

Delaware Corporate Law Once Again Invoked In Fannie Mae And Freddie Mac Litigation

Mar. 15, 2016 7:17 AM ET22 comments

by: Rule of Law Guy

Summary

- SA readers following GSE litigation are aware that with the Hindes/Jacobs case, Delaware corporate law has been invoked to supplement the federal law-based Perry and Fairholme litigation.
- Now a second Delaware law case, Pagliara, has been filed that seeks to invalidate net worth sweep (NWS) dividends under another provision of Delaware corporate law.
- It may turn out that FHFA/Treasury's achilles heel is their federal hubris, in promulgating the NWS without appreciating its state law consequences.

In a Pi Day complaint filed with the Delaware Chancery Court, Timothy Pagliara has sued FHFA under Delaware General Corporation Law (DGCL) Section 220, seeking to inspect the books and records of Fannie Mae (OTCQB:FNMA), after his shareholder demand made to FNMA's board of directors to review such records had been ignored.

The purpose of this demand is spelled out in complaint, and it can be gleaned from the demand letter that preceded the complaint. The NWS dividends distributed to Treasury are subject to invalidation, and the FNMA directors are subject to personal liability, in the event the NWS dividends were distributed in violation of DGCL Section 170, which prohibits dividend distributions made when there is insufficient capital.

To put this Pagliara case in context, SA readers following the GSE litigation are aware that Perry has challenged the net worth sweep (NWS) dividends in DC Federal District Court on federal law grounds, claiming that FHFA as conservator exceeded its statutory duty under its organic statute, HERA, in connection with the NWS. Fairholme has challenged the NWS in the Federal Court of Claims in DC on federal law grounds, claiming that if the NWS is not a violation of federal statute, then it constitutes a violation of the Takings Clause of the 5th Amendment to the US Constitution.

The Hindes/Jacobs case switched legal gears by claiming the NWS was void under state law, DGCL Section 151, insofar as the NWS dividend provisions violated Delaware law relating to the permissible terms of preferred stock issued by Delaware corporations, such as FNMA.

The Pagliara case can be understood as progeny of Hindes/Jacobs, insofar as Pagliara alleges in his complaint that:

"197. The Board violated Section 170 of the DGCL in voluntarily declaring and paying the dividends under the Net Worth Sweep.

198. Based on the information available, Fannie Mae's capital in respect of its issued shares of preferred stock was impaired as of each of the dates for which dividends were paid under the Net Worth Sweep. The capital was impaired because Fannie Mae's net assets, which ranged between approximately \$3.6 billion and approximately \$62.4 billion, as of each of the relevant dates, fell short of the apparent capital in respect of the Senior and Junior Preferred Stock, which by default is the amount of cash consideration paid for the stock, an amount exceeding \$129 billion, based on public records."

One reason for the suit for production of FNMA's books and records is to determine whether the board of directors recorded the proceeds from the issuance of its preferred stock as anything other than the default treatment of paid-in capital equal to the cash proceeds received from their issuance. If it is determined from FNMA's books and records that it did not elect an alternative treatment, then Pagliara will promptly follow up with a new complaint, or an amended complaint, alleging the DGCL Section 170 dividend impairment violation.

One other reason to inspect the books and records is to determine whether at the time of each NWS dividend distribution, the board reevaluated the net assets of the issuer to increase the value of the surplus available for dividends. If the board did not make this reevaluation analysis, then this will further support Pagliara's DGCL Section 170 dividend impairment claim.

So, as Hinds/Jacobs seeks to void the NWS stock itself as a violation of the type of preferred stock that can be issued by Delaware corporations such as FNMA, Pagliara seeks to void the NWS dividends made in respect of the stock as a violation of the capital impairment provisions that must be observed by Delaware corporations. When Hinds/Jacobs and Pagliara are taken together, you have a "tree root and fruit" attack on the NWS under the DGCL, seeking dual paths under Delaware law to invalidate both the NWS stock itself, as well as dividends issued in connection with the stock.

Both cases derive support from the recent *Aurora Loans* case, the 9th Circuit Court of Appeals decision, which made clear that corporations under FHFA conservatorship remain private corporations, and FHFA's conservator powers are those powers it inherits from the corporation's board of directors under state law (unless additional conservatorship powers are specifically set forth in the conservatorship statute).

So, when FHFA as conservator caused FNMA and Freddie Mac (OTCQB:FMCC) to issue preferred stock, and the board of directors caused dividends to be declared on that stock, they needed to take into account applicable Delaware corporate law. When FHFA and the board fail to do so, they can find no succor in the federal conservatorship statute which, as the court in *Aurora Loans* held, places FHFA in the shoes of FNMA and FMCC boards of directors with respect to corporate powers, and affords the boards of directors no greater powers than they had pre-conservatorship.

Disclosure: I am/we are long FNMA.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

Editor's Note: This article discusses one or more securities that do not trade on a major U.S. exchange. Please be aware of the risks associated with these stocks.

Comments (22)

maps666

Thanks ROLG.

Can you comment on the anticipated timelines of various cases you mention here?

15 Mar 2016, 07:41 AM

Rule of Law Guy, Contributor

Author's reply » perry appeal set for oral argument 4/15/16. decision likely by early fall. hinds/jacobs full briefed, oral argument not yet scheduled. should be decided not long after perry appeal

15 Mar 2016, 09:33 AM

briantthatbrian

SCHWING!

16 Mar 2016, 03:30 PM

artman123

Fantastic article, legal departments across America should employ you on retainer and universities should be inviting you to guest lecture at their law schools.

15 Mar 2016, 09:34 AM

First Class Capital

Great article! Investors Unite- TIM PAGLIARA, the man behind the latest case is holding a conference call today 3/15/16 at 2pm EDT.

15 Mar 2016, 10:33 AM

briantthatbrian

"It may turn out that FHFA/Treasury's achilles heel is their federal hubris."

Well said.

15 Mar 2016, 10:44 AM

InTheTube

'The NWS dividends distributed to Treasury are subject to invalidation, and the FNMA directors are subject to personal liability, in the event the NWS dividends were distributed in violation of DGCL Section 170, which prohibits dividend distributions made when there is insufficient capital.'

Make some room at Bernie Madoff's card table, new players coming!

Excellent article!

15 Mar 2016, 11:18 AM

briantthatbrian

IntheTube gets it.

16 Mar 2016, 03:30 PM

S2000M3

Another fine article. Thank you.

You stated:

"Timothy Pagliara has sued FHFA under Delaware General Corporation Law (DGCL) Section 220, seeking to inspect the books and records of Fannie Mae (OTCQB:FNMA), after his shareholder demand made to FNMA's board of directors to review such records had been ignored."

Question:

Assuming FHFA used 4617(b) (2) see below as their argument, is it possible they can get the case dismissed or prevent information from being released?

12 U.S. Code § 4617(b) (2) General powers

(A) Successor to regulated entity The Agency shall, as conservator or receiver, and by operation of law, immediately succeed to—

(i) all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity with respect to the regulated entity and the assets of the regulated entity; and

(ii) title to the books, records, and assets of any other legal custodian of such regulated entity.

(B) Operate the regulated entity The Agency may, as conservator or receiver—

(i) take over the assets of and operate the regulated entity with all the powers of the shareholders, the directors, and the officers of the regulated entity and conduct all business of the regulated entity;

(ii) collect all obligations and money due the regulated entity;

(iii) perform all functions of the regulated entity in the name of the regulated entity which are consistent with the appointment as conservator or receiver;

(iv) preserve and conserve the assets and property of the regulated entity; and

(v) provide by contract for assistance in fulfilling any function, activity, action, or duty of the Agency as conservator or receiver.

(C) Functions of officers, directors, and shareholders of a regulated entity

The Agency may, by regulation or order, provide for the exercise of any function by any stockholder, director, or officer of any regulated entity for which the Agency has been named conservator or receiver.

(D) Powers as conservator The Agency may, as conservator, take such action as may be—

(i) necessary to put the regulated entity in a sound and solvent condition; and

(ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity.

15 Mar 2016, 12:35 PM

Rule of Law Guy, Contributor

Author's reply » govt will resist this demand, saying federal law governs and has displaced delaware corp law. if fact, it will likely try to remove to federal court.

15 Mar 2016, 01:20 PM

briantthatbrian

Yes.

15 Mar 2016, 01:07 PM

Caludio

ROLG

do you know when can we expect and order from Judge Sweeney regarding the motion to compel?

15 Mar 2016, 01:12 PM

Rule of Law Guy, Contributor

Author's reply » soon

15 Mar 2016, 01:18 PM

cavlogix

I have coached many sports teams across numerous sports over the past thirty years (from youth to National team), some teams were better, some teams were worse....I also coached a couple of undefeated teams...so, here is my sports analogy...the US Government is trying to go undefeated in all of these court cases...and that is difficult to do and EXTREMELY unlikely. Good job, Mr. Rule of Law Guy.

15 Mar 2016, 08:47 PM

Caludio

Dear ROLG

What is your opinion about this motion to consolidate all the cases in DC court?

Is it possible that Judicial Panel on MDL orders it ? or the parties can refuse ?

Thanks

16 Mar 2016, 08:14 AM

steven haffner

Your further legal analysis appreciated ROLG, but really the fact the Government has not settled and thus far gotten away with this heist, in spite of all the courts involved, is surreal. The Government has a completely untenable position. Utterly jaw dropping.

16 Mar 2016, 08:51 AM

briantthisbrian

It certainly feels "completely untenable." But it is merely untenable. The difference is the amount of time it will take to reduce it. Not to worry. Got some smart boys with a lot of artillery bringing it up. Time for a good old-fashioned siege. It is only a matter of time.

Longs will win. And they will win big.

16 Mar 2016, 03:45 PM

rirossington

Rule of Law Guy,

All of the recent disclosures, judgements, and (though limited) legitimate press coverage seem to be positive catalysts. In fact, the most positive catalysts throughout this eight year debacle. Why are the share prices not reflecting? Within the last 36 months, we were at over \$6+ for a very short time on very small catalysts, yet with everything that has transpired in the last 12 months, not only do we still sit below \$2.00 and tend to stagnate, but we have large downward swings (percentage wise) many days of the month, but no real large positive swings. Why? What gives?

Thanks

16 Mar 2016, 08:54 AM

LostOkie51

Yeah I've been wondering the same. Thinking about buying more here. But, , , I don't know. Like you, I'm wondering what's goin on here!!

16 Mar 2016, 11:24 AM

First Class Capital

institutions who want in, are already in.. Weak hands of the past that wanted to test the waters jumped in and are too scared to get back in.. I would presume that we are at the strongest point since the inception of NWS even if the stock doesnt reflect.. Also could have something to do with people losing faith in ackman, hes still smart, just got burned on a big play

16 Mar 2016, 12:01 PM

briantthisbrian

The answer is good news. Attrition. Skittish and weak hands have left. And now they stay gone. That means more people on the wrong side of this "bet."

Those who have been wrong and those who have recently joined them in being wrong will be the ones who come back later after court victories and pile in and pay much higher prices to power this thing much, much higher.

16 Mar 2016, 03:25 PM

briantthisbrian

Listen to First Class Capital. He gets it.

16 Mar 2016, 03:26 PM