Recent Fifth Circuit Case Hands Tentative Victory to GSE Shareholders and Declares FHFA Governance Structure Unconstitutional

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On September 6, 2019, the Fifth Circuit Court of Appeals issued its opinion in Collins v. Mnuchin, a case in which shareholders of Fannie Mae and Freddie Mac were challenging the so-called "Net Worth Sweep" that transfers substantially all of the GSE's net earnings to the Treasury Department. The court's decision gave the shareholders a partial victory, deciding that the shareholders' statutory claims were not subject to dismissal and sending those claims back to the lower court. The court also held that the Federal Housing Finance Agency's governance structure was unconstitutional, although it was not clear how that decision benefitted the shareholders.

The decision is an important one, for two reasons: addressing the Net Worth Sweep, apart from any impact on the shareholders, is critical to any plan to recapitalize the GSEs, as was recently proposed by Treasury. Second, the issue concerning the constitutionality of the FHFA's governance structure is essentially the same issue that has arisen regarding the governance structure of the Consumer Financial Protection Bureau. With the Collins decision, the Fifth Circuit has come to a different conclusion on constitutionality than has the Ninth Circuit and the DC Circuit, thus setting up the issue for likely consideration by the Supreme Court.

The court's ruling – comprising six concurring and/or dissenting opinions in addition to the majority opinion – includes substantial background on the evolution of the Preferred Stock Purchase Agreement, which is the mechanism by which Treasury provided a backstop to the GSEs during the financial crisis. Pursuant to the PSPA, Treasury purchased preferred stock of each GSE, along with warrants to purchase up to 79.9% of the common stock. In exchange, each GSE received funding commitments from Treasury. Initially, the preferred stock had a 10% fixed dividend. The PSPAs were entered into by FHFA, as conservator of each GSE, and Treasury, in September 2008, the day after FHFA appointed itself as conservator for the GSEs.

In August of 2012, FHFA and the Treasury entered into the Third Amendment to the PSPA. The Third Amendment replaced the 10% dividend with variable dividends equal to the GSEs' entire net worth, less a capital buffer that decreased over time to zero. The dividends on the preferred stock do not reduce the liquidation value of the preferred stock, so it is never "repaid". This the so-called Net Worth Sweep that directly impacts the value of the GSEs' stock held by the public. The court noted in its opinion that Treasury announced at the time of the Third Amendment that this arrangement would "expedite the wind down of Fannie Mae and Freddie Mac", and ensure that the GSEs "will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form". The shareholders pursued two separate

arguments, one under the FHFA's statute, the Housing and Economic Reform Act of 2008, and one under the Constitution.

The statutory argument was essentially that the FHFA has appointed itself as a conservator for Fannie and Freddie, not as a receiver, and that entering into the Net Worth Sweep exceeded FHFA's powers as conservator since it did not "preserve and conserve" the assets of the GSEs. Rather, the Net Worth Sweep was a mechanism that only a receiver could implement, as it was more evocative of a liquidation strategy. The court held that the FHFA cannot be both conservator and receiver at one and the same time, and its current status and appointment authority is that of a conservator. As a result, the FHFA exceeded its authority in entering into the Net Worth Sweep.

The Constitutional argument was that the FHFA's governance structure was unconstitutional and, as a result, actions taken by FHFA, i.e., the Net Worth Sweep, were invalid. The basis of the Constitutional argument is that the FHFA's statute provides that the FHFA is to be managed by a single director who serves for a fixed term, and is removable by the President only "for cause". This distinguishes the FHFA's governance structure both from other federal agencies managed by multi-member, bi-partisan boards or commissions (such as the SEC), or by a single individual who serves at the pleasure of the President (such as the head of the Treasury Department, the Secretary). Both of the foregoing structures have been found to be Constitutional governance structures for federal agencies, the theory being that these structures are consistent with the President's obligations under the "Take Care" clause of Article II of the Constitution, to "Take Care" that the laws be faithfully executed.

A secondary Constitutional objection arises under the "Appropriations Clause" of Article I of the Constitution, that since FHFA is financed via assessments on the GSEs, FHFA, in addition to suffering from a lack of Presidential oversight, also suffers from a lack of Congressional oversight via Congress' "power of the purse". The Court agreed with the shareholders on the Constitutional issue, holding that the governance structure of the FHFA was unconstitutional. Essentially the same governance structure is shared by the CFPB, and has also been the subject of several court challenges concerning the CFPB. Currently both the Ninth Circuit and the DC Circuit have found this governance structure to be Constitutional, thus setting up a "conflict among the Circuits" that can only be resolved by the Supreme Court.

An appeal for certiorari – the process in which the Supreme Court agrees to hear appeals – is currently pending at the Supreme Court on the Ninth Circuit decision upholding the CFPB's Constitutionality. On September 18, 2019, the CFPB submitted its brief to the Supreme Court in support for certiorari in the Ninth Circuit case. In the brief, the CFPB stated that it has "reconsidered" its previous position that its governance structure was Constitutional, and the CFPB is now agreeing with the position that the governance structure is unconstitutional. Given this new position taken by the CFPB, it seems likely that the Supreme Court will address these issues.

Perhaps the most interesting aspect of the Collins case for SFA members and the broader public is the final issue considered in the case – given that the FHFA's governance structure is unconstitutional, what does that mean for the GSE shareholders? The Court was sharply divided on the answer to this question. A nine-member majority of the Court held that the proper remedy in response to the findings of unconstitutionality was to sever the restriction on removal of the FHFA director only "for cause" – thus, presumably subjecting the FHFA to increased Presidential oversight as an officer serving at the pleasure of the President, similar to the Secretary of the Treasury.

Seven members of the Court dissented from this approach, questioning first, whether (and notwithstanding the popular impression) a court can actually re-write or "strike down" a statute, rather than just not apply it to the case at hand. Second, and certainly more germane to the shareholders, the dissenting judges pointed out that the "severing" remedy, in and of itself, would not remedy the injury to the shareholders. Rather, the dissenting judges would vacate (nullify) the Net Worth Sweep.

Any Supreme Court decision that both holds the governance structure of the FHFA and/or the CFPB unconstitutional and nullifies prior actions by the agency – as a near-majority of the Fifth Circuit would have done – would have far-reaching effects. Among other actions, the adoption of the "Qualified Mortgage Rule" by the CFPB and the consummation of the credit risk transfer transactions by the GSEs could become problematic – to pick just two examples.

Although such a result may sound farfetched, a review of recent case law – including at the Supreme Court level – reveals a general lack of agreement among the federal judiciary in the areas of "Constitutional administrative law" and "separation of powers" that are the fundamental issues in the FHFA, CFPB and other cases. Very few court decisions in these areas lead to clear guidance, and majority opinions are usually accompanied by a host of opinions by concurring and dissenting judges – as in the Collins case.

SFA will continue to monitor these and similar cases, and keep its membership promptly informed of developments. In appropriate situations and with the backing of membership, we will be prepared to weigh in on these cases through amicus curia briefs to the courts.