompensation of a claimholder who is entitled to at least $100 at the time of the bankruptcy, if you're going to allow the upside of future events to go to someone else, to go to the junior. I think I confused who the senior and the junior was a moment ago, but—I confused it before, but I think I got it straight now. This is a serious problem, and one way to see the conservatorship is as, again, a disservice to the government who bought the assets, or as the guarantor, was subrogated to the rights of the senior claimholders against the equity holders.

So it just isn't clear to me that it's correct to say that what we need to do is wait and get the correct valuation because that correct valuation may be an appreciation that belonged to the government to begin with. In 2012, when everything looked good, it doesn't mean that that value really belonged to the equity holders. It could well have belonged to the government properly to begin with. Let's see, I guess I'm going to stop there.

[Applause]

MR. MENASHI: Okay, thank you very much. Next up is Judge Arthur Gonzalez. Judge Gonzalez is a senior fellow at NYU, and has served as Chief Judge in the United States Bankruptcy Court for the Southern District of New York, on which he served from 1995 to 2012.

JUDGE ARTHUR GONZALEZ: Thank you. I do not have any prepared remarks, other than to reflect on what would happen in a bankruptcy case, and this battle that Barry just identified, under the Bankruptcy Code, would generally go—that the appreciation in value is going to go to the senior creditor at the end of the day in a priority scheme, and although there's a lot of negotiation and back and forth, and ultimately, leverage gets played out, at the end of the day, if they don't come to an agreement, that's really where the value is going to end up.

PROFESSOR EPSTEIN: Could I comment on that?

JUDGE GONZALEZ: Sure.

PROFESSOR EPSTEIN: Look, it seemed to me, what has happened here, if you take what Randy said at the beginning, is the government has an option to go one direction or go to the other direction, and it would be a mistake, I think, for us to say, at this particular point, that they were duty-bound to take the receivership. The interesting thing, of course, was that the government's own internal determinations said that they did not think that insolvency was on the cards, which meant that there was actually a serious litigation risk to them, having to go into court and to reverse their proceeding, so if they are going into a receivership, they are doing essentially what I said, and the question is, is there any gain to it?

The argument for gain that I made was that if, in fact, you know that you're in very troubled times and you act like a single owner of all these assets, the delay in fact reduces the variance, and allows you to get a more accurate assessment of the relationship that exists between these particular assets and the overall debt, so that turns out to be essentially, if it's correct, sort of a benefit for which there is no uncompensated loss.

Now, if, in fact, you had decided to allocate a particular asset out of bankruptcy to a particular party, the only correct rule is if it stays in bankruptcy, jurisdiction, that asset, and then appreciates, it clearly belongs to the senior credit, because he owns it, in exactly the same way as if it had been distributed, but I don't think that that's exactly what happened here.

The other point is that the question on this, Barry, again, it's something of a disagreement with you, is that there are a lot of things that happened between September 2008 and August of 2012. The government has an implicit, indeed, explicit say that we want this market to continue to operate in trading shares. There are many people, for example, who get involved in the Fannie and Freddie stuff after the debacle, and they're starting to buy at $2 and $3 a share on the faith that the market, in fact, will become increased. And we do understand that the August 2012 reorganization took the value of the preferred stock, the junior preferred, as it now was, and knocked it down by about 55%, so it's not as though, at that point, there's any ambiguity about the direction in which it goes, and the only reason it doesn't go lower is because people believe that this thing may be reversed either by judicial or by political reason, and at this point, therefore, trying to get any market assessment of what is going on when you have implicit guarantees that may be waived, when you have political reversals that may take place, and you have takings claims that may mature, what it shows you about all this stuff is the reason we are in such an incredible mess, is that from three or more directions, simultaneously, the financial integrity of the system has been attacked, and so that the valuations that you have to make are not dependent on anything upon the intrinsic value of the assets in sale. They are now dependent upon a wide range of political considerations, and the reason why every future effort to clean up Fannie and Freddie will fail is because unless you limit or remove these kinds of systemic risks, you're going to have the same problem of implicit guarantees, implicit obligations forced upon you, political risk, judicial oversight, gurus like myself disagreeing with other people and being shouted down by the multitude, by having congressmen who say, well, you know, conservatorship has got only one set of duties—to taxpayers—which it knows to be wrong, and then, in effect, not acknowledging the whole set of priority kinds of stuff, so the serious issue here is that if you continue with this kind of a position, you'll never private capital back into the market with the next generation of reform because these guys—I think there are a few hedge fund guys around here—and last I looked, none of them had IQs in single digits; they will essentially understand that the political circumstances that we have today will replicate themselves in the future, and so that it's not that it's going to necessarily wipe them out, it will take an exogenous shock to hurt them, but that's certainly going to impair the efficiency of the capital markets.

MR. MENASHI: Did you want to—

PROFESSOR ADLER: No, I don't disagree that the process is flawed. What I disagree with is the assumption that the flawed process necessarily ended up in a taking, at least in the amount of value—I could well imagine a court holding the takings valuation that Richard determines is appropriate and say, your damages are zero because at the time that the government essentially took control of this enterprise in the conservatorship, and then had its way with the assets from that time forward, the equity was entitled to nothing.

So it doesn't seem, though the process was flawed, that there was necessarily any harm done, and the other thing that happened between 2008 and 2012 is, the world didn't end, and there was some concern in 2008 that it would have, and if it had, those assets—the assets that have led to the recovery—would have been valued at a much lower amount than they ended up being worth. And again, this is a value that I'll keep straight this time, this is a value that belongs to the seniors at the time of the day of reckoning, and so it's a standard bankruptcy or insolvency problem of deciding when the day of reckoning is, and it doesn't seem to me so crazy to say, at the day you are about to completely collapse, when the government came in and, for all intents and purposes, bought everything: bought everything in a ridiculous way, and then proceeded in a ridiculous way and a political way thereafter. But if in 2008 those assets were worth less, then the government, as a guarantor, and then standing in the shoes of the debt guaranteed, worth less than they were owed, then on the no-blood-no-foul rule, it may be that the shareholders weren't entitled to anything.

PROFESSOR EPSTEIN: Yeah, but the objections, as I said, there are two transactions. Perhaps they should have tried the receivership in 2008, and if they had done so, everybody would have been gone and we wouldn't have this conflict, but what they did is, they didn't do that. They said, please go ahead is transit [phonetic], so at that particular point, the vested expectations created by the 2008 settlement dictate all subsequent behaviors.

PROFESSOR ADLER: And I don't necessarily disagree with that, I'm just trying to take the other side here, since no one was doing it.

[Laughter]

PROFESSOR EPSTEIN: And so, I mean, there's this funny little test called investment-backed expectations, which I generally hate, because it's so vague, but what it really means is, once the government has the power to commit itself to this or that contract system, it gets one choice on this question, and doesn't get a second free option to look at the thing down the road after it has made its first commitment. And so the way in which you handle this, understand a doctrine, is you figure out what that $77 billion excess is, you treat that as a return of capital, and the government can then liquidate as they want, so that what Chuck said in the morning is right. You can partition the future from the past by essentially getting the right accounting rules, and the great advantage of doing all of that is, you create more confidence in capital markets going forward for the reorganization.

PROFESSOR ADLER: And the last thing I'll say about that is, the only way I can see, as I understand the 2012 transaction, to combat that, is to say that even in 2012, the entity was insolvent. I don't know if that's a fair bet.

PROFESSOR EPSTEIN: [Inaudible].

PROFESSOR ADLER: Yeah, okay.

MR. MENASHI: Okay, we already have a queue, so let's just go to—

AUDIENCE MEMBER: Well, the first point I'd make is that they did not choose receivership, they choose conservatorship, so I don't know why we keep on looking at 2008 and trying to value it as of 2008. I have two questions for Judge Gonzalez. The first question is, have you ever seen a DIP loan, because let's assume this was a bankruptcy, a DIP loan where, at a certain point in time, the DIP loan, the terms of the DIP loan are, we get to capture 100% of the upside of the valuation from the time we entered into the DIP loan to the time of exit. And the second question is, if this were to end up in your court, how would you look at the government claim, given, let's assume for a moment, that they've been paid back 100% cash on cash on their dollars they put in?

JUDGE GONZALEZ: The first question, in terms of the DIP loan, I've certainly had people argue before me exactly what you've said. I haven't found that that existed, but they've certainly made that argument about what the dip loan effectively would do in a particular case. On a second—see, I come from a different standpoint—I'm trying to understand what was the government's duty at a particular point in time, what was its obligation, and to the extent it didn't violate that same rule, that obligation, then I think things play out the way they are, and the funds can go whichever direction they are, they went, and to the extent the marketplace is upset with that, well, I understand that, but then you need to change whatever structure within which the government operated and not allow that to happen.

AUDIENCE MEMBER: This is really just a follow-up question along those lines for the Judge. We've heard a lot today from corporate and bankruptcy scholars saying, if this were a transaction between private parties, this is how it would play out, and we've had disagreements, but I guess this may just follow up on your last response, but how is this different from a private transaction, and how—what is the extent to which we shouldn't follow bankruptcy law, because it's not going to be in bankruptcy court, and it's a conservatorship under a very unique set of circumstances?

JUDGE GONZALEZ: Well, I'd have to look to other members of the panel, specifically Richard, on how is it different? In a sense, it seems to me that the government isn't held to the same standard. It seems to be a different standard that's being played out, which the government had done at the time.

AUDIENCE MEMBER: And so that standard would come from the relevant statues?

JUDGE GONZALEZ: I would assume so, but frankly, I'd have to ask one of my law clerks, I think, that question.

[Laughter]

PROFESSOR EPSTEIN: You want to comment on that, or should I?

MR. GUYNN: Go ahead.

PROFESSOR EPSTEIN: Yeah, I think what happens is, there is a difficulty under statues, whenever you're a single fiduciary for people with different classes of stock, because the optimal strategy for one will be different from the optimal strategy for the other, but this is a case in which that conflict doesn't come into play, because it's the senior preferreds who are essentially wiping out the junior preferred and the common holders, and they're doing so when they're in control of the transaction. The basic argument is, of course, that as a conservator, you have fiduciary duties to everybody inside the structure, and so I would assume, then, as a conservator, you could not say on day one, I am a conservator for the preferred, now junior preferred, and common stock, I'm wiping out the commons. That is, I do think that once you commit yourself to the conservatorship, what you do is, you have to commit yourself to the long view on this particular stuff, and that the choice of the form of the transaction essentially dictates the fiduciary duties.

I think, also, by the way, if what Randy said is correct, that the government's own people had decided that Fannie and Freddie were not insolvent, then the effort to throw them into receivership might well have floundered. It certainly would have delayed things; this would have created even greater mistakes inside the market. So I'm just not—I don't think that people are right, I think Peter Wallison had said it this morning, that they picked the wrong choice. I think, in fact, they probably picked the right choice, and they ought to be able to live with this and remember, it's not just hedge funds that are making money. These people actually have clients, and taking the money from universities like this one, for example, and all the courts of fiduciary—hospitals and religious organizations and so forth.

So one of the things that I think you have to be extremely careful about is trying to make arguments that all we've got to make this superior distribution of wealth by the coercive behaviors in question, when you have no idea what the alternative distribution of wealth is going to be if you actually follow through the conservatorship to its logic, which I think you're bound to do once you select that form, and I also think there were very good reasons for them to do so.

It was certainly not—let's put it to you this way—if somebody wanted to sue the government, to call them before a congressional committee and say, we think you basically violated your fiduciary duties to the public at large by putting them into a conservatorship, I think the guy who answered back says, in hard times, I'm acting in good faith. This was the right thing to do, you cannot second-guess me. I do not think that that guy is going to be removed from office, subject to financial sanctions, or anything else, because that's what happens in high-risk circumstances. The good faith standard applies, and if they are going to act in good faith in picking the one institution rather than the other, it's fine, but once they pick the institution, they have to follow its fiduciary duties.

PROFESSOR ADLER: Richard, doesn't the government still have a right to 80% of the common stock for a nominal amount, under the 2008 setup?

MR. GUYNN: I actually want to just follow up on the conversation just a minute ago, and that is, there have been a lot of analogies, during the course of the day, between the conservatorship and the bankruptcy code, and I'd like to make two points about that. One is, most of the analogies are maybe helpful, but they're not quite on point, because they're actually very different words, and they have very different traditions, and very different case law to back them. But on this particular point, that somehow—at least, I get the impression that somehow, somebody thinks, well, unlikely bankruptcy, where we actually have to respect property rights and so forth—somehow, the government becomes the conservator, that's the same thing as nationalizing the institution, where now the government owns the thing, and it belongs to the government. They obviously own whatever common stock they buy or convert the warrants into, but the fact of the matter is that under the Supreme Court decision that I mentioned, *O'Melveny & Myers v. FDIC*, which I think is absolutely on point here because the language is identical, the fact is, they stepped into the shoes of Fannie and Freddie, they have the same obligations under state and federal law that Fannie and Freddie had before, which is to respect the property rights of the shareholders and debt holders, except to the extent that the federal law overrides it and I'm not aware of anything that overrides any of that. So I think, in fact, that's one of the most important things to distinguish, at least in that respect, I don't think conservatorship is really different from bankruptcy.

PROFESSOR EPSTEIN: I'm going to answer Barry's question, which is a follow-up on this question. I don't think they can wipe out the common. They owe a fiduciary duty to all shareholders. If, in fact, they go in there and say, we're wiping out all the common, they clearly are in violation of that duty. It seems to me, 80% is an 80% violation of that duty.

I think what the government is entitled to do is to move on a single dimension, and that dimension is to set a figure on the interest rate for the preferred, which compensates it in full for its risk, and the danger of allowing a double instrument to work is, it creates very untoward conflicts of interest between the two classes of people, because if you can create an option to buy on the common, why can't you create an option to buy 80% of the preferred as well?

So, I think, in order to discipline the fiduciary duty, what you have to do is to give them a single dimension which cuts down discretion but does not prevent them from giving the full level of protection that they needed.

PROFESSOR ADLER: Yes, but if you have to accept the 2008 rules, which I know you don't, the 2008 capital structure—

PROFESSOR ADLER: No, these are the 2008—

PROFESSOR ADLER: If you have to accept the 2008 capital structure—

PROFESSOR EPSTEIN: Oh, then—oh, in 2012—

PROFESSOR ADLER: Yeah.

PROFESSOR EPSTEIN: I don't think you can challenge that a bit, but remember, Cooper here only represents the preferred.

PROFESSOR ADLER: I understand. [crosstalk]

PROFESSOR EPSTEIN: All right, but now it turns out I represent the common [laughter], and I come into court, I think I am free to challenge the 2008 thing, subject to statute of limitations and all other stuff, on the grounds that this is a very complicated fiduciary issue. And generally speaking, you want to get the hard fiduciary issue, you get multiple classes, and the reason, for example, public corporations typically have only single classes of stock, is because you can't run very good fiduciary duties with more complicated corporate structures.

MR. IVAN ROSS: So, supporting the notion that we need to respect the rights of the common and preferred as set up at the time of the government investment in the conservatorship, to what extent is that position which we all generally agree with, bolstered, and I'm thinking about Barry Adler's comments that maybe the position is not that strong, bolstered by the fact that the government went in to set the rights with their eyes open, for their own very self-interested and good reason.

So, for example, they intentionally left a 20.01% block of common stock outstanding to avoid consolidating $5 trillion of debt on their balance sheet. That was intentional, and they would have done that regardless of whether or not there was any equity value left to the common. They said, that's in our interest. We're not giving it to you because you deserve it—and maybe they did deserve it, maybe not—it's irrelevant. They gave it to them for their own self-interest, so one would think the position is bolstered, they can't go back in 2012 and retroactively change that.

The second thing: conservatorship versus receivership. A lot of people talked about that. That was a purely self-interested decision to let the government have the best chance, in their view, at a difficult time, of keeping the capital markets open, and foreign liquidity, Chinese, et cetera, Japanese liquidity flowing into U.S. securities, where there are agency securities or treasury securities, so the government, very, very rationally, this was not just a last minute surprise that this came up and they had 12 hours to come up with something, they did a very, very rational decision, the rights were very clearly laid out unambiguously, and then it seems to me that that background, legally, to me, it seems that that background ought to bolster the position of those who relied on the rights as they were set out at the time.

MR. GUYNN: Let me comment on that. Those are really important points, I think, particularly in light of Barry's comments, because it's very easy to somehow say, what the government was doing is, they were promising to give money in return for certain rights, and then they balanced the deal and said, we're going to leave some rights to the shareholders, leave, say the 20% in place. That was actually one of the things the government was buying in this process, because it was in the government's interest, because what the government wanted to get out of this was not just resolving Freddie and Fannie. They were literally trying to use this as a device to stabilize the system at the time. They did not anticipate, and I don't think they even foresaw that Lehman was going to fail the following week.

They thought that when they stepped in and did this, this would stabilize an otherwise destabilizing system, and part of what they were buying was, they actually affirmatively wanted the shareholders to stay outstanding in order to send the signal to the market that things were okay, calm down, see, we didn't wipe everybody out, we've got all this capital going in, and so it was actually—that was part of what the government was buying—was the things that are now being characterized as benefits for the existing shareholders.

PROFESSOR ADLER: And as I said earlier, what happened in 2012 is a lot harder to defend, but what happened in 2008 may be easier to defend.

PROFESSOR EPSTEIN: So, on Ivan's point, he said something else, there's another implication from this. If the question is, did they discharge a fiduciary duty, the more you could find self-interested reasons why they did it in this particular form which are unrelated to the welfare of the individuals inside the group. The stronger the case for a conflict of interest, the stronger the case for higher—

JUDGE GONZALEZ: Just one point. It comes to mind, if the government goes into this to save the world, once they get there, they still have to fulfill their fiduciary duties to the entity in which they now run, and it came up in Lehman, it came up in the auto industries, in the bankruptcy, it made a lot of pleas to the court, you must approve this sale, because if you don't approve this sale, the world is going to end as we know it, or the auto industry is going to end. At the end of the day, the obligation of the court, and whoever is prosecuting the point, the sale before the court, is what's in the interest of the estate. The interest of the estate, Lehman, was to approve the sale, so the world doesn't end from an economic standpoint, and they can recoup some of the value, but if you ever had a divergence of that interest, the judge in the bankruptcy court, in my view, should not consider the interests of the world, and only the interests of the estate.

PROFESSOR HENDERSON: So I'm going to ask a kind of Ivory Tower question. The only reason that I care about whether majorities mistreat minorities is because the externalities of allowing a majority to mistreat a minority are not fully captured by the majority in a particular firm. So if it's private companies, and the majority oppresses the minority, that raises the cost of capital for all private firms. Here, I don't so much care if the government is oppressing the minorities. I mean, the minorities, yes, they're sort of worse off, but it seems like the government captures all of that, because then, it's not like, if the government gets its way in this case, this is going to raise the cost of capital for all firms.

All it will do, as Richard said, is discourage hedge funds from investing private capital in government-run enterprises, because they won't be able to trust the government in these kinds of cases, and my question is, why is that a bad thing? I don't want private money being invested in these government enterprises, so why wouldn't, Richard, a small government guy like you say, screw Chuck Cooper's clients and the hedge funds, because that's a surefire way that we won't see a repeat of governments trying to attract private capital?

PROFESSOR EPSTEIN: Well, as a small government, I agree with you that we ought not have gotten into this situation beforehand.

AUDIENCE MEMBER: [Inaudible].

PROFESSOR EPSTEIN: No, but let me tell you, and we'll be here again, is the problem. 1938, of course, was a very bad year because of all the bad government stuff that manages to come down the pike, and I can't undo the undo all that stuff today, but this is my point: in fact, you're trying to encourage multiple people multiple ways. You don't want people to be investing in hedge funds; that's terrific. I don't do government business, but if you want to make that claim, then you can't turn around and say, okay, and by the way, the only hedge funds that are around are those which, in fact, the government runs are supported.

At this particular point in time, there was a very sobering document which was submitted to the hearings, I think it was on the House side before Hensarling by a firm called Millstein, and what they reported was the anemic level of investments in private, non-government supported mortgage funds, at about 5 or 6 or $8 billion, something of that sort, and you ask yourself, well, why is it that you can't get any more money in that? Because what happens is, in this world, if you try to go into a firm which essentially doesn't have government guarantees and prices things correctly, like you talked about in the morning with Wells Fargo and its dirty situation, there is no protection that you have against the kind of situations that took place with the Fannie and Freddie statues of 1992 and 2007, and my view about it is, the government is not allowed to do that. That is to be perfectly blunt about it.

I think the 1992 Act, to the extent that it could be construed, as I think is accurately the case, to force people to take things that they didn't want on fear of government sanctions, that's a taking. And that the only way in which you can do this is to force the government to basically underwrite those things individually, so my reform, I will now state it, going forward, is, in fact, to never allow non-monetized obligations to sit there on the books. So going forward in the government, if you want to give subsidized mortgages, what you do is, you set aside a reserve for each mortgage you wish to subsidize at the time of its creation, then figure out what the market rate of interest is and use the government to do that, so you pre-fund it.

That way, it puts things on the balance sheet, so that you know exactly how much of this stuff is going to take place, and exactly how much this thing is going to cost you, and that you therefore run your subsidy there because—let me put it this way, Todd. A small government guy, I am. The thought that you are going to get the government out of the home owner-ship market in the immediate future, that's more wishful thinking, I think, just not going to happen.

So, the ultimate question in modern society is not whether we do subsidies that are unwise, it's whether we do them in a bad way or in a thoroughly destructive way, and our job is strictly one of damage control. Putting these thing on prices, the analogy that I would give is, you know I'm not a real fan of rent control and rent stabilization, but if you are going to do it, what you don't want to do is force the costs on the landlord. What you do is give each person a subsidy and tell them to go out into the market and keep the subsidy. At the point, they're marginal dollars of their own, the subsidies allow them to beef things up, and what you do is, you put it on the public books, and it goes right back to the *Armstrong* case.

These are all complicated variations of this. If you want to be a social dreamer, be my guest, but do it at public expense. Now, the real Richard doesn't even want you to do it at public expense, but he's not in this room today. [Laughter] He just doesn't exist for these debates, but once you put it on the public books, what's going to happen, unambiguously, is the size of the subsidies will go down, and I'm willing to take a politically responsible way to minimize the problem, but if what you're saying is true, nobody will invest in the real estate market, because even if you can negate the guarantees, under current law, you cannot negate the regulatory obligations because of the rational basis test under the Constitution and unless we change that test in connection with property rights, we're in for a long, cold winter.

MR. GUYNN: Let me also comment that, I don't think if the government does this here, it will actually be restricted to Fannie and Freddie. I think, if anybody knows anything about the bank insolvency laws or liquidation authority, the hedge funds and other investors are going to say, hmm, if this could happen to us as owners of Freddie and Fannie, this could also happen to us as owners of banks and systemically important financial institutions. We need to take that into account and discount our prices accordingly, and so it's going to reduce, I think, investment there, and I don't think that's a good thing.

An illustration of this—in other words—I just think generally, whenever the government operates in a way that seems inconsistent with the rule of law and pre-existing principles, you're going to end up paying a price in the long run. An example of this happened during the financial crisis. Remember, we had the troubled asset relief program, and in fact, it was used to inject capital, and then only late in the day did they say, oh, by the way, we'll actually buy some troubled assets, and that was called the Private Public Investment Program, PPIP. People were all excited, this was great, let's go—if you look at PPIP, it was a complete flop, and it was foreseeable as a complete flop because people were forced to mark down their books to model, so they were marking stuff at 40 cents on the dollar, when in fact, they were performing, and so they—the sellers were not willing to sell at 40 cents on the dollar. They would have said, 98, 90 cents on the dollar, and then you had the buyers, where the government was giving a whole bunch of leverage that should make them more encouraged to bid up higher, but they didn't want to participate and bid higher, because this was at the time when there was a lot of controversy about the AIG bonuses, and all kinds of things, and Congress was talking about windfall profits taxes and things, and the buyers said, gee, if we actually buy some of these troubled assets and actually make a bunch of money, the government is going to impose a windfall profits tax on us and wipe it out, and so there were virtually no buyers, no willing buyers or sellers in the PPIP program, so it failed.

Again, I think the lesson there is that the buyers didn't trust the government to behave in a fair and consistent way, and I think that's the lesson that investors will take from this, if in fact, it's not resolved in a way that is fair.

MR. MENASHI: Okay, I think we can take one last question.

MR. COOPER: This is more in the nature of a comment. I don't represent a hedge fund. I represent a mutual fund with tens of thousands of organizational and individual investors. I represent a series of insurance companies, also with tens of thousands of investors, and that bought preferred stock and other securities, and Fannie and Freddie, even before 2008, when the conservatorship was put in place. In fact, within three months of the time the conservatorship was created, Fannie, at least, went out and raised $7 billion worth of fresh capital at the urging of Treasury and the FHFA, and so—or its regulators—and three months later, that value was virtually completely destroyed. So, I don't represent hedge funds, but I would be proud to represent a hedge fund, because I don't think there's—

PROFESSOR EPSTEIN: [Interposing] Any difference—

MR. COOPER: —any difference in the rule of law that governs the government's conduct in this case, I don't think there's any difference whether or not the plaintiff is a hedge fund, or those of us in this room seeking recovery under the Takings Clause in the Court of Federal Claims, and I think when the day comes, when we decide, okay, do the rules of law here apply? Well, who's the plaintiff? It's going to be a very sad day.

PROFESSOR EPSTEIN: Just one comment, I can't resist. If, in fact, we have different classes of plaintiffs, homeowners, ordinary Joes, and hedge fund guys, what it does is, it kills the secondary market, because then the moment the homeowners want to sell to the hedge funds, the claimants get wiped out, and so you cannot get the efficient redistribution of capital. So when Aristotle said the law ought to be blind to these things, he didn't mean it ought to be blind as in stupid. He meant it ought to be blind in order to facilitate voluntary transactions, and what we take away from this is that he was right, when he said that the stability of possession and the social expectations is the key to success in the long run for any civilized society.

MR. MENASHI: Okay, please join me in thanking your panelists.

[Applause]