

PANEL TWO:  
REGULATION OF GSES, ADMINISTRATIVE LAW,  
AND FIDUCIARY DUTIES

PANELISTS: CHARLES COOPER, M. TODD HENDERSON,  
TROY PAREDES  
MODERATOR: MARIO RIZZO

PROFESSOR MARIO RIZZO: This panel is called “Regulation of GSEs, Administrative Law, and Fiduciary Duties.” Now I’m an economist, one of the maybe three or maybe there’s more in this here today. We economists are used to dealing with the level of abstraction that’s fairly high. It’s a happy world because we have all these institutional details spinning in our heads and worrying about legal analogies and then this and that. We can just sort of analyze the thing just straight away.

Now there are some economists and I think certainly my colleague Larry White is one of them, who have institutional detail and institutional knowledge but that’s not something that I have on this issue. I’m the perfect moderator or chairperson because I cannot interfere. I will ask naïve questions so that those of you in the audience who don’t know much about the area, just as a first year law student here or something like that, I can ask something that will enlighten.

My role will be more of as a facilitator than a wise person on the issues. Okay. The ground rules are each speaker gets about 10 minutes to 20 minutes and then we’ll have 30 minutes of discussions. I’m going to call on the speakers in alphabetical order. I’ll introduce each one separately so we’ll have an introduction and then the speaker.

Our first speaker is Chuck Cooper who’s the Chairman and Founding Member of Cooper & Kirk. He has 35 years of legal experience in government and private practice but still has to get CLE credit.

[Laughter]

PROFESSOR RIZZO: I find that amazing. Your discipline—does Richard have to get CLE credit?

[Laughter]

PROFESSOR EPSTEIN: I’m an academic so I don’t.

PROFESSOR RIZZO: Oh, good.

MR. CHARLES COOPER: Only if he appears in court.  
[Laughter]

PROFESSOR RIZZO: Anyway. Chuck has been named by the *National Law Journal* as one of the ten best litigators, civil litigators, in Washington. He graduated from the University of Alabama Law School and served as Editor-in-Chief of the *Alabama Law Review*. He's quite a distinguished person in this area so he will now talk to us for about 15-20 minutes. Chuck.

MR. COOPER: Thank you very much Mario and good morning ladies and gentlemen. First I'd like to thank my old friend Professor Epstein for organizing this conference and more specifically for inviting me to participate. I appreciate that.

The question before the House is the future of Fannie and Freddie. We've already heard from the previous panel that there's a robust difference of opinion on what that post-conservatorship future should look like. Now I'm agnostic on that. The proposition I want to advance today is that any changes to the structure of Fannie and Freddie or their existence should be accomplished in accordance with the rule of law and to respect therefore the legitimate property rights of those existing shareholders in Fannie and Freddie.

As the conservator itself, the FHFA, has acknowledged, and this is a quote, "the only post-conservatorship outcome that FHFA may implement today under existing law is to reconstitute the two companies under their current charters." Unfortunately that's not what's happened. On August 17, 2012 the federal government effectively nationalized Fannie and Freddie, expropriating to itself all of the future earnings that those companies may earn and in the process wiping out what we believe are tens of billions of dollars of value owing to the existing private shareholders.

The nationalization of Fannie and Freddie was accomplished by essentially a backroom, interagency agreement between the FHFA, the conservator and the Department of Treasury. And it ignored the express limits on the FHFA's statutory authorities and we believe it ignored as well fiduciary duties that were owed to Fannie and Freddie's shareholders.

As we heard from the earlier panel, particularly Peter Wallison's very fine remarks, Congress responded to the housing crisis by enacting a statute called The Housing and Economic

Recovery Act of 2008 or HERA that authorized Fannie and Freddie's regulator to place the companies in either conservatorship or receivership. It also gave the Treasury Department the authority to purchase securities in the companies on a temporary basis. That authority expired December 31, 2009.

Now it's important to understand that HERA draws a very clear distinction between the powers and responsibilities of FHFA when it is acting as a conservator and when it is acting as a receiver of Fannie and Freddie. Here's how FHFA itself describes, quoting from the statute itself, its responsibilities as conservator. "As conservator, FHFA is obligated under HERA to take such action as may be necessary to put the regulated entity in a sound and solvent condition and appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity."

The conservator's own regulations further make clear that "a conservator's goal," I'm quoting again, "is to continue the operations of a regulated entity, rehabilitate it, and return it to a safe, sound, and solvent condition." Now contrast that with the legal obligations of FHFA as a receiver.

Again, here's the FHFA's own regulations: "The ultimate responsibility of FHFA as receiver is to resolve and liquidate the existing entity." So if it establishes a receivership it has a statutory obligation then and there to gather the assets and to liquidate them in an orderly process obeying its further statutory duty to maximize the value for all of the claimholders and stakeholders of the entities.

On September 6, 2008, under the authority it had under this statute HERA, the FHFA placed Fannie and Freddie in conservatorship—not receivership. In other words it made a very deliberate decision, and now five years later, obviously a very fortuitous, fortunate decision for everybody concerned, not to wind down and liquidate the companies but rather, in its own words at the time, "to help restore confidence in the companies and to put them in a sound and solvent condition." James Lockhart, who at the time was the director, when he created the conservatorship, said this: "Conservatorship is a statutory process designed to stabilize Fannie and Freddie with the objective of returning the entities to normal business operations."

The FHFA further explained in a series of written questions and answers published at the time they created the conservatorship the following. This is what they said. “Question: What happens to the companies’ stock during the conservatorship? Answer: During the conservatorship the companies’ stock will continue to trade. However by statute the powers of the stockholders are suspended until the conservatorship is terminated. Stockholders will continue to retain all rights in the stock’s financial worth as such worth is determined by the market.

“Question: When will the conservatorship period end? Answer: Upon the director’s determination that the conservator’s plan to restore a company to a safe and solvent condition has been completed successfully. The director will issue an order terminating the conservatorship.”

So it was clear when the conservatorship was created what their purpose was. It was governed by a statute, black and white rules of law, what they could do and equally well what they could not do. So on September 7, the next day, FHFA entered into agreement with the Treasury Department which has been described previously to provide funding for those then insolvent institutions in exchange for a new class of senior preferred stock.

Under the deal the government agreed to provide up to \$200 billion to each company in order to maintain its net worth at a breakeven or positive level. In return on this new form of government stock the Treasury insisted upon, number one of course, a senior liquidation preference. They would take before all others should the entities ever be placed in receivership and liquidated. They would receive, in the meantime, an annual 10% dividend for the value of that preference. That is, every dollar that these entities drew down on this funding commitment would add to a liquidation preference and it began with a \$2 billion initial—essentially—fee but that was the measure of the liquidation preference.

Finally, Treasury insisted upon warrants that it could exercise for a nominal fee, something like under \$10,000, for 80%—79.9%—of the common equity in the institutions. So in the earlier panel one of the panelists described these as onerous terms. And they were indeed onerous terms. But that was the deal that the only funder in the world that was prepared to

and able to step in and provide this kind of funding commitment as we've previously heard insisted in return for that funding.

So over the course of the next four years a couple of things happened. Fannie and Freddie drew down on that funding commitment to the tune of about \$189 billion. At the 10% dividend rate the companies owed approximately \$419 billion annually or just under \$4 billion every quarter payable to the Treasury. During that period, of course, the four-year period, oftentimes these companies actually borrowed money in order to turn around and pay it back in a circular operation in order to keep their net worth at the breakeven point.

The other thing that happened over that course of four years was that the housing market began to recover. Fannie and Freddie began to make money and in August of 2012 they announced that they had returned to profitability and in connection with that they suggested that their profitability—they would be profitable and they have been hugely profitable and would be for the foreseeable future as the entities themselves have said.

For the quarter ending June 30, 2012, for example, that quarter alone they had a combined net profit of \$8 billion which essentially was obviously \$3 billion in excess of what they needed to service their debt to the United States. It was also clear by that time over the course of that four years as the housing market recovered and Fannie and Freddie returned to profitability that they had very significantly overestimated their loan loss reserves and their deferred tax assets. Things that, in the course of time if they remained profitable, as they projected they would, would ultimately be reversed and be taken into earnings – as we will mention in a moment, many, many billions have been already.

Less than two weeks after Fannie and Freddie announced their return to profitability, the government unilaterally revised its backroom, interagency, not-arm's length agreement to expropriate all of Fannie and Freddie's earnings going forward and to extinguish in the process, obviously, any value and any rights in direct contrast and direct contradiction of what FHFA announced when the conservatorships were created. As you'll recall from my earlier comments, it announced that the

100% so-called net worth sweep would extinguish all the value in the existing shareholders.

They did this by, again, purporting to amend the original deal that I described a moment ago, eliminating the 10% annual dividend and replacing it with a 100%, every dollar, dividend going forward. Now this is what the Department of Treasury said about the new deal at the time it was announced. “The quarterly sweep of every dollar of profit that each firm earns going forward will make sure that every dollar of earnings that Fannie Mae and Freddie Mac generate will be used to benefit taxpayers.” The Treasury Department also emphasized the net worth sweep ensures, and these again are its words, “that Fannie and Freddie will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form.” In other words will not be allowed to do exactly what the statute requires be done in a conservatorship.

So instead of conservatorship, what they essentially converted into was a de facto, slow motion receivership ignoring all of the statutory requirements for creating a receivership. Now the size of the dividends that Fannie and Freddie have paid over the course of the last year under this new deal are enormous. On July 1 of this year the government paid itself a \$60 billion dividend, surely the largest dividend in history, which was composed primarily of its reversal of deferred tax assets that had been, according to its—and I don’t understand there to be a dispute about this—overestimated in light of the restoration of the recovery of the housing market.

To date dividends have accrued for three full quarters. Under the original 10% dividend deal, Treasury would have been entitled to dividends of approximately \$14.1 billion through those three quarters. Under the net worth sweep, the Treasury has been paid \$91 billion, \$77 billion more than it was entitled to under its original deal and \$77 billion that would have increased the capital profile of these entities that the conservatorship is designed to bring back to a sound and solvent condition.

Now it won’t surprise you to hear that I think this was unlawful and violated the very statutes under which the government agencies were bound to operate. Let me just outline a couple of the APA points we’ve made. Under the Administra-

tive Procedure Act, as I'm sure most if not all of you know, a court is to set aside government action that exceeds its statutory authority or that is otherwise not in accordance with law.

Point number one, again, as the Treasury Department itself emphasized by expropriating every dollar of profit for the government the net worth sweep ensures that Fannie and Freddie, as the Department of Treasury announced in connection with this so-called conservatorship, will be wound down and that the companies will not be allowed to retain profits, rebuild their capital, and be returned to the market in a safe and solvent condition.

So it's difficult to imagine anything that could be more directly contrary than this net worth sweep to FHFA's statutory responsibility as conservator, in its own words, "to continue the operation of a regulated entity, rehabilitate it, and return it to a safe, sound, and solvent condition." FHFA's own regulations promulgated, of course, before it was, if Peter Wallison is correct, which one could certainly suspect—before it came under duress from the Department of Treasury to enter into this clearly one-sided arrangement—its own regulations said "that allowing capital distributions to deplete the entities' conservatorship assets would be inconsistent with the agency's statutory goals as they would result in removing capital at a time when the conservator is charged with rehabilitating the regulated entity." There are conservatorship principles 101. They come directly out of statute but none of them should be surprising.

Second point, HERA specifically provides that the appointment of FHFA as a receiver, but only as a receiver, shall terminate all rights and claims that stockholders of the regulated entity may have against the assets or charter of the regulated entity except for their rights in liquidation under the priority scheme that the statute itself sets forth. FHFA as conservator can't do that. That's precisely what it has already done.

Third, HERA expressly mandates that the FHFA perform its duties as a conservator, this is in black and white, independent of the direction or supervision of any other agency. Independent. Well we shall see when we get into the APA record and discovery in these cases how independent FHFA was in agreeing to this net worth sweep.

Finally, the final point I'll make as I—

PROFESSOR RIZZO: [Interposing] You can use a little bit more.

MR. COOPER: —my designated time, is this. Treasury's authority under HARA to purchase securities issued by Fannie and Freddie expired by operation of statute on December 31, 2009. It couldn't buy any more. And yet in August 2012 they allegedly amend the existing agreement to replace their 10% dividend with a 100% dividend going forward. It was a sham, pure and simple. Under any realistic understanding, it so fundamentally changed the nature of that security that it was a new security established after the opportunity for Treasury to purchase securities had, by the terms of the statute, expired.

With that I turn it back over to you.

PROFESSOR RIZZO: All right, thank you. Now we know why Chuck is one of the top ten litigators. I found this rather impressive. Thank you.

As our next speaker, I'm very happy to introduce Todd Henderson who is a Professor of Law at the University of Chicago but he's also, as an economics graduate student of a certain era, the Aaron Director Teaching Scholar. Now Aaron Director, who you don't know, was a member of the Law faculty who took on mythical status among economics students of my generation. He rarely published anything but was the source of all genius ideas at the University of Chicago. Everybody owed everything to Aaron Director. I'm awed that he would be the Aaron Director—

[Laughter]

PROFESSOR RIZZO: —but also Todd has made his own expertise in corporation securities regulation, bankruptcy, and law and economics. He was also the Editor of the *University of Chicago Law Review* and is a member of one of the two finest law schools in the world and the other one is, of course, NYU, and I'm not going to arrange the two but I'm very happy that Todd is here.

PROFESSOR M. TODD HENDERSON: Thanks for having me. My favorite movie when I was a kid and to this day is *Star Wars*. And the reason that's relevant is because my Obi-Wan Kenobi is sitting there in the front row. I don't have any interest in Fannie Mae or Freddie Mac but when Obi-Wan, Richard Epstein, came to me and said you will come to this conference and talk about fiduciary duties. These are not the droids

you're looking for. I was under his Jedi mind tricks so here I am.

And just to respond to the Aaron Director point, I was also going to lead with Aaron Director. I'm probably the opposite. I write a lot but don't have any good ideas.

[Laughter]

PROFESSOR HENDERSON: I'll start with a quote from Director. He famously said "all government activity should be viewed under a presumption of error" and that's where I start. It's a rebuttable presumption but a presumption that should carry over both to the formation of Fannie Mae and Freddie Mac—a terrible idea. There was no evidence of any market failure and so no need for government activity. If there was need for government activity in 1938 it certainly isn't true today. The secondary mortgages market is something the market can perfectly handle.

I should note also that the reason Fannie Mae and Freddie Mac became quasi-governmental agencies or government sponsored entities in 1968 was the first use of off balance sheet accounting. People lament the off balance sheet accounting of Enron and the banks and things and this was the Johnson Administration trying to get the debts of Fannie Mae and Freddie Mac off of the U.S. government's books so the budget would look better.

It's also not a coincidence that the government's investment in Fannie Mae and Freddie Mac was capped at 79.9%. When a corporate lawyer looks at 79.9% they see that that's not a coincidence and the reason is because at 80% you have to consolidate your balance sheets. Taking an 80% stake would force Fannie Mae and Freddie Mac's debts to come onto the budget of the United States.

Anybody out there who's laboring under the continued misimpression that the government is benign and looking out for everyone's interests and trying to do the right thing for the public interest, no, no, they're just like everybody else. They're trying to do what's in their narrow self-interest and that's where Director's insight really comes in. We should look at it in that vein and be critical of it in the way that Chuck and others are.

Okay. Richard asked me to look at the corporate law analogies here. As someone who thinks a little bit about corporate

law, my biggest fear, you know, is that I'm afraid of the government. So I'll be clear about that. But I am especially afraid when government and business get together. That is especially the scariest thing in the world.

That's happened today here with Fannie and Freddie and I think the idea that somebody said earlier, this sort of hedge fund was on top of what was at least an arguable basis for government action, that is a guarantee of mortgages that would otherwise not be guaranteed. You could say there's a public good component of that and maybe you could say that's a legitimate public function but I don't think anybody, including President Obama, believes having a government funded hedge fund sitting on top of this function makes any sense.

We have an entity that guarantees mortgages as its whole business. It's called Ginnie Mae. That's not part of our discussion today because it's sort of a boring entity that just does this business—conforming mortgages—and that seems like it's a workable model maybe for the future.

Richard asked me to look at corporate law analogies for fiduciary duties because you look at this transaction and you see the government is on every single side of it. The government is running Fannie Mae under the conservatorship. The government is an investor both through the Fed, who has invested enormously in buying mortgage backed securities, and through the Treasury Department, which has made these loans. The government is on every side of this. Whenever one entity is on all sides, imagine these transactions in the corporate space. We would have lawsuits galore alleging self-interested transactions and breaches of fiduciary duty. I ultimately don't think that there is much to be learned, unfortunately, from the corporate law analogies here so let me say why.

Obviously if you just think about majority and minority shareholders, the protection of minority shareholders is not something that is this gift from the government. It is in the rational interest of majority shareholders to have protections for minority shareholders. In the absence of these protections minority shareholders would not invest or they would invest on terms that would be much, much worse than what they would with a grantee that the majority will not mistreat them.

So it's in the majority's interest because it lowers the cost of capital. These kinds of arrangements are facilitated through

government enforcement of fiduciary duties and majority/minority protections but they are certainly not something that is a gift. They arise from a state of contracts.

The value of the government enforcing this is that the majority shareholders might not be able to credibly commit that they would not expropriate wealth from the minority shareholders. And the minority shareholders might not be able to distinguish between majority shareholders who would treat them well and badly. So having it external to the majority shareholders that, as a government function, is something that we think is valuable in corporate law for this sort of signaling function.

Where there are conflicts of interest, where there are directors who are on both sides of transactions in corporate law, we have some very well-understood ways of handling those conflicts. Section 144 of the Delaware Code provides some of these. We can have approvals by the majority of shareholders if there's a self-interested transaction, we can have shareholders vote. We can have committees of disinterested directors vote on transactions. Then we can have judicial review in the form of entire fairness. Even if there's a conflicted transaction where there are two parties on each side and the shareholders don't approve it and the directors don't approve it, the courts will bless it if it is entirely fair: that is, if it was a fair transaction.

Well here we have obviously the potential for conflicted transactions because the government is negotiating with itself. But the directors here, or the conservator here; [are conflicted] because the director, the conservator under the statute, has basically stepped into the shoes of the directors. The directors are not actually functioning in any reasonable way with respect to these kinds of transactions. The conservator doesn't have a conflict under Delaware law. It is insufficient under Delaware law to be in a conflict or not considered to be a conflict if all you are is in a position. You have to have some financial interest to be in a conflict.

So a director is not disabled by a conflict just by virtue of being a director. You might argue and people have argued, ah, yes, but your directorship is valuable to you and you're going to continue to be in this directorship. You could say the conservator, it's valuable for him. He's going to keep his positions in the government by doing the thing that government wants

him to do. He makes Obama happy or Treasury Secretary Lew, and that is insufficient under Delaware law to generate a conflict. So that doesn't work very well.

The board powers here and by the statute as I read it, the shareholders' powers are all vested in the conservator. The conservator is made the king. So the idea that the shareholders could vote here to approve a transaction is not really a sensible concept in Delaware law because the conservator has all their powers to decide these things. Now again, I'm not saying there isn't a conflict here and it shouldn't trouble us but Delaware law's not really doing a lot of help.

When I looked at this transaction and what happened, the net income sweep, I'm not sure the person at the Treasury Department that came up with that term should be fired because as a rhetorical matter that's not really a good way to think of it 'cause it sounds bad: sweeping away all your income. It looked to me like the best analogy might be what we see in a typical venture capital transaction.

So in a typical venture capital transaction you've got a big lender, they're the venture capital firm. You've got this little entrepreneur. The typical scheme in the venture capital context that is bad, the kind that Chuck and his clients are sort of alleging is going on here, looks like this. The venture capitalist knows they are the lifeline to the entrepreneur. They are the best source of capital for the entrepreneur. So when the firm, this startup firm, runs out of money, which they all do, the place they will go to is the venture capitalist. And no other outside venture capitalists are likely to invest if the main venture capitalist who has the informational advantage doesn't invest. So they're not the only lender in town but they're at a very privileged position.

Typically what happens is the venture capitalist, cynical here, will starve the entrepreneur and the firm and make it mostly dead, a *Princess Bride* reference, another movie. Mostly dead as we know is not completely dead and when the first is mostly dead it will then go to the venture capitalist and say we're mostly dead, we really need your money, and the venture capitalist will say, oh, okay, here, take some more money but I'm going to do it on onerous terms. I'm going to wipe out the equity share and take a very strong position about ownership.

You could make an analogy in this case that that's sort of what was happening, right? But the problem with that analogy is the government was doing everything it possibly could to help Fannie and Freddie. They gave them a virtual monopoly on the business that they're in. They gave them the right to borrow to pay off the dividends that they were owed, like this isn't even borrowing money on one credit card to pay off another, it's borrowing money on the same credit card to pay off the credit card bill. And the Treasury Department was buying mortgage backed securities, the garbage mortgage backed securities, the toxic ones, which then turned out not be so toxic and it sold those off at a profit and then it said, well, instead of just giving that dividend to the American public, we're going to go and buy more toxic securities from Fannie which was all helping Fannie. Again, I'm not saying there's not conflict here or no problems but the Treasury's behavior here stands in stark contrast with what we would normally see in a kind of "we're going to make you mostly dead and then come in and put these onerous terms on you."

Okay. I don't think the corporate law analogies work very well. We need something else because this transaction, since I've learned about it when Richard invited me to come here two weeks ago, has kept me up at night, that and the typhoon that is bearing down on Hong Kong, where I'm supposed to be in 24 hours.

What are the ways to try to remedy the situation? How could government sponsored entities, if we have them which we shouldn't and I should just stop there and say we should just do away with this, go back to 1938 and stop it. What should we do?

Well we could have political accountability. That's one way of making political government actors responsible, not fiduciary duties enforced but just hold them politically accountable. I don't think the American public is going to hold anybody politically accountable here at all. In fact the taxpayers are getting, according to if you believe Mr. Cooper's version of the facts, a huge windfall. Money that should have been going to the shareholders, the taxpayers are better off, who's going to vote for something like what David Skeel said is the rule of law or for some hedge fund guys? I mean aren't they rich enough? There's just no way that people are going to be held politically accountable.

I just don't think in our modern era with the administrative status [phonetic] as large and as complex as it is that these kinds of things trickle up to the President. I think it's a good argument to be obsequious to Richard here for doing away with the administrative status, I think it's just got too big and complex. I don't think these kinds of things happen so I don't think political accountability works.

Judicial enforcement I don't think is going to work. Courts have had opportunities to pass on this on transactions that looked a lot like this in the Chrysler and GM bailouts. They flaked out. They had chances to act aggressively in the Obamacare situation and they flaked out. So I don't think any judge in America is going to stop what's happening here. Maybe. I know Mr. Cooper will try his hardest and I'm sure his clients have the best counsel they can get, but I'm not optimistic that any judge is going to stand in the way of the government here given what's at stake.

We could have something like a standing special committee—corporate entities use this all the time. They get people who are completely disinterested to come in and pass on particular transactions. We could imagine something like that, some neutral group who doesn't really have a stake here. They don't really work for the government. Corporations usually hire people like corporate law professors or people who are completely disinterested to come in and say, hey okay, look at this transaction, the 2008 transaction, the 2012 transaction, and what do you guys think? We're going to pick five experts, like a blue ribbon commission of corporate law or bankruptcy experts, and say what do you guys think, right? Hire experts, do the valuation, what do you think would be a fair—you could imagine a situation like that that would be a potential that would kind of offer a cleansing of these transactions that's an analogy from corporate law.

Maybe at the end of the day the best option here is to not put in place any mechanisms for making the government more accountable because that's the last thing we want is the government to be involved in making investments like this in private firms. I'm not sure I want to be in the business of facilitating a way that we can try to imperfectly police government actors when they're on all sides of these transactions. I'd just prefer the government not to be involved at all in the first place.

Let me just close by making one other observation. Ultimately, just to go back to the bankruptcy panel, everything here turns on the valuation. I think if you believe that the company was bankrupt in 2008 and bankrupt in 2012 and so under water there was no hope for it then what happened here, the negotiation with government on both sides, probably was fine, right, for the reason my colleague Tony and my former colleague Adam suggested.

We can't know. We can't know because the government is not going to have a process that allows us to do a good valuation. The government is intimately involved in trying to unwind and liquidate this entity so the idea of doing some snapshot valuation when everything turns on what the government's policy is in the first place makes this a Gordian Knot that I just don't think we can undo, which means the government is going to do whatever it is the government wants to do and there's no way we can try to abstract out the valuation of this entity from the complexity of all the government policies.

I should just close by contrasting with this idea in your head that the government will do what the government will do, and all of us are kind of helpless, with the auto bailout. The government did what the government was going to do in the auto bailout. They took money from the creditors, the junior creditors, in the Chrysler case and gave it to the auto unions who were inferior to them out of priority. They took money from more senior creditors and gave it to more junior creditors. This is a violation of bankruptcy law.

The best you can defend is that—and they tried to take this to the Supreme Court and the Supreme Court didn't want anything to do with it—the best argument you could make is the government rigged the auction in the Chrysler bailout so that Fiat would get the business and then out of bankruptcy the people who won the auction, the senior creditors, just decided to gift, they just gave money to the auto unions. Here's a little package under your Christmas tree. Which means the government can do what the government's going to do.

In this case there's a sharp contrast. Here the government could have also sent a gift to our hedge fund friends just like they did to the auto unions. They could have shared when they did the net income sweep on a kind of 80/20 split which was the preferred conversion of warrants they had. They could

have said we're going to take over the company. We're going to forgive the dividend. We're going to take the 80% stake we agreed would be our kind of convertible option in 2008 and we're going to share the 20% of the residual, whatever that is, with everyone else. They could have done that and they chose not to.

That says to me comparing these two transactions what's good for the goose is not good for the gander. Right? We're going to help out our political friends, the labor unions, who were in an inferior position and had no legal claim at all to the rights of the assets of Chrysler but we're not going to do it in this case. With that I'll stop.

PROFESSOR RIZZO: Thank you very much. I think Aaron Director would have been proud.

Our next speaker is Troy Paredes. Troy was Commissioner of the Securities and Exchange Commission from August 2008 to August 2013. He was a Professor at Washington University School of Law. His research and teaching focuses on securities and corporate governance and he was a graduate of the Yale Law School. Troy.

MR. TROY PAREDES: Thank you. Thank you Richard, Mario, as well as Peter Horn for all his efforts in organizing and giving us all here—we appreciate the invitation.

I'm going to start with some big picture remarks before getting into some of the particulars when it comes to what the SEC has been doing on the securitization front which is certainly closely related and Peter Wallison made a passing reference to some of that in his remarks. We've heard a lot already and we'll certainly be hearing more on the institutional details which is why I'm going to take a step back and in some sense elevate up to maybe even then 50,000 foot level to start with.

When I was at the Commission, among all the various things we had to do and think about was not, in fact, housing policy as such. So the chance to think about this conference from a little different perspective gave me the chance to try and take all of the institutional detail, all that has been discussed and that will be discussed, and ask myself a very simple question. Which will we go on? Which will be the core of the difficulty or the core of the challenge? Why are we five years on and still where we are? Well we have legislative proposals

but it's five years after the crisis and it still remains to be seen what exactly comes out at the other end.

What I came to and I'm sure many, many others have come to the same realization and I think it's lurking in all of the discussions we've heard and all the discussions around Fannie and Freddie up to this point more generally, is that there is a tension on the policy choices. Now people may line up more or less on one side or the other but what you have is on the one hand the policy, the politics if you will, around home ownership and promoting home ownership.

Now there are empirical questions as to the extent to which you need Fannie and Freddie to do that but the goals of promoting home ownership on the one hand and on the other hand the goal of no more bailouts. And the goal of the government not being there to provide the backstop and the goal, I guess, to put it differently, taxpayers not being on the hook.

When you think about the role of a government subsidy, so subsidize home ownership by having a Fannie/Freddie backstop to drive down, so the claim goes, 30-year fixed mortgages and if that then results in a mispricing of risk, at some point when and if the risk actually materializes, it results in loss, who's left holding the bag? Well if that's going to be the taxpayers or seemingly has been the case in the past then you implicate the other goal of, yes, you may have promoted home ownership but now you have potentially taxpayers on the hook.

So what you have then is policymakers needing to make a fundamental choice. I think it's important for that choice to be above-board and to be explicitly identified, articulated, and talked-about so at least folks have to own the choices they made. I'm not prepared to say at this point where I would necessarily land on that. I have my views on that but I think it's important to be very clear that is, I think, why we are in part finding it so difficult to achieve real reform because to achieve one goal is to potentially come at the risk of the other goal. Then you see the pressures that are brought to bear by various interested parties and five years on we are where we are.

Now when it comes to the SEC and my time there and even, of course, what the SEC continues to be focused on, you get to the very closely related and important topic of securitiza-

tion. That comes back to, I think, a good illustration of the kinds of interests that get engaged when questions of home ownership are at play.

What do I have here in mind in particular? Well over the last few years the Commission has done a number of things Dodd-Frank required and otherwise that come to adding more regulation to the securitization marketplace.

The issue that has gotten the most attention and some very recent attention are the risk retention rules. So Dodd-Frank provides, put it very simply, that securitizers have to maintain on their books, have to retain 5% of the risk of an ABS offering that they undertake. The logic here is straightforward. If you think the concern with the crisis was the originate to distribute model where there wasn't enough sharing of loss, if you will, by the securitizers and the ultimate investors, risk retention is designed to align those interests to a greater extent because the securitizers have to have at least to some extent the same exposure as the investors or so the logic goes. I think there's lots to be asked about the originate-to-distribute model. I think there's lots to be asked about whether or not there are other ways in which securitizers and lenders find themselves bearing risk in the role of market discipline and all the rest but that's the basic logic.

Well what it turns out though is that there are some big exceptions to the risk retention requirement. The first is that Fannie and Freddie are excluded. The second is that there's an exception for the risk retention requirement if you have so-called qualified residential mortgages. The logic there being that if you have a qualified residential mortgage it is thought to be of sufficiently high quality that you don't need the alignment of interest that is thought to be achieved by having risk retention. The assets are sufficiently high quality that are underlying the asset-backed offering that risk retention isn't warranted.

A while back the Commission as well as other parts of the government undertook a joint rulemaking pursuant to Dodd-Frank to give life, if you will, to risk retention. One of the things that was provided for in terms of the definition of qualified residential mortgage or so-called QRM was a 20% down payment requirement for a mortgage to qualify as a QRM in which event, along with some other requirements; those mort-

gages would be excluded from the 5% risk retention requirement.

Well the notice and comment process very much part and parcel characteristic of the administrative process generated a whole lot of interest on the part of various parties when it came to the definition of qualified residential mortgage. The basic concern that many expressed was the recognition that if you require securitizers to hold 5% of the deal, if you will, on their books, that makes it more expensive for them. If you make it more expensive to undertake securitization process then that could impact the liquidity that's in the marketplace to continue to fund mortgages and that could have an adverse impact on interest rates for mortgages which comes back to potentially frustrating or being at odds with the goals of home ownership.

So you get a lot of comment that come in and what the Commission as well as other parts of the government, the banking regulators, just came out with, this was after I left the Commission, was the re-proposal of the risk retention rulemaking. Among other things when it came to the definition of qualified residential mortgage, QRM, they got rid of the 20% down payment requirement. Now there's no longer a requirement that there be a 20% down payment. There's now no down payment requirement. There are other requirements but no down payment requirement.

A lot of folks have expressed concern about that, and that goes back to some of the concerns about policy choices that were made in the past about efforts to promote home ownership and that if you in fact think that risk retention is important to alignment of interest, you now have created a huge exception to the risk retention requirements so that the section may back-swallow the rule so that you end up not having much by way of risk retention as a practical matter because the QRM basket is so expansive.

Now my former colleague, still very good friend, Commissioner Gallagher dissented from the rulemaking and addressed this issue at some length. And Commissioner Aguilar, also a former colleague and a good friend, while he supported the rulemaking, if I recall his statement at the meeting, recognized that the new definition of QRM means that in fact you have loans that are going to be included in QRM where you

don't have the 5% risk retention requirement that may in fact nonetheless be subject to a considerable risk of default.

The process will move forward. Comment will come in and we'll see where it all lands but it's one of the important aspects of this broader discussion that has been in fact in front of the Commission. You can see the politics and the policy that are involved in any discussion that implicated home ownership as well as any discussion that impacts the prospect of taxpayers being on the hook.

Let me move on to one other quick point to conclude and then jump into the conversation. That is this, the sweep amendment which has been discussed at so much length. I won't talk about the particulars which you've heard a lot about. To Todd's point, what will the judicial accountability be? What will the political accountability be? That will all play itself out. I'll just say that from my perspective while one may share in the goals of winding down Fannie and Freddie and one may share in the goal of taxpayers getting their money back, if you will put in those terms, the fact of the matter is there has to be some constraint on government and it can't simply be that the ends justify the means. It can't simply be that the goals are sufficiently laudable that the government has free reign to do whatever it sees fit to achieve those goals.

Again, there are legal questions, there are economic questions, there's questions about what the regulatory and the legal regime would have contemplated and the rest. Others are versed in those particulars to a greater extent than I am. But for me it's at least caught my attention at the general level particularly when the statement that this is all to the end of winding down Fannie and Freddie which many people think is the main reason we're striving for, it doesn't give the government in my estimation free reign to do whatever it thinks, whether that's the goal or something else, that there are constraints. Again we'll see what the accountability ultimately proves to be but I think we can't lose sight of the fact that there are limits to government's ability to do even what it thinks are good things even if we agree on those ends.

PROFESSOR RIZZO: Okay. Thank you very much.

[Applause]

PROFESSOR RIZZO: Okay. Now we'll have a question and answer session but I would like to ask just a factual question.

What was the mortgage market like pre-1938? Can somebody give us some idea because you toyed with the idea of going back to pre-1938? What was that like? How did it work?

AUDIENCE MEMBER: [Off mic] It was short-term mortgages for maybe a maximum of 60% loan to value, 5 years, there would be a balloon at the end and so there was a problem with —

AUDIENCE MEMBER: [Off mic] — that was a benefit, in fact 50% of the market was long-term mortgages. It was — sector — but there were widespread 30-year mortgages but more amortized over—

AUDIENCE MEMBER: [Interposing] I think that was for bonds. Yeah I'm not familiar with that. The general history says those were short term.

[Off mic crosstalk conversation]

PROFESSOR HENDERSON: I know nothing about this but I do know that in terms of international comparisons the US is almost alone in thinking that 30-year fixed mortgages is a good idea. So the idea that you would have short-term financing is what is the predominant norm in most other countries. We don't see housing collapses every couple of years and I think they've probably had fewer housing problems than we've had in the places where they have the rules that look more like we do you see more housing crises.

But it's not a surprise that we have these bubbles in housing when at the time if you wanted to borrow money to invest in the stock market you could only borrow 50% from your broker, but you could borrow, you could be infinitely levered in investing in housing. It's not shocking that people would, with infinite leverage in one area and 50% in the other that we would see money diverted to investments in housing in unnatural ways.

PROFESSOR RIZZO: Hugh?

MR. McCULLOUGH: I have a question — this question is for Mr. Cooper. The analogy between the Treasury preferred stock and other preferred stock, in particular Berkshire Hathaway's injections of money into Goldman Sachs just before the TARP bailout. Goldman Sachs was so desperate for money that they agreed to very onerous preferred stock deal from Warren Buffett and he took 10% a year for four years and if they paid it back before that they had to pay a penalty.

They in the end did swallow the penalty and pay it back before maturity but when you're subject to that kind of deal you want to pay it back as fast as possible if you can. If there's no penalty they would have been paying it back even faster.

So it makes sense to me for Fannie and Freddie that the best interest of the firm would be to pay down that 10% onerous preferred stock as fast as they can, if they can, and it would make sense from the Treasury's point of view to have insisted in the first place that they use any profits to pay it down, at least especially when they borrowed to pay the previous dividends, rather than paying it out as dividends to common, to the junior equity. Then once they paid that down then they should be freed to use any further profits to pay to equity. Was that not the case, that they could not pay down the preferred stock? And if they did pay it down they could not then have the profits to themselves?

MR. COOPER: That wasn't the case.

MR. McCULLOUGH: It was not?

MR. COOPER: The original agreements would not allow Fannie and Freddie to redeem the senior preferred stock without Treasury's consent. Okay?

MR. McCULLOUGH: Okay.

MR. COOPER: So it's up to Treasury and that is the original deal. Our challenge isn't to try to upend the original deal. It's to try to hold the government to the original deal.

You mentioned the Warren Buffett arrangement with Goldman. Even more analogous kind of similar type of bailout was the government's arrangement with AIG where in terms that were not as onerous as these the government made a lot of money as essentially an investment banker.

MR. McCULLOUGH: Well so did Warren Buffett but that was the price of taking on that risk.

MR. COOPER: That's exactly right. The government, for all it appears, the government was going to make a tremendous amount of money under the original deal in this situation. In fact, I think many educated projections are that under the original senior preferred stock terms the government will pay back—excuse me, Fannie and Freddie will pay back—all of the, I take that back, under the current terms where all money goes to the government, the government would be made whole completely with interest by the middle of next year.

MR. McCULLOUGH: And still would continue to collect any further profits under the sweep.

MR. COOPER: Under the net sweep, yes.

AUDIENCE MEMBER: This reduces the federal deficit?

MR. COOPER: Yes, that's another thing. That's another thing that needs to be understood about this. The government is very, very interested in this net worth sweep and vacuuming out every dollar of profit from these now very profitable enterprises because they're applying it to the deficit and extending the day of reckoning when the debt ceiling has to be increased. They extended it several months simply on the basis of this sweep amendment.

PROFESSOR RIZZO: Yes?

AUDIENCE MEMBER: Hi. Professor Henderson mentioned that the date upon which, I guess it was the August date, when the third amendment was entered into, the value of the firm is critical to the legality of whether or not—the legality of the third amendment. So I was trying to understand why the value of the firm at that point in time is relevant.

PROFESSOR HENDERSON: Well that's when they renegotiated the terms of their deal. So, I think if the company was—and I'm not a bankruptcy person—but it seems like if the company at that point was not insolvent or nearly insolvent then the case that the conservator acting as the directors would renegotiate the terms on the basis that he did looks a lot worse than if the company was insolvent. I'm here just parroting what my colleagues said on the earlier panel which is if this has all the appearances of a prepack kind of bankruptcy where the conservator says the best thing for the estate to maximize the value of the estate is make the seniors secure and pay them off and wipe out equity, that's an arguably reasonable decision if the company's near bankruptcy or in bankruptcy or nearly insolvent.

If it's not, if instead they run the forecasts and they say we're going to make \$12 billion a quarter in perpetuity and they do the valuation, then that choice seems like they're stealing 20% from equity because they could convert—they entered into a convertible preferred contract in 2008—they could convert, take the 80% or 79.9% share and share with the other 20% so that's the basis I was operating under. If that's wrong, let me know.

AUDIENCE MEMBER: It should not be a static look at the balance sheet is what you're saying.

PROFESSOR HENDERSON: No, no, no. It's a "what is the value of the going concern" circa August or March when they entered into the contract, 2012. And if the going concern at that point, if the director—imagine the directors sitting down and they say, look, there's no way. We can't redeem this early. We're dependent on Treasury. We're borrowing more money to pay the dividends. We can't project in the future that we would ever get out of the hole we dug ourselves into on the terms of the 2008 agreement, if that's the case, then the directors took a deal with the devil but they had to take it.

If it was the case that everybody said, boy, it looks so sunny tomorrow and we're going to have clear skies for the foreseeable future, then the deal that they struck looks like they were trying to do it for political reasons to pay down the deficit and steal money from the shareholders. I think it all turns on that question.

MR. COOPER: Well really if the scenario was as you described and there was no hope of any profit in the future, why change the deal? Why change it? They're already the only creditor who can possibly get anything out of it. We've stipulated they're not going to get everything out of it. Why change the deal?

There was only one reason to change this deal. One reason. They knew that they weren't the only ones who were in line. They insisted that they be the only ones in line and that they destroy all the value of the stockholders that existed and that none of these people that they don't like making money would be entitled to any of that value for their property interests.

You earlier said, and I agree with this, the guy at Treasury who came up with the net worth sweep, that wasn't very politic but what's the alternative? It would certainly probably beat out we want all the money amendment. I agree with you Todd that there's not any likelihood of a political resolution of this that will restore value to the existing stockholders. I disagree with you in terms of the possibility of judicial resolution of this. Is there truly no judge in the country that will look at these—

PROFESSOR HENDERSON: [Interposing] You know better than I would.

MR. COOPER: —look at these rules of law and say they count for nothing? They count for nothing? They are to be violated at the whim of the government. 25 years ago I heard exactly this proposition in the aftermath of the S&L crisis. Many of you in the room will recall that. Some of you will not.

In 1989 the Congress itself enacted a statute that simply abrogated some very clear arm's length commercial contracts between the government regulator at the time, the Home Loan Bank Board, and thrifts. Healthy thrifts that were impounded by the government to absorb the sick thrifts that the government was on the hook for, under the insurance—the deposit insurance.

You could fill a room a lot smaller than this with the people who thought ultimately those healthy thrifts would be able to enforce their contracts for damages against the United States but as it turned out the Supreme Court rules 7 to 2 in the *Winstar* case: when the government enters into a commercial contract with an American corporation or an American citizen it's held to the same contract requirements that everybody else is. And how could it be otherwise? How could it be otherwise? In this country anyway. I mean this net worth sweep would make Kim Jong-Un blush.

AUDIENCE MEMBER: So I understand the lawsuits and some of the lobbying on the part of the hedge fund investors and the other preferred shareholders as tactics in the battle to get some value out of those preferred shares. What I'm trying to think about is not just tactics but broader strategy. I'm trying to get in the head of Treasury. Earlier discussions had noted that the government is on really almost every side of this transaction between Treasury and FHFA.

What I don't understand is the preferred shareholders, the juniors win the battle in court, they get on APA grounds or on other grounds, they get that third amendment overturned or found to be invalid, but then you look at all the other tools that the government has to kind of achieve its goals. They could lower the guarantee fee and thereby reduce profits or drain profits. They could increase reserves. They could not pay out dividends. They could, by Congressional act, restructure Fannie and Freddie in all sorts of ways that keeps the money from ever being distributed to any preferred shareholders.

I'm just curious: what's the end game? If the government is really focused on keeping this money or not distributing the money, aren't there a lot of other tools they have at their disposal other than the third amendment?

MR. COOPER: The tools that you've identified sound to me like tools that would be destructive to the government's own interests, not just to the interest of preferred shareholders but to the government's own—

AUDIENCE MEMBER: [Interposing] Well they just lower the guarantee so that they have kind of a zero net worth.

MR. COOPER: Yeah, well they could do that. And if they want these entities that owe them this money to have a zero net worth rather than the ability to pay back everybody including the taxpayers. Look, the government has two choices under the law. They can place it in conservatorship and try to restore their competence and bring them back to a sound, solvent condition and return them to normal business operations, exactly what the statute requires, and FHFA understood was its obligation when they created the conservatorship, which implies that at such time as they are restored to safe and sound business practices with adequate capital that they don't have the authority to continue a conservatorship beyond that indefinitely. They have to do one of the two statutory outcomes that are available to them, either end the conservatorship as Director Lockhart said he would do as soon as the purposes had been served, or they declare a receivership. But to declare the receivership, they have to—it has to qualify under the statutes' specified conditions for creating a receivership which means you've got to look at its economic profile today. Today. According to the economists that I've heard look at this including some on the previous panel, it wouldn't qualify for receivership today.

That's it. Congress can do something else but based upon the law that we have now that's it. Will a judge enforce that? We'll see. As a lawyer who deals in rules of law every day I hope for our sake that a judge will enforce this.

AUDIENCE MEMBER: Hi. We're an institutional investor in junior preferreds and so I agree obviously with a lot of the observations. I just wanted to go back to the August 2012 amendment and Todd you had mentioned the analogies with Chrysler and GM with respect to the government will do

whatever it wishes in some respect. Could you just flesh out a little bit in what ways the conditions in August 2012 contrast so dramatically with the conditions that GM and Chrysler had both for the firms themselves as well as the fact that they were in a highly distressed environment, that we were in a bankruptcy court versus, today, the judicial review being in a court of appeals or a district court? Would that chance the calculus of judicial review?

PROFESSOR HENDERSON: Well I don't want to make too much out of this point that I was making because there are some significant differences, as you said. And I'm not an expert on the state of affairs of Fannie and Freddie circa August or March of 2012. My only point was the best-case scenario for the government's position in the bailout of Chrysler was, we were into Chrysler for way more than the value of Chrysler; we basically foreclosed on Chrysler. We ran a bankruptcy process with what I believe was a rigged auction. They basically couldn't get a judicial valuation through the auction process of what Chrysler was actually worth because they put in condition that would mean they were Fiat and this combination were the only bidders. So they sort of rigged the valuation. Win the auction for the assets and then decide to gift the labor unions this big present which they weren't owed legally. That's what happened in that case.

Obliviously in this case we're not in bankruptcy court. There is no auction for the assets. We're imagining in Professor Casey's and Badawi's example a kind of prepackaged bankruptcy, an out of court bankruptcy process with a kind of DIP lender of sorts. So this is obviously quite a different scenario.

My point there was the government could have at that point said, look, the deal we struck was in 2008, if the future turns out to be bad we will foreclose on the assets. If the future turns out to be good we will, like any other normal investor would, convert our shares by the warrants and take 79.9%. Okay. They could have done that and it would have looked—I mean they didn't legally have to if you believe the company was legally insolvent in 2012 but they could have done that and taken 79.9% share and to Chuck's point, do everything they're doing now as a 79% owner and then share the other 20%. They could write down the guarantee fees and they would share the pain of that 80/20. They could let the future go for-

ward and Fannie and Freddie continue and capture 80% of that. Instead they said, no, no, we're going to take 100%.

That's where he's finding fault and if you look back at 2008 I think that's kind of the contract that they imaged. Bad times, we'll take over the company; good times we'll take 80%.

The hard part is unwinding this all when the back story here is that President Obama came out and said I want to get rid of these entities. That just makes the whole thing so complicated because now we don't really know what the future's going to look like. It's so circular with what the policy choices are. It's different than the auto companies were we're not going out—President Obama didn't come out yet and say, global warming we need to stop producing cars. If that was the case, boy, that would have made the bankruptcy process much more complicated in the Chrysler situation.

AUDIENCE MEMBER: I have a two-part question, first for Troy and then for Chuck. It has to do with the definition of a security and what constitutes a new security. Under established jurisprudence, under 10-b of the '34 Act or 11, 12 or 17 of the '33 Act, the definition of what constitutes new securities is pretty well known because the triggering of liability depends on the purchase of a new security.

Under the Internal Revenue Code you have gains or losses that actually become realized based on whether or not a new security has been issued in exchange for an old security. To me a sweep of all net income has recharacterized the Third Amendment from what is essentially a preferred instrument into a common equity issuance. It has all the indicia of common equity and any private corporation that would have issued such a sweep, a net income sweep, would have been held liable under SEC precedent as having issued a new security. If you exchange for such a thing, you would have a realizable gain or loss.

So my first question to Troy is would you recharacterize a net income sweep as an issuance of common equity given that it's the entire residual interest, and that's essentially the definition of common equity?

Then my second hard question is under HERA the authority to issue any securities or to purchase securities by the Treasury expired in 2009. You've made, I think, a very eloquent argument that the Treasury acted outside of its jurisdic-

tion, alluded to additional arguments that in 2009 their abilities to make this amendment have expired, but I'd go one step farther. They have actually purchased a new security. That's an explicitly unauthorized action under HERA and I'd like your comments on that please.

MR. COOPER: My comment can be very quick. I agree with every word you just said.

MR. PAREDES: My comment won't be quite as quick. It's great to hear the question because as I was thinking about this before, look, there are others who are into the particulars more than me so I'm going to reserve a little bit of judgment having not spent the time with the documents in particular areas in bankruptcy law and all the rest. But as I was thinking through the economics of it, when I was introduced to this, I had a very similar reaction without thinking about it in the specific way of is this a new security as a technical matter but thinking about the economics now of what the government has, versus what it had, that it basically when it realized that having the claim to the residual made better economic sense decided it was going to have the claim to the residual as compared to having a fixed claim, if you will, with the 10% dividend and the payback.

That is a fundamental change in the economics. Whether or not one wants to technically characterize as the issuance of a new security in terms of the nature of the economic interest, they are much more like a residual claimant than they were before and that certainly maps onto having different topics of the capital structure and you can overall technicalities on top of that or not.

When it comes to the core question of the economics and the core question of value and who's better off, who's worse off, who priced in what risks or not, again, whether you have the technical overlay of calling it a new security, you end up with, I think, the same set of general concerns.

I'll go back to what I said before, and we've heard continuous echoes of this point. Todd made the point to the government will do what it will do. For me, again, I keep coming back to the fact that we can't allow for what might be seen as good policy choices when it comes to winding down, scaling back Fannie or Freddie or even paying back taxpayers to get in the way of what are in fact constraints on the government's ability,

and Chuck put it, there may be many other ways for the government to achieve a comparable outcome. The government should then pursue those other ways for achieving the outcome they think is best but if one of those avenues is in fact cut off as a matter of law, if in fact it's cut off as a matter of law, the fact they can achieve a similar outcome through different means doesn't, I think, win the day. There may be reasons why political accountability or otherwise they chose this means as compared to those other alternatives and that should be brought for ownership, not only the substance but also the process.

AUDIENCE MEMBER: I have one follow-up question if I may.

Let's posit for the moment that this is an issuance of common equity because it has the indicia of residual interest. Putting that debate aside, the GSE charter itself says that the common stock has no par value and there's no authorized maximum issuance so there are no limitations but it has a very strong statement about when common stock can be issued. It can only be issued in exchange for capital or surplus. The Third Amendment was done in exchange for essentially a guarantee of debt going forward in the future.

How does that add to capital or surplus or, in your opinion, if that were an issuance of common stock could that be violative of the GSE charter? You may not be in the weeds enough I guess to answer that question specifically, but Part B is who would own the right to bring that action? If the FHA as conservator is not following the GSE charter, who sues and how?

MR. COOPER: I'm very happy, especially now, to be at this conference because this is a point that sounds very sound to me and that I'm not acquainted with in terms of the actual charter. But the charter itself is a law. It's a statute. To the extent that it confines Freddie and/or Fannie in the way that you suggest, that unless there is some amendment to that charter implicit or explicit in HERA and the authorities that a conservator has, then it should be enforceable. Whether or not individual preferred stockholders or common stockholders can enforce it is something I'd have to really look into. I don't know.

PROFESSOR HENDERSON: We should have a screen in the back with the current stock price of Fannie stock to see if we

can measure the responses of everybody. It's a new piece of information. The stock—I see people on their Blackberries back there. The stock has risen.

[Laughter]

PROFESSOR HENDERSON: No. People are shaking their heads no. Oh, okay.

PROFESSOR EPSTEIN: I mean I have two questions, one going on this line and then one about the home ownership bit. On the first question I think I disagree with the characterization that the third amendment creates a new class of common stock. If it created a new class of common stock it would be subordinate, of course, to the junior preferred which is above it. So therefore, the only way that the government would be able to get anything on the common that it—the so-called common is first to pay off the junior preferred.

And then Chuck, I'm just actually curious, it's a one sentence answer please, you represent the junior preferred and the common shareholders or just one or the other?

MR. COOPER: Just the junior preferred.

PROFESSOR EPSTEIN: Just junior preferred, so then somebody has to come out there and figure out what's going on with respect to these common shareholders. It seems to me, at least as a first approximation, the real objections to this is not that it's an issuance of new shares of common because they would be subordinate to you so you would be essentially indifferent, what it is is a modification of a contract in which all the benefits go to the government and none of the benefits go to the other side which it has to be since zero is coming in a breach of fiduciary duty which is dependent on a fair valuation. I think that's probably the more accurate way in which one's to say.

Then to ask the administrative law question, after 2009 can you modify a contract in such a fundamental and one-sided way wholly apart from the takings issue. Am I wrong? How can you call this a common stock if in fact it has priority over your clients? First to you and then to anybody else.

MR. COOPER: Well even if you don't call it a common stock and it seems to me that the argument for doing so that we heard previously is a pretty good one—

PROFESSOR EPSTEIN: [Interposing] But then it would be subordinate to you.

MR. COOPER: Yeah, this common stock would be subordinate.

PROFESSOR EPSTEIN: [Interposing] Yeah, this stuff, the one thing we can say about this Third Amendment agreement is that it is superior to you.

MR. COOPER: Well but even if you simply look at it in terms of the preferred stock, is it's preferred stock that has now eliminated a finite fixed—

PROFESSOR EPSTEIN: [Interposing] Yeah.

MR. COOPER: —dividend for 100% of all earnings. In the process it has wiped out every other share of stock. That seems sufficiently fundamental to me. It must be a new issuance—

PROFESSOR EPSTEIN: [Interposing] Well it is— I mean there are residual claimants but a residual claimant means you're last on the line and you get all of the unspecified earnings. These guys, residual claimants and first claimants—they're basically the whole kit and caboodle. It seems to me that if I were thinking about this from your point of view, the litigation point of view, I would not want to do this.

Now I have another question on this which I'm going to push right now which is if this is in fact a receivership in which the government is supposed to—the trustee is supposed to work for the benefit of the common shareholders, right? I can understand why it is that you give a senior interest and a very ample rate of interest, maybe not this one, but let's assume that this is a fair interest. The question is how can a fiduciary give away 80% of the common stock for nothing when in fact there are other ways in which you can organize the transaction so that the priority is given to the government so that it's better off when it makes the loan than without it. But the only reason you're willing to make that kind of thing is you think that the infusion's going to be a gain/gain situation all the way down. Because if you're a fiduciary, it seems to me under these circumstances, you must be a fiduciary not only for the junior preferred but also for the common. If you're a common fiduciary for the common how can you essentially say, look, what we're going to do is surrender 80% of this stuff for about \$.16 for the whole bunch, right? If in fact this thing starts to go up.

So this is sort of a question to everybody as to whether or not the fiduciary duties that are imposed under the conserva-

torship are consistent with the notion that you can give this absolutely, 79% of the—

PROFESSOR HENDERSON: [Interposing] So you're talking about the 2012 transaction?

PROFESSOR EPSTEIN: [Interposing] No, I'm talking about the 2008 transaction.

PROFESSOR HENDERSON: 2008 transaction.

PROFESSOR EPSTEIN: It seems to me a fair question and nobody's addressed it. Those are not your clients, right, so you don't have a fiduciary duty to them, right? But somebody presumably does. I don't even know who's talking—

PROFESSOR HENDERSON: [Interposing] That's me.

PROFESSOR EPSTEIN: Oh, I was looking around—

PROFESSOR HENDERSON: [Interposing] After all these years you don't recognize my voice, I just called you my Obi-Wan Kenobi.

[Crosstalk]

PROFESSOR EPSTEIN: You were coming from on high, that's all.

[Laughter, crosstalk]

PROFESSOR HENDERSON: Boy. It seems like given the situation that Fannie and Freddie were in in 2008, the deal they got was a pretty good one. It was a pretty good one. I mean it is very common in these, as I made the analogy to the venture capital transactions, it's very common for the lender and there it wasn't like the only lender in the world, it's just the privileged lender, to come in and say, we're taking—we'll put in some more money, we'll do a bridge loan, we'll take senior preferred, a Round B, a Round C, a Round Z financing—and we'll take 95% of the equity.

So I don't think the convertible preferred 2008 in the financial situation they were in in 2008 was that bad, especially because the financial crisis could have been short and then they would have been sharing. I think the real issue is in 2012 and my presumption about government error to the point Chuck was just making when the government says, look, the situation of Fannie Mae was so bad in August or March of 2012 that there was no way that anybody was going to make any money so we had to restructure this on completely onerous terms, take our word for it. Well, boy, given it's the government acting, I'm very sensitive to that.

PROFESSOR EPSTEIN: You mean August 2012.

PROFESSOR HENDERSON: Yeah. Well I think the deal was struck—they started to negotiate in March.

PROFESSOR EPSTEIN: Well yeah, but I'm asking a slightly different question because remember the government is on both sides of this particular deal. So it's coming in on the one side on a lender and on the other side it's acting as a representative of the common shareholders. Clearly they discharged that particular duty without some kind of determination that they have to throw in—

PROFESSOR HENDERSON: [Interposing] Given the business judgment rule—wait, given the business judgment rule and given the fact that the directors, imagine the conservator wasn't deciding this, imagine it was directors, Fannie directors in 2008 vis-à-vis the judgment rule, the deal they struck, you lose every day and twice on Sunday.

PROFESSOR EPSTEIN: I asked what about the fairness as whole rule as opposed to the judgment rule which I thought you had earlier said would be the—

MR. COOPER: What about the fairness as a whole rule, as opposed to the business judgment rule which I thought you had earlier said—

PROFESSOR HENDERSON: [Interposing] There's no conflict of interest here. The directors are not on both sides of this.

MR. GYNN: There's a problem here with the analogy which is the analogy is to a board of directors of shareholders who would say we're about to go into the tank and so we're looking around for lenders to lend us money and so we agree to certain terms. That's not what happened here. What happened here is the Treasury voluntarily came in, put a gun to the head, and said you will take this money on these terms or we will tank you which they had the power to do. I'm not sure that the analogy to a voluntary transaction quite works because it wasn't as though, at that point, I don't think the shareholders and the directors of Fannie and Freddie actually thought they were insolvent or about to go in the tank. They were told that they were about to and therefore—

MR. COOPER: [Interposing] To the contrary, within a month of the time they were put in conservatorship, FHFA itself had certified to both entities that they're in capital compliance.

MR. GYNN: Yeah, the only qualification from that Chuck—I agree with that—except that the capital compliance under the statute was so low to be laughably low for institutions. So two percent capital for institutions that had their kind of exposure was kind of silly—

MR. COOPER: [Interposing] Fair enough. Fair point, fair enough.

MR. GYNN: They were in compliance.

PROFESSOR RIZZO: I think our time is up.

PROFESSOR EPSTEIN: Let me put it this way. I am going to cede my shares back to the public good and not claim any consideration in return. Thank you all for this wonderful discussion.