

The Government's Seizure of Private Property Behind a Veil of Secrecy

By Saikrishna Bangalore Prakash | May 16, 2016

In response to a private lawsuit seeking relief from the government's expropriation of all the future profits of Fannie Mae and Freddie Mac, the executive branch has invoked "executive privilege" to shield thousands of documents from disclosure. However, when private parties allege government wrongdoing, the government's interest in securing confidential advice should yield to the plaintiffs' need to prove their case. Private parties, in this case shareholders of Fannie and Freddie, have billions of dollars at stake, while the public has inestimable interests in open government, the rule of law, and accountability. Given the circumstances, the court reviewing the claim of executive privilege should rebuff the executive's attempt to cast a shroud of secrecy over its expropriation. While the executive's generalized interest in confidentiality may prevail in other contexts, its relatively weak interest in this case should not trump the constitutional rights of plaintiffs seeking just compensation for a taking of their property.

Background

Fannie Mae and Freddie Mac, federally-chartered and privately-owned companies, were established to provide market liquidity and stability by maintaining a pool of lending capital for mortgages. Amid uncertainty about their financial health in the midst of the 2008 financial crisis, Congress enacted the Housing and Economic Recovery Act (HERA), *PL 110-289*.¹ One of its provisions created the Federal Housing Finance Agency, an independent regulatory agency authorized to act as a conservator. In this capacity, HERA expressly required FHFA to "preserve and conserve" Fannie's and Freddie's assets and property so that the entities could be restored to a "sound and solvent" condition. HERA drew from language in the Federal Deposit Insurance Act, the Depression Era statute that stipulates principles and practices governing insolvency of financial institutions.²

Under HERA, the Treasury Department provided liquidity to Fannie and Freddie and, in return, received warrants for 79 percent of the shares of companies' common stock and \$1 billion worth of senior preferred shares. Yet the government was not content with the deal it struck with FHFA.

In August 2012, the U.S. Treasury Department amended the investment agreement with FHFA and obtained for itself a quarterly sweep of the profits of Fannie and Freddie. As justification for the one-sided terms, FHFA asserted that the new policy would prevent Fannie and Freddie from having to draw on public funds to meet its dividend obligations to the Treasury.³ This unanticipated and ongoing profit sweep rendered privately held shares in Fannie and Freddie almost worthless.⁴ Commonly called the "Net Worth Sweep," the Treasury has diverted over \$246 billion into the government's general coffers.⁵

¹ <https://www.congress.gov/110/plaws/publ289/PLAW-110publ289.pdf>

² <http://www.bna.com/treasury-fhfa-ignoring-n17179923428>

³ <http://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-FHFA-Acting-Director-Edward-J-DeMarco-on-Changes-to-Fannie-Mae-and-Freddie-Mac-Preferred-Stock-Purchas.aspx>

⁴ <http://seekingalpha.com/article/3263145-valuing-freddie-mac-and-fannie-maes-common-and-preferred-stocks>

⁵ https://www.washingtonpost.com/business/economy/freddie-and-fannie-are-making-money-again-and-everyone-wants-it/2016/02/19/e02416b2-d71e-11e5-b195-2e29a4e13425_story.html

The Net Worth Sweep prompted scrutiny almost immediately as questions arose as to whether Treasury had overstepped legal bounds. Treasury itself spoke of a “managed wind down”⁶ of Fannie and Freddie, something not provided for by law. Two critics of the Treasury’s actions are Mark Calabria, a former congressional aide, and Michael Krimminger, a former chief counsel for the Federal Deposit Insurance Corporation, both of whom were intimately involved in drafting HERA. They note, “Congress consciously chose to vest FHFA with the sole authority on whether to proceed with a conservatorship or receivership. The roles of other agencies, notably Treasury, were purposely made narrow and limited. The Banking Committee’s intent in HERA was to limit the role of Treasury to one of creditor, even if a preferred creditor. Both the House and Senate Committees with jurisdiction on the legislation debated a larger policy role for Treasury but ultimately rejected it. The drafters of HERA never envisioned, nor intended, for Treasury to maintain a large equity stake in the companies.”⁷ Given FHFA’s status as an independent agency, its role as a conservator, and Treasury’s limited statutory authority, FHFA and Treasury were supposed to maintain an arm’s-length relationship, not a cozy one where Treasury could dictate terms to FHFA.

What makes the institution of the Net Worth Sweep particularly suspicious was that Fannie and Freddie were profitable even before the sweep and have largely remained so ever since.⁸ This invited the conclusion that Treasury was trying to shrink the federal deficit by using profits from Fannie and Freddie. Relatedly, given their profitability and Treasury’s stated objective of “winding down” the companies, the Net Worth Sweep may have been conceived and executed as part of a strategy of terminating Fannie and Freddie.

The Fairholme Funds Suit

Beginning in 2013, investors in Fannie and Freddie brought a number of suits, alleging variously that Treasury’s and FHFA’s conduct exceeded their statutory authority, violations of the Administrative Procedures Act, breach of contract against FHFA as conservator, and breach of implied covenants. Some cases alleged that FHFA, as a conservator, had violated a fiduciary duty owed to shareholders. By agreeing to Treasury’s siphoning of all the profits, FHFA had dissipated (rather than conserved) the assets of Fannie and Freddie.⁹

In *Fairholme Funds v. United States of America*, filed in 2013 before the U.S. Court of Federal Claims, private holders of preferred stock made a different charge. They asserted that, by redirecting all future profits to the Treasury, the federal government had effectively acquired their preferred shares and given them nothing in return. In essence, the investors asserted that the federal government had “taken” their property without just compensation, in violation of the Constitution’s Fifth Amendment.¹⁰

The investor-plaintiffs in *Fairholme Funds* sought discovery from the Federal Housing Finance Authority and the Treasury Department. Discovery is a pre-trial request for documents and depositions directed to the opposing party. Plaintiffs need discovery as a means of proving their claims. In this case, the plaintiffs sought to establish that Fannie and Freddie were financially sound at the time of the inauguration of the Net Worth Sweep and that plaintiffs therefore had “a reasonable investment-backed expectation” of return.¹¹ After all, if the companies were generating profits and were financially sound at the time the Sweep went into effect, the government confiscated something of tremendous value from shareholders.

⁶ <https://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx>

⁷ <http://www.bna.com/treasury-fhfa-ignoring-n17179923428/>

⁸ <http://www.bloomberg.com/news/articles/2016-02-18/freddie-mac-to-send-u-s-treasury-5-5-billion-for-2015>

⁹ For a list of lawsuits challenging the Net Worth Sweep see <http://bankrupt.com/gselitigationsummary201602.pdf>

¹⁰ http://gselinks.com/Court_Filings/Fairholme/13-465-0001.pdf

¹¹ http://gselinks.com/Court_Filings/Fairholme/13-465-0001.pdf

The Protective Order

The government had two responses to the discovery request, both of them steeped in a desire to shield documents, conversations, and depositions. First, the government asked the court to impose a protective order.¹² Under such an order, only the plaintiffs' lawyers, and no one else, would be able to read the materials. The government argued that making such documents publicly available would (a) destabilize financial and housing markets and the general economy and (b) impede the passage of new congressional legislation regarding Fannie and Freddie. In 2014, Judge Margaret Sweeney, of the U.S. Court of Claims, imposed a protective order.¹³

After subsequent review of filings from both sides, Judge Sweeney, on April 13, 2016, lifted the protective order on seven of the many protected documents.¹⁴ The unsealed documents revealed quite a bit about the financial state of Fannie and Freddie in 2012. For instance, the then Chief Financial Officer of Fannie, Susan McFarland, told high-level Treasury officials that Fannie was "now in a sustainable profitability [and] that we would be able to deliver sustainable profits over time." Just days before Treasury announced the Sweep, McFarland informed Treasury officials, including Mary J. Miller, then the Undersecretary for Domestic Finance, that Fannie would soon reap some \$50 billion in income.¹⁵ Similarly, an employee of Grant Thornton, an accounting firm tasked with assessing the financials of Fannie, concluded that Fannie would generate profits over the next three years.¹⁶ These confident assessments of Fannie suggested that its shareholders had excellent reasons to suppose that they would reap a return on their investment.

After the government's imposition of the Sweep, McFarland said she came to the conclusion that Treasury implemented it "in response to my communication of our forecasts and the implication of those forecasts, that it was probably a desire not to allow capital to build up within the enterprises and not to allow the enterprises to recapitalize themselves."

This supposition is consistent with two other facts. First, the Sweep occurred when the Administration was in the midst of negotiations with Congress about the federal budget. By sweeping the additional profits into the Treasury, the executive reduced the annual budget deficit and delayed a fight over raising the debt ceiling.¹⁷ Second, senior executive officials preferred a new secondary mortgage market model and believed that preventing the recapitalization of Fannie and Freddie would make it easier to wind them both down.¹⁸ After all, winding down Fannie and Freddie was a Treasury goal.¹⁹

Whatever the government's precise motives, the documents make clear that shareholders had a reasonable expectation of profits, a factor that favored their takings claim. Moreover, the statements of insiders also lent weight to the suspicion that FHFA was not really acting to conserve the assets and property of Fannie and Freddie. This motivation is highly relevant in other suits. Indeed, the *Fairholme Funds* plaintiffs had sought permission from Judge Sweeney to use the newly public documents in another suit.

Furthermore, the public release of these documents underscores the crucial importance of disclosure. The public (and not just the lawyers for the plaintiffs) have a right to know why the

¹² <https://timhoward717.files.wordpress.com/2014/05/motion-for-protective-order-530.pdf>

¹³ <https://timhoward717.files.wordpress.com/2014/04/71614-protective-order-fairholme-lawsuit.pdf>

¹⁴ https://ecf.cofc.uscourts.gov/cgi-bin/show_public_doc?2013cv0465-315-0

¹⁵ http://investorsunite.org/wp-content/uploads/2016/04/Doc-304-3-Exhibit-C_Redacted.pdf

¹⁶ http://investorsunite.org/wp-content/uploads/2016/04/Doc-304-3-Exhibit-C_Redacted.pdf

¹⁷ <http://nlpc.org/stories/2014/08/20/documents-reveal-government-saw-gold-fannie-maefreddie-mac-profit-sweep>

¹⁸ <http://www.bloomberg.com/news/articles/2015-03-05/fannie-freddie-profit-sweep-defended-as-treasury-seeks-wind-down>

¹⁹ <https://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx>

government expropriated profits from Fannie and Freddie. As Judge Sweeney properly noted when she partially lifted the protected order, “the only ‘harm’ presented [by disclosure] is the potential for criticism of an agency, institution, and the decision-makers of those entities.”²⁰

A Sweeping Invocation of Executive Privilege

With respect to roughly 12,000 other documents, the government continues to invoke “executive privilege.” This prevents even the plaintiffs’ lawyers from ever seeing certain information and documents and greatly limits the usefulness of discovery.

Executive privilege can be a legitimate (if invariably controversial) means by which the executive branch protects confidences and information from judicial and congressional discovery. Though the privilege has roots that extend back to the administration of George Washington, the Supreme Court belatedly sanctioned the concept only in 1974.²¹ Claiming executive privilege, President Richard Nixon refused to turn over his presidential tapes to those investigating the Watergate burglary. The Court endorsed the general idea that the Constitution’s separation of powers implicitly incorporated a right of the executive to keep some documents and conversations secret.²² In some cases, concealment might be indispensably necessary in cases touching upon military and diplomatic secrets.²³ In other cases, confidentiality would foster candid advice for the President.²⁴ Essentially, the Court found that the President should not be treated as an ordinary party before Congress and the courts. Rather the President should have some ability to protect internal communications and conversations.

At the same time, the Supreme Court made it crystal clear that executive privilege would not always prevail. For instance, it suggested that some sort of balancing of interests was necessary in cases where the President claimed executive privilege.²⁵ More importantly, it ordered the President to comply with the subpoena for his tapes.²⁶ Hence the very case that recognized executive privilege also said that the President’s claim of secrecy would have to yield.

In the years since, the contours of executive privilege have become more precise and categories have become more refined. *In re Sealed Case* (Espy), divided the privilege concept into the “presidential communications privilege” and the “deliberative process privilege.”²⁷ The more potent of the two, the presidential communications privilege (the one at stake in the Nixon tapes case) is meant to protect “direct decisionmaking by the President.”²⁸ This privilege may be overcome only if the materials sought “likely contain[] important evidence” not available elsewhere.²⁹ This privilege rarely surfaces because only the President may invoke it and because most governmental communications and documents do not involve the President.

Far more common is the deliberative process privilege. This privilege, rooted in the common law, is meant to protect the quality of agency (and not presidential) decisions. For the privilege to apply, several requirements must be met. First, only materials generated before a government decision that relate to internal deliberations are protected.³⁰ This requirement makes sense in light of the desire to foster free debate and discussion prior to a final decision. Second, and

²⁰ http://gselinks.com/Court_Filings/Fairholme/13-465-0313.pdf

²¹ *United States v. Nixon*, 418 U.S. 683 (1974).

²² 418 U.S. at 711.

²³ 418 U.S. at 706.

²⁴ 418 U.S. at 709.

²⁵ 418 U.S. at 711.

²⁶ 418 U.S. at 713-14.

²⁷ 116 F.3d 557-58 (D.C. Cir. 1997).

²⁸ 116 F.3d at 573.

²⁹ 116 F.3d at 580.

³⁰ 116 F.3d at 558.

relatedly, the deliberative process privilege does not shield documents that simply state or explain a decision the government has already made or protect material that is purely factual.³¹ Third, only the agency head may invoke the privilege and only as to documents he or she personally reviews.

Because the deliberative process privilege does not protect the most important governmental decisions—those made by the President—it is a weaker privilege that can be more easily overcome. The courts make this determination on a case-by-case basis, balancing the need for the information against the harm to the government’s internal deliberative processes. Among other things, the courts must consider relevance of the evidence, the availability of other substitute evidence, the seriousness of the litigation, whether the government is a litigant, and possible effects on future government employees.³² Moreover, unlike the presidential communications privilege, which protects entire documents once successfully invoked, the deliberative process privilege only protects the privileged portions of documents leaving the rest discoverable. In other words, under the deliberative process privilege, agencies have to turn over partially redacted documents, thereby revealing the non-privileged material.

Considering these factors in the abstract, the courts have said that where there is reason to suppose that documents may shed light on government misconduct or malfeasance, “the privilege is routinely denied,”³³ because shielding internal government deliberations in this context does not advance the public’s interest in honest government. As the D.C. Circuit put it, the privilege “disappears altogether when there is any reason to believe that government misconduct has occurred.”³⁴ The executive branch itself has made similar concessions. For instance, the Reagan Justice Department acknowledged “the privilege should not be invoked to conceal evidence of wrongdoing or criminality on the part of executive officers.”³⁵

Judicial Review of the Assertions of Executive Privilege

In *Fairholme Funds*, the government raised the presidential communications privilege over 45 documents and the deliberative process privilege over thousands. The government also has claimed that the privilege extends to both FHFA and the Treasury, asserting that because the FHFA is a government agency, it may avail itself of executive privilege.

Judge Sweeney has yet to rule on the government’s claims. However, her written opinion to unseal seven documents suggests a healthy and warranted skepticism about the government’s penchant for secrecy. The notion that revealing documents and communications *from years ago* would threaten *today’s markets* seems rather implausible.

Because the presidential communications claim involves officials closest to the President, perhaps Judge Sweeney will ask for the relevant documents and conduct an in chambers review to determine whether the plaintiffs should have access to them. Such confidential judicial review allows her to better balance the needs of the plaintiffs against the government’s desire for secrecy.

With respect to the thousands of documents over which the government claims deliberative process privilege, judicial scrutiny of each would be far too labor intensive. Recognizing this, the plaintiffs have sought clarification from the judge about the scope and applicability of the invocation of the privilege. The plaintiffs have identified several documents that the government claims are privileged and asked that the Court issue guidance to the parties that would be useful with respect to all of the supposedly privileged documents.

³¹ 116 F.3d at 558.

³² 116 F.3d at 558.

³³ [Texaco Puerto Rico, Inc. v. Department of Consumer Affairs](#), 60 F.3d 867, 885 (1st Cir. 1995).

³⁴ 116 F.3d at 566.

³⁵ 8 Op. O.L.C. 252, 267 (1984).

By specifying when the government may invoke the privilege, the Court can ensure that the government is not asserting the privilege too extensively. Moreover, Judge Sweeney also should make clear when the plaintiffs' interest in prosecuting their case against the government overcomes the privilege.

First, the Judge should insist that the government properly review the thousands of documents over which it has asserted privilege. As the lawyers for the plaintiffs recount, the government has twice released dozens of documents that the government formerly claimed were privilege. For instance, after plaintiffs asked the government to reexamine the classification of 88 documents, the government released 17 of them as not subject to the privilege. While the belated release is admirable, it rather clearly demonstrates that the government did not properly invoke the deliberative privilege in the first instance. Mistaken invocations of the privilege are inevitable when dealing with thousands of documents. But an admitted mistake rate of about 20% is far too high, suggesting that the initial determination of privileged status was poorly done. Ill-considered and wholesale invocations of the deliberative process privilege do little to inspire confidence in the merits of those invocations.

Second, Judge Sweeney should hold that the agency head must invoke the privilege. It is common for government lawyers to make initial determinations of privilege. But under established doctrine, only agency heads may make the claim of deliberative process privilege. No agency head has made the determinations necessary for the invocation of the privilege.

Third, the Judge should declare that the documents related to the intentions of the government are relevant to the takings case. The government asserts that its motivations for the Net Worth Sweep are immaterial in the context of a takings claim and hence any request for documents to ferret out improper motivations cannot overcome the deliberative process privilege. But Judge Sweeney has previously held that governmental intentions are relevant to whether FHFA was acting as an arm of the Treasury and thus was suable as the government. Moreover the executive has admitted that the intentions of its officers are relevant to whether investors had reasonable investment-backed expectations to a return. If Treasury Department officials entered into the Net Worth Sweep knowing that there would be prodigious profits to sweep up, that factors into whether the investors suing the federal government had a reasonable expectation of profits from their continuing ownership of preferred shares in Fannie and Freddie.

Finally, Judge Sweeney should declare that documents generated after the Sweep and financial projections are not privileged. Documents generated after the Net Worth Sweep are not documents that helped spawn the decision and hence should not be covered by the *deliberative process* privilege. Financial projections are factual in nature and hence not privileged, as numerous courts have held.

Conclusion

Under federal law, the plaintiffs have a right to documents and testimony that help prove their takings case. The Court of Claims ought to vindicate that right. More broadly, the public has a right to understand why its government chose to sweep up the profits of Fannie and Freddie and whether the executive branch has been honest with the American people about its motivations. Just as judges must “not condone the misuse of a protective order as a shield to insulate public officials from criticism,”³⁶ so too must courts not excuse the abuse of executive privilege via haphazard, sweeping invocations that insulate public officials from the obligation to follow the law and pay just compensation for takings.

³⁶ http://gselinks.com/Court_Filings/Fairholme/13-465-0313.pdf