

Fannie Mae Takeover Confuses a Class Action

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Lawyers behind a class action against mortgage giant Fannie Mae are about to find out what happens when the company you've sued becomes a government ward.

Investors filed suit against the publicly traded behemoth in 2004, in the wake of an accounting scandal. Now, [more than six months after the Treasury Department's September decision to place Fannie Mae in a government conservatorship](#), many players in the litigation are still wondering how the change will affect their case. Fannie Mae's attorneys have said in court that the move could open up new defenses for the company, though they haven't yet said what they will be. And securities law experts say the uncertainty swirling over Fannie's future could give the company powerful leverage in settlement talks.

But for now, the only sure thing is that nobody knows what's coming next.

Judge Richard Leon of the U.S. District Court for the District of Columbia has already forced the uncertainty into open court. "The 800-pound gorilla sitting in the room is the obvious question: What's Fannie Mae?" he asked during a Jan. 9 status hearing. "Where is it going? What is it? What does it consist of? ... I mean, I'm not sure I even understand it."

Even Fannie Mae's lawyer, Jeffrey Kilduff of [O'Melveny & Myers](#), couldn't clear it up for him.

"I am not sure I do either, your honor," he said, adding that his firm was still exploring what the takeover means for the case. "It raises some defenses that we aren't prepared today to raise ... but there are some unique defenses that are involved."

The suit started five years ago, after a report by Fannie's government regulator accused it of overstating its profits by billions of dollars. The [Office of Federal Housing Enterprise Oversight](#) found that between 2001 and 2004, the mortgage dealer had failed to comply with [Generally Accepted Accounting Principles](#) and had maximized executive bonuses with improper bookkeeping that created the illusion of steadily rising profits. The revelation sent Fannie Mae's stock price tumbling and the company was eventually forced to restate its finances, shaving off \$6.3 billion in earnings from those three years. The attorney general of Ohio filed suit against Fannie Mae on behalf of the state's pension programs. The class includes anyone who bought Fannie Mae stock between 2001 and 2004, and now stands at roughly 1 million people.

The suit also names several of Fannie's then-executives, as well as its auditor, KPMG. The OFHEO report had accused the accounting firm of rubber-stamping its client's improper activities. Fannie Mae and KPMG sued each other as well, adding more layers to an already complicated case. In 2004, Fannie Mae's employees piled on an Employee Retirement Income

Security Act complaint. [The four cases have since been locked in a massive discovery process](#), with Fannie alone producing 30 million documents.

Lawyers for Fannie Mae, KPMG and the Federal Housing Finance Agency, the company's conservator, either did not return calls or declined to comment. But several lawyers and professors with expertise in securities and corporate restructuring said that the government takeover has sent the litigation into uncharted territory.

TEMPERING LIABILITY

Federal conservatorships are extremely rare, and not a particularly developed area of law, says Harvard law professor Mark Roe, who researches corporate bankruptcy and reorganization.

As a result, Fannie Mae's legal team could try to pull ideas from related parts of the law. For instance, Roe says, they might try to argue that some of the protections meant for companies in Chapter 11 bankruptcy should also apply to Fannie Mae. That could significantly reduce any potential award.

Michael Bradfield, counsel for [Jones Day](#), says the argument might be attractive to Fannie's defense team, but he doesn't believe it would hold up in court. Bradfield was the general counsel to the Federal Reserve in 1984 when it intervened to rescue Continental Illinois National Bank and Trust Co., an action some have cited as an early precedent for the Fannie Mae takeover.

The government could have chosen to put Fannie into a receivership rather than a conservatorship, as the FDIC did with IndyMac last summer, he says. That choice would have meant essentially dissolving Fannie and selling its assets to cover debts. Receivership also requires that all ongoing litigation against the company be stayed, and makes it extraordinarily difficult to win new judgments. But nothing about conservatorship, which leaves the company intact under government control, explicitly protects it from legal claims, Bradfield says.

"Congress had the option of establishing different regimes, and they chose a conservatorship," Bradfield says. "They knew the difference between the two. It would be an issue as to what was the congressional intention."

The threat of receivership itself is also casting a shadow over the case. Almost no one seems to believe that the government would take such an extraordinary measure just to make the lawsuit go away. Still, Fannie's poor financial condition means no one is explicitly ruling it out, and it could be a potent weapon at the negotiating table. Although the Obama administration has identified it as a key player in fixing the mortgage market, Fannie Mae has continued to hemorrhage money, reporting a \$25 billion fourth-quarter loss, and asking for \$15 billion from the Treasury.

"I think that what that does is it pushes back on the amount the plaintiffs' class action will be able to recover," says James Cox, a securities law professor at Duke University.

"Settlements always happen in the shadows of reality, and it will temper what the liability will be."

HUNDREDS OF MILLIONS

At stake: hundreds of millions of dollars, if not more, at a time when Fannie Mae is surviving on public money. Freddie Mac settled a similar class action over its accounting practices for \$410 million in 2006, before the government takeover. That same year, Fannie Mae paid the SEC and OFHEO \$400 million to settle a related enforcement action. Most of that money went into a fund to compensate investors and was distributed in 2007.

If Fannie Mae were to extricate itself from the litigation, either through receivership or a novel defense, KPMG could ultimately end up the biggest loser. Apart from undercutting its own lawsuit against the company, that development would leave it as the only company left in the class action. Fannie Mae's former executives, who are named in their personal capacity, would also still be liable for damages.

During the January status hearing, after Leon suggested the possibility that KPMG could end up alone in the case, class lead counsel Stanley Chesley of Cincinnati's [Waite, Schneider, Bayless & Chesley](#) said the plaintiffs are prepared for that.

"If Fannie Mae is gone, the plaintiff, the attorney general of Ohio, plans to proceed against KPMG, and we are ready to go to trial," he said. "And if they go bankrupt, then there will only be three accounting firms in the United States instead of four. So be it."

In an interview, Chesley says he does not believe that scenario is likely, given that the government seems to be counting on both Fannie Mae and Freddie Mac to help fix the problems in the subprime mortgage market. And he says the conservatorship shouldn't stop the lawsuit.

"The company has trillions of dollars of mortgages and the government is looking to them to be a major, major vehicle in the future," he says. "As far as we're concerned, they're viable, and we're moving forward."