**CAPITOL FORUM CONFERENCE CALL TRANSCIRPT**
**THE FUTURE OF FANNIE MAE AND FREDDIE MAC: LITIGATION RISK**
**AN INTERVIEW WITH NYU LAW PROFESSOR RICHARD EPSTEIN ON 12/11/13**
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**TRANSCRIPT MODIFIED SLIGHTLY FOR CLARITY**

MODERATOR: Welcome to the Fannie Mae and Freddie Mac conference call with Richard Epstein. It is now my pleasure to turn the conference over to Mr. Teddy Downey. Please go ahead.

MR. TEDDY DOWNEY: Thanks to everyone for joining the Capitol Forum's second conference call on the future of Fannie Mae and Freddie Mac. I'm Teddy Downey, Executive Editor here at the Capitol Forum and we're delighted to have esteemed Professor Richard Epstein here with us today.

As a quick introduction, Professor Epstein is currently a professor of law at New York University and was previously on the faculty at the University of Chicago and the University of Southern California. Richard also serves as a senior fellow at the Hoover Institution and is the author of over a dozen books, including his latest "The Classical Liberal Constitution: The Uncertain Quest for Limited Government".

Perhaps most importantly, Professor Epstein specializes in complex regulatory takings cases. And finally, an important note, Richard is currently doing work for certain firms involved in the litigation against the government.

Also before we get started, a few quick things to note. I'll spend the first thirty minutes or so interviewing Richard, and then we'll turn it over to the audience for questions. If you have a question, please email editorial@thecapitolforum.com.

And with that, let's get started. Professor Epstein, thanks again for joining us. I think the most interesting thing here and one thing I want to separate out is what you think should happen and what you think is likely to happen.

So if you wouldn't mind maybe starting off talking about your legal, ideological framework for viewing this case, and then talking for a minute about how the judicial system and the judges that are likely to hear some of these cases, what their framework will be. And if we can start with

that, maybe that will give people the context to view this conversation through.

MR. RICHARD EPSTEIN: That's the right place to begin. And it's not a simple – it's a rather long story. To make it as short as I can, the basic orientation that I give towards virtually every legal problem that I face in any area is captured in the title of my book "The Classical Liberal Constitution".

Classical liberal differs in substantial ways from the libertarian by two major features. They have no categorical opposition to the use of the eminent domain law and they have no categorical opposition to the use of the taxing power.

But by the same time, they are deeply suspicious, particularly at the federal level, of mandatory programs of government redistribution. Because if that joker is led into the deck, then virtually any particular substantive result that you care to achieve can be justified by that kind of end. Or to put it another way, what the takings and taxation positions that I take are, it's all right to take from A to give back to A something greater than he lost. But it's not okay to take away in large sums from A in order to give to B, particularly if B doesn't do anything in return for A. And, in fact, if there is reciprocity, it's called implicit in kind compensation and it's what keeps the system of taxation going.

Now, with this particular framework, your judicial attitude is that you must take the takings clause seriously. That in turn then leads you to answer what to lawyers is an obscure but vital question: What's the appropriate level of scrutiny that you give to various issues under the takings clause? And scrutiny essentially is a function of what you think to be the error rate of too much government action or too little.

And in my view, the danger of government over-action is extremely important. So what I want to do is to have a

fairly high level of scrutiny with the way in which government programs work. Not to make sure that you can't solve standard collective action problems like runs on banks which have been long upheld, that is legislation against it, but to make sure that the redistribution angle of this thing does not overwhelm everything that you have.

If in fact you apply that situation, you do not draw any categorical distinction between outright occupation of particular forms of property or "mere regulation" of that property and you draw no distinction between physical assets that can be occupied and financial assets or other intellectual property type assets that are all forward in the rubric of private property.

So under this particular orientation, when you look at something like what we've seen in this case with Fannie and Freddie, you have two reactions. The 2008 situation is exceedingly complicated because it was never quite sure whether or not these firms were or were not insolvent. There would be a lot of government discretion figuring out how you combat the particular dangers of running.

There were two vehicles available for the government. One was the conservatorship and one was the receivership. If you take the conservatorship route, as they did--and for good reason I believe--it means that you're now committed to the business of rehabilitating these companies and returning Fannie and Freddie to the private sector.

If you took the receivership situation, orderly liquidation would be the appropriate situation with residual values after expenses going to these same shareholders. The conservatorship puts you in a very different position and there are many features of it which I do not like in particular. The 79.9 percent common shares being subject to the option and there is some argument, although I don't think one of constitutional proportions, as to whether or not the interest rate on the senior preferred at ten percent would or would not have been appropriate.

So in my view what happens is the first case is a complicated one. I do believe that the Washington Federal people in principle have a fairly strong case about the way in which that has been handled. But on the third amendment, which is the thing that converts the senior preferred from ten percent to essentially everything, is in fact basically a complete non-starter and should be forthwith and summarily shutdown. And nothing that the government wrote in its two briefs that I've read so far, both for Fairholme and for Washington Federal, changes that conclusion.

When you start to deal with the question of the law as it is, it is a very different situation. First of all, any sort of systematic concern with respect to redistribution is very much put on the back burner. And any doubts that one has about the efficiency of regulation is also put on the back burner. And any argument that the rules that apply to the outright possession of land and carries over to regulatory arrangements is squarely rejected within this system in not all, but in many, many cases.

So what this does is it translates into a general view that the Constitution should be construed under a rational basis stand which means that if there's one or two things that the government can say on behalf of its program, then the courts do not look closely at the means that are used in order to achieve the end in question. And to the extent that one is dealing with financial arrangements that are reviewed under the rational basis test, it's extremely difficult for any claimant against the government to be able to do that.

So there's no question that the government has at this point a very strong leading position on this issue going into it. But the situation turns out to be much more complicated than that because there is at least one opposition strand that has to be taken into account and it has three separate parts to it.

One is it's quite clear that there's a per se rule with respect to possessory takings of real estate, and that can easily translate to situations where the government gobbles up your money on the one hand, just takes it out of a particular private account or where in fact it imposes regulations that make it impossible for you to use it by giving itself the use.

So, the government cannot essentially borrow money from a private party and arbitrarily set the rate of interest and hope to stave constitutional scrutiny. The argument here is that financial claims against private assets are liens and that liens are governed by the same rules that govern occupation. So that's one strand.

The second strand is that there's a long history which deals with confiscatory regulation which says in effect that when the government regulates industries to control monopoly preferences, what it has to do is to make sure that it gives them at least a competitive rate of return adjusted for the risk involved. And although there's lots of discretion in the means that you use to achieve that particular end, there's much less means available for you in terms of the way in which you could try to avoid that end. And many recent cases have said if the government just sets the wrong rate base for compensation, then it cannot systematically defend itself.

And the third line of cases is the Winship line of cases which says that when the government enters into contracts with private parties, it is required to deal with those parties under the rules that apply to ordinary contracts between ordinary people so that it doesn't get the kind of advantage that it gets in the regulatory arena.

The leading case on that is the Winship case from the mid-90s. It is no accident that Chuck Cooper and David Thompson who are leading the charge at Fairholme were in fact the winning lawyers in that particular case. Nor is it I think any accident that this particular case involves not a form of general regulation, but in fact involves the

explicit contractual arrangement that was entered into by FHFA, the Federal Housing Finance Authority, with the Department of Treasury and with everybody else. Because those were contracts with respect to the issuance of a senior preferred.

So how does this then shake up? Well, if you apply the sort of generalized, diffuse rational basis test, you write the kind of brief that the government wrote in both Washington Federal and in the recent Fairholme case. And frankly, they're very bad briefs.

They're sloppy. They don't give you particular statutory language. They cherry-pick facts. They argue questions of fact that are highly refuted on a motion to dismiss where those things are not to be allowed. They are, in effect, briefs which communicate the following message: We don't take this case very seriously because we're not really trying to sit down and figure out strong and coherent theories.

So where does it leave you? On the normative side, this case with respect to the amendment should be toast and it's difficult with respect to the 2008 reorganization. Given the current law, what one has to remember is that there is always a strong government finger on the scale.

And what that does is it means that basically whenever you litigate against the government, the stronger your case may be, the more powerful you may think it to be, getting yourself over better than even money on winning that thing is extremely difficult. It is hard for people to realize what the extent of the deference is that is given to government. And if you don't get yourself within the contract or the regulatory or the occupational sides that I've talked about, then the case is over.

Anytime the court begins with a sentence which says we confer upon the government broad discretion in figuring out how to deal with complex financial crises that are beyond our ken to understand, you don't have to read the rest of

the opinion. You know that the government is going to sweep the board.

So the first vital is to make sure that you fight over the classification of the case and then it becomes I think a closer struggle. Knowing that people like Chuck Cooper, David Boyse and Ted Olsen are on some of these cases, what you do is you have a kind of bipartisan elite lawyers representing many of these Fannie and Freddie claimants, and that suggests to me that it's going to be a rough fight as you go down. I do not regard this as a kind of a government walk over. I think the government lawyers are underestimating the peril of their position. But on the other hand, one can never ignore the power of the basic presumption in their favor.

MR. TEDDY DOWNEY: I think that's a phenomenal context for digging into some of the weeds. And maybe the first thing, and you've already addressed a little bit of this, but maybe we can dig into more detail on the recent government response to the Fairholme case that you mentioned. You said that it was sloppily written, that it wasn't taking things seriously. If you could just list for us or get into some detail about what you think the weakest points of that case are. Or is it not easy to do that?

MR. RICHARD EPSTEIN: No, no. It's easy to do it. I mean, I try to summarize these things for my own purposes, particularly when I give private evaluations. But there's no trade secrets with respect to this. The first thing with respect to this case is what I call the chutzpa claim which is the arrogance of saying that you guys have no right to be in this particular litigation at all because you do not have any technical standing to bring this suit. And the definition of standing with respect to the Constitution has the following account.

People take a clause which says the judicial power shall extend to all cases in law and equities covering a bunch of things, including suits against the government which would this be counting in. And what happens is the argument is

that somehow or other, the individual shareholders whose holdings are essentially subordinated to a government lien which has become omnivorous don't have standing to protest the fact that that priority's been put upon it.

The government looks at the various authorization that's found in the FHFA. And what that language seems to say, patterned on earlier stuff which gave government agencies power, that all rights of shareholders, all rights of officers, and all rights of the board of directors in these corporations are taken over by the executor.

And the government says if that's the case, then you don't have any claim to sue because your rights are all taken over. What that means, if you take it seriously, is that anybody who purports to be a beneficiary of a government conservator is essentially a supplicant at the government trough because all the rights of the shareholders have essentially been read out.

Now, this also came up in earlier cases like Winship and the government position has essentially been rejected on the simple ground that a conservator has fiduciary duties to the shareholders once it takes over the position of the board of directors, which also had fiduciary duties to the shareholders.

So it becomes almost inconceivable to say that once you take over the operation of this thing, there is nothing to conserve for anybody except the people to whom you wish to give money. The correct view therefore is as follows. When the government is engaged in trying to figure out how it deals with third party claimants, how it defends lawsuits, for example, that are brought against it by outsiders who claim that they've been bilked in the mortgage [?] situation. They have all of these powers and they can defend. Because what happens is they have to have these powers because the shareholders, the officers, and the directors have all been neutralized by the conservatorship.

So that's just fine. And the government in effect defends themselves against various types of claims by saying, you know, everybody out there who's suing us had full knowledge of what's going on. At the same time, when they bring suits against J.P. Morgan or a variety of other banks, say, you know, you guys deceived us.

So, on the one hand, the government claims ignorance when it's a plaintiff, and full knowledge to everybody when it's a defendant. I find the substantive positions rather dicey in dealing with this. But at least that turns out to be a reality. But if there is self-dealing between the government on the one hand through the Department of Treasury and through FHFA, then it turns out that the presumption that they have all rights of shareholders is impossible.

If you had a corporation which was put into bankruptcy and what the bankruptcy trustees decided to do, or the equitable receiver decided to do, was just give away the farm to a stranger or to somebody in whom it was cahoots, it would lose on the grounds that (a) it's not an honest business judgment to give away assets when you're trying to preserve them and (b) that there's an incurable case of self-dealing which requires that you get fair value back for everything that you've given out.

Now, you can make that argument with respect to the ten percent preferred that took place in 2008, that it was a square deal. Harder to make it with respect to the common that gets wiped out because they're getting nothing from the conservatorship if they are giving away an option which allows the Federal Treasury to buy the share at .0001 cents per share.

So I think in effect that they're in deep trouble with respect to that issue. And I regard it as almost a stupendously kind of arrogant sort of claim to say that you look at something which could be read in a perfectly sensible fashion, and then read it in this way which basically says that the lawsuit is over before it began.

If this were in fact a true defense in this particular case, what the government should have been able to do in 2008 was to simply announce we're taking you over and wiping you out. And they didn't have to worry about the difference between a conservatorship and a receivership because they can wipe them under I have the power.[?]

And one of the bad things that the government does when it does this brief is it kind of constantly says that these powers are held by conservators and by receivers and it never bothers to distinguish between them. But remember, the objectives are very different. With the conservatorship, it's orderly return to the private market which is certainly not happening here. And with respect to the receivership, it's orderly liquidation with the preservation of the residual claim. So that's one procedural issue.

MR. TEDDY DOWNEY: Can I just interrupt you really quickly?

MR. RICHARD EPSTEIN: Sure.

MR. TEDDY DOWNEY: I have a hard time understanding how someone can make a case that what they're doing right now is not making an orderly return to private shareholders because we don't know the resolution of what's going to happen to Fannie and Freddie. What are the arguments that they're certainly not doing that, the point that you made?

MR. RICHARD EPSTEIN: Well, essentially what happens is if you take the benchmark as being the preferred agreement from 2008, what that says if things are fine, you pay us ten percent. And if they're not fine and you have to make up your default, you pay us 12 percent.

So if you're thinking about this originally as saying indebtedness of around $180 billion and you look at ten percent, they've got to get paid $18 billion a year to keep the accounts current. I don't wish to argue anything about the legitimacy of that evaluation.

But with the third amendment, it gets introduced at a time when it's quite clear that both Fannie and Freddie are about to return to profitability. And the fact that the government divines this as a factual matter on a motion to dismiss indicates no respect for the pleading rules whatsoever.

And then it turns out that you probably have now well north of $100 billion which has been paid to the government above and beyond the amount of the interest payment. And you have the various folks in Congress Hensarling and Corker announcing since it was their contract, i.e., the contract of FHFA entered into with the government, they've already given us this money. So they'll never be able to repay principle. So therefore, we could write them out with liquidation.

And the correct way to do this is to figure out what the arrangement was with respect to the 2008 agreement. And what you then do is treat the interest on that as indeed interest and anything above and beyond the amounts owed under that agreement are treated as a return of capital to the government. Which means that it reduces the amount of senior preferred that's outstanding, and therefore, pumps up the value of both the junior preferred on the one hand and the common stock on the other. And the government, in its brief, never tells you the amount of money that's put into place and never explains why it is that this is something which is an incorrect way in which to treat this situation.

So this is really quite an extraordinary feat. I mean, I have never seen a scheme in any private transaction that I've ever worked with, including those involving self-interest, where a so-called contract renegotiation has been so utterly one-sided. And then the government official says, well, we're representing you through FHFA.

Now, there is this irony here. A second point, that the government makes which I haven't talked about thus far, is

who is the proper party and what is the proper forum? This is a jurisdictional issue which can be raised in virtually any case. Because if you wish to sue the government in the court, the Federal Court of Claims, you have to bring an action under the so-called Tucker Act, which doesn't cover cases that sound in tort, whatever that phrase turns out to mean. And you cannot bring it against a private party.

And what the government has argued is that FHFA does not count as a government agency in this particular case. The argument presupposes that there's an arm's length difference between it and the United States Treasury. And one of the things that has to be resolved by litigation and discovery is exactly how that negotiation which was published on a Friday afternoon between these two government and non-government agencies took place.

My view about it is it's a straight conspiracy against the individual shareholders, that it would be almost inconceivable that the Treasury did not dictate the terms. And unless you could show some signs of real pushback, and there was actually nothing got through the supposed pushback by FHFA, then in effect what you can say is that the Treasury and the FHA together worked as a kind of a single body against the shareholders so you could bring this suit in the federal claims court.

The other thing is to say, well, you can't go there. What we can do is sue you in ordinary district court. And it's clear that the Fairholme guys are pretty shrewd and they bring both these lawsuits. My view is obviously one of them has to disappear. Unless you decide that there's no connection between FHFA and the Treasury, which I can't believe would be sustainable. So that ultimately these are kinds of delaying procedural tactics which will not get in the way of a final resolution of the suit, but will make things take time.

And this is extremely important because the basic situation is that they keep shoveling this money out at a record rate into the hands of the Treasury. Now instead of trying to

enjoin a transfer and instead of trying to say you get the credit for the amount, you're going to have to be suing the Treasury for a refund. Because it's quite conceivable if this goes on for a year or two, they will not only be paying back all of the original loan with all of the original interest, but they'll be paying amounts above and beyond that because this is the gift that keeps on giving. And there's no sentiment in Congress whatsoever to reverse this. Corker and Hensarling are both Republicans remember.

So I regard this as kind of a version of I don't know what part of space I'm in. But those are the first two procedural claims that I didn't refer to. And the government's position is that if it can drag this thing out, what happens is it keeps on shoveling the money in. And if it keeps on shoveling the money in, reversal is more difficult.

At some point, you may see somebody moving for a preliminary injunction which is extremely difficult to get. Because you have to show that in all events the government is likely to be wrong and that you have a very high probability of winning that particular lawsuit. And given what I said earlier about the strong presumption in favor of the government, it's not clear you can do this.

I do think, however, that if you present the case in its correct form, the presumption in favor of the government should dissolve in the face of all the stuff that takes place with the record.

And in answer to any of these things, the government's brief is so bad. I mean, they cite cases almost at random, never once talking about how they relate.

To give you one illustration, there's the federal crop insurance program. And what happens is the administrator there has to be able to give its approval before there's a transfer of ensured contracts between companies that are teetering on the edge of reorganization. That's clearly a government discretionary function. The government has no

stake in the game between these two private entities that are trying to reorganize and consolidate their insurance losses. And never could you sue the government on a takings theory or anything else.

And what the government says is, well, we won this case because there was no private interest in private property that stood against the government. They don't give you the facts. They don't give you any of the reasoning. They sort of make it appear that when money is paid into the Treasury, it's exactly the same thing as the veto of a consolidation or reorganization between two insurance companies.

I mean, it's like that all the way through. I mean, it is a shockingly bad brief. One of the things that you do in order to see how bad it is, is as I have done, you go back and you take all the cited cases and read the statement of facts that are given even in summary form. And you realize that most of them are just miles away from the sorts of issues you're on.

And generally, there's a good sign of what is a good brief and a bad brief. A good brief is one when it wants to rely on authority, tells you essentially what the case was about, gives you the ruling. Then it gives you some quotation as to what it is and then explains why it is when you've taken all these steps, you can now explain with a great degree of clarity why it is that that case comes out in your particular fashion.

In neither of these two briefs has that been remotely tried for by the government which seems to me to say that they really are not trying to make a winning case on the merits. They are basically trying to say we win. And why is that? Because we've shown up. I mean, I was really quite disappointed. Not that I thought they had good arguments. But I was just -- the whole technical side of these briefs leave so much, so much, to be wanted.

MR. TEDDY DOWNEY: That brings us to another point. What is the hope that there will be a judge that won't be overly deferential? Can you give examples of some judges who might be more likely to look at the merits and not just give the government such a huge benefit of the doubt?

MR. RICHARD EPSTEIN: Yeah, I mean, look. This case, much of it is in the District of Columbia Court of Appeals. And obviously, the reason they're fighting so much about these recent nominations is because of the four-four versus five-four split. And the people who oppose--I guess her name was--Ms. Millett. Nobody doubted her qualifications. It would have been insane to try and do that. But there's no question that you're more likely to find a receptive thing on the Republican side of the line than on the Democratic side of the line.

But on the Republican side of the line, there's a deep cleavage between those who think that substantive commands ought to be respected and those who believe in judicial restraint. So you take very able judges who sit on that court, Steve Williams, Doug Ginsburg, both have senior status, Brett Kavanaugh and Ray Randolph, I mean, these are really smart people. They're very torn on some of these issues. And they do not have the kind of muscular judicial review strategy that has characterized my view for the last thirty odd years, ever since the mid-80s I declared the New Deal unconstitutional as a matter of first principal in my takings book.

That doesn't mean that they don't come across on some of these issues. It just makes it harder to do. When you get to the Supreme Court, frankly my dear, it is an open crapshoot. We really do not know. There are certainly virtually every one of the conservative judges has some degree of orientation with respect to property claims in those cases where the treatment looks to be egregious, as I think it is in this case. You take somebody like Justice Breyer, an incredibly smart guy, who is a former telecommunications and antitrust lawyer, and he's actually

somewhat more property protective on these issues than you might expect.

Justice Kagan, you know, hard case to read, but she used to go to Federalist Society meetings. And she along with Breyer essentially supported basically the brief that was brought by the NFIB with respect to the Medicare expansion, and they both struck it down. They didn't do it on the same grounds as the more conservative people, but it tells you that this thing is open.

And ultimately, let's put it this way. If the government win down below, I think there's still, since the case is so big, a chance that the Supreme Court will take it. But I can guarantee you, if the Solicitor General shows up and says, you know, there's just been a government judgment entered into against us for about $120 billion, cert granted. That's all they have to say. They don't have to write up a petition. They don't even have to send a live body into the Supreme Court in order to get it.

The Solicitor General has an enormous advantage in big cases in essentially commanding the attention of the Supreme Court, at least with the courtesy of a hearing. So I think in the end, this thing is likely to be resolved by the Supreme Court. And on that particular point, it's actually not as clear as one might think. Remember, Winship was done six or so years ago. And there were several liberal Democrats, I think it was Souter in particular, who sided with the bank.

And that was the case for those of you who don't know it in which the government entered into an explicit contract with the bank and said, you know what? We have to worry about your capital requirements. We're going to allow you to take business goodwill and treat that as satisfying the capital accounts.

One could disagree with this on the merits arguably and obviously. But once they did it, then they turned around and say, you know, we've changed our mind. Forget about

this contract. You're in serious default because you don't have the number of hard assets you need. And that case was won by Chuck Cooper and by David Thompson. So I think in effect a lot of this depends on slotting the case into the theory. And I see this thing going a very long way before it's resolved.

I think Eppleports[?]is the best substantive judgment I can give today. There's also another complication. If the government decides to exercise its option on the common, that will create another kind of real furor because of the opportunism that's seen with respect to it. And that might actually incline the justices to say, look, this whole thing was completely jerry-rigged from the beginning. They're getting ten percent. You don't have to take 80 percent of the company from people for whom you're a fiduciary. And oddly enough, exercising that option might in the end actually strengthen the case of the people we're trying to strike down, the various government arrangements under both the 2008 agreement and the 2012 amendment.

MR. TEDDY DOWNEY: That gives me a last question before we turn to the audience. As probably a very cynical person from D.C., born and raised. The Supreme Court not looking at some of the other political elements here. I mean, you've got effectively from a macro standpoint money going either to the taxpayer or to the government versus money going to shareholders in an entity that was rescued by the government.

MR. RICHARD EPSTEIN: Yeah.

MR. TEDDY DOWNEY: How does that shake out politically or influence anyone politically, either at the D.C. Court level or at the Supreme Court level?

MR. RICHARD EPSTEIN: Well, I mean, I think it's a fair question to ask. But one of the things to do is not only worry about these things that have gone into litigation, but also those that haven't. Of the ones that went into litigation, the one that has the worst odor is the Chrysler/GM

situation where essentially you had a reversal of priorities such that the general creditors in the pension plans were given priority over secured creditors, many of whom by the way were other union plants as you must remember under these circumstances.

That left a very bad odor in the financial community, and it also left, I think, a bad odor on the part of most of us who kind of regard ourselves as understanding something about this subject and the importance of having a consistent set of priority rules in place from the time that the money is lent to the time that the transaction is closed up.

So, I mean, that I think would influence the court. I don't think it's particularly proud of that decision and its rather artificial role that it had played in it. So you have that.

Then, of course, there are many of these things which essentially when they got done, the government paid back the money and basically sold the chairs or got its loans repaid so that there was something which could have been done in this case. Think of what happened with GM, the great celebration of having sold its last lot of shares and returning it to the private market. If they can do it in that case, why can't they do it in this case?

Now, people will argue that the real loss in the GM situation was that they gave this huge benefit to the UAW which is not taken into account in these transactions. But certainly, somebody can say, hey, look at this thing. You're saying in effect that we got the money, the bailout was a success, and we put the business back into private hands. They could have said that as well here.

So I can conceive of the question asking why didn't you follow the course that you did in every one of these reorganizations in connection with Fannie Mae? But this is two or three or four years down the road and the amount of intervening events that could alter this judgment one way

or the other is almost impossible to predict at this particular point. What you can do is you can talk about the fundamentals. What is much harder to do is talk about the political dynamics.

MR. TEDDY DOWNEY: And with that, I'd just like to ask for questions again. Please email us at editorial@thecapitolforum.com. Maybe I'll throw out a quick question to follow-up with you right there. What do you think the most important next steps are for watching how this whole thing plays out?

MR. RICHARD EPSTEIN: Well, I mean, you know, this is a question, I think it's going to have a lot do with the interaction, oddly enough, between the political side and the legal side. The first thing is I have no idea what will happen when Mel Watt takes over with respect to the litigation. That's a wild card. I don't want to speculate on it.

But remember, there's an effort at this particular point to try and recapitalize the private market. The amount of private equity available to fund mortgages is probably about two to three percent of what you would need if you take a kind of quote which says you've got to have basically a ten to one ratio. So if you want to support a $5 trillion mortgage market, you have to have $500 billion in invested capital.

My view is they're not going to raise this money at all. If in fact, when they go into these things, into an investment community, and say, look, we did everything perfectly okay with respect to this Fannie and Freddie stuff. So don't get upset about the loss of $150 billion, or whatever it's going to turn out to be. Just treat it as part of the business. At the same time, you're asking them to put in $500 billion.

And the thing about it is, well, maybe they won't pull the same stunt that they pulled with respect to Fannie and Freddie or even the same stunt that they pulled with

respect to GM and Chrysler. But once it becomes clear that there's a bipartisan willingness on the part of governments to pull the rug out on private investment when it turns out that things have gone badly, I think the problem of general reform is going to be disastrous.

And the question then is will the government decide to back down here in order to be able to get some kind of refunding, recapitalization, substitute entity, whatever you wish to call it, to take over these functions on the public side without killing off the private market.

And in my view, any private investor who would want to go into a mortgage market under some kind of symbiotic relationship where they're a government sponsored entity who can be hit with very heavy community service obligations, subject to all sorts of shenanigans of this sort, I don't think the implicit guarantee, which I regard as a real thing, is actually enough in compensation, particularly in the going forward mode for these particular risks.

So what's going to have to happen is sooner or later Corker and Hensarling are going to have to sit down with themselves and say do we really want to bind these people to "their contracts" when they had no say in everything and the entire investment community is up in arms?

And I might add, money doesn't all go to Wall Street. Most of these guys actually have fiduciary duties to their own customers who include union funds, interestingly enough, on the pension side, universities, hospitals, churches, all sorts of private operations of one kind or another. I mean, it's not as though what happens is all the money is going to go to a handful of 5,000 rich guys sitting in Manhattan and Stamford, Connecticut. It's going to go to a very wide range of institutions.

So it's the public taking, to some extent, from the public. And I think in the end if they start thinking about the distributional consequences, they will realize that if they

want to raise money, they can't play the redistribution game and hope for credible commitments that will get them up to anything close to $500 billion of private capital committed to this market.

MR. TEDDY DOWNEY: Thank you. That's an interesting thing to look out for certainly. We've got a great question from the audience. Professor Epstein, what do you expect from the administrative record being filed or lack thereof if there is none?

MR. RICHARD EPSTEIN: Well, I think that the administrative record on this case in terms of public documentation is already particularly telling. And not only that, we also have a lot of public speeches by Demarco. We have I think a memoir was written by Hank Paulsen explaining how wonderful it was when he knocked some of this stuff down. And there's no question that that makes its way into the Washington Federal complaint which is important because I think it shows just how tenuous the government's insistence is that they got the consent of the board of directors to let the conservator take place. They got it under huge kinds of duress of what would happen to these people if they decided to resist all of that.

But there will be discovery. And the discovery will turn out to be absolutely key. And number one issue in my judgment on this discovery is exactly what deliberations took place between these two trading partners, FHFA and Treasury, at all points during this particular negotiation. If it turns out that FHFA took orders from very strong willed people like Hank Paulson and Tim Geithner, I think it puts a huge compromise inside the government's case. And yet, I do not see how it is that they're going to be able to keep this thing confidential under a discovery order when it's so germane to the question of whether or not there was self-dealing in a very important sense.

So I think in fact the revelations that come out will systematically help the guys on the plaintiff side. And remember, you always have the question about, well, is

there anything you could do in terms of discovery on the other side--that is going after these guys? And this is often the case when you have people suing to recover money who themselves have been active participants in a transaction. But you'll have a lot of people coming out there.

And frankly, I don't know the kinds of questions you want to ask a group of shareholders which do anything except go to the size of their losses. I mean, I can't believe that the government could come up with an argument which says to some extent when you were a private shareholder who bought this stuff, you had done something wrong. And I don't think they can make the argument that you were always on notice of how we played this game because the truth is the government was quite happy to keep these markets alive. And indeed, just before the breakdown in the market in 2008, the government was touting new issues in the way in which this was going.

I hope that people will realize that this two-faced GSE, Government Sponsored Entity, is an unstable business because you can never square the accounts between the mortgages you have to take under the various community redevelopment loans against the implicit guarantee on the other side.

The government has tried to make something out of that with respect to this litigation, and indeed has gone so far as to say, you know, if it hadn't been for 2008, the third amendment wouldn't arise. So therefore, we don't have to worry about any of this at all. We should have won.

But that's got to be wrong. The moment you allow a market to trade after the 2008 situation, it's a clear symbol that these shares are supposed to have positive values. Which means that even if the option is against the common, it's clear that you can't wipe out the other 20 percent with the same technique that you do the first 79.9 percent. And it's also clear that you've got to regard it as being some

serious limitation on the way in which you treat the junior preferred.

MR. TEDDY DOWNEY: Really quick follow-up there. You mentioned that there could be a lot of discovery about the relationship between GSE and Treasury. There's been some pretty overt public disagreement between Treasury and the White House and FHFA over other issues, not exactly relating to this. Do you think the discovery will have to be fact specific about the treatment of Fannie and Freddie? Or does the general understanding that Demarco has sort of refuted the administration on a number of issues create any level of independence there?

MR. RICHARD EPSTEIN: My view is if I were the plaintiffs, I would not care at all about Mr. Ed Demarco's general position. It's common knowledge that the reason he wasn't given the permanent position under a Democratic administration is because they weren't entirely happy with him. And they regard Mel Watt as somebody who's more in alignment.

But the correct way in running your deposition is to have a narrow definition of relevance. And you do it with respect to the two transactions that matter and say it doesn't matter the slightest bit one way or another, which is why we're not asking about it, whether or not these guys have some differences about what should be the maximum size of a jumbo mortgage, or whatever those other questions should be.

In litigation, it's a terrible strategy to go in a dragnet situation when the information you get won't help you. And most of it is public knowledge. The interesting question is whether or not when the discovery takes place, the government can find any announcements of its own that it would like to make to offset what's revealed. I think the answer to that question is highly unlikely that they will try to do anything outside the discovery framework.

Look, my own experience with this is I helped organize at the university here at NYU a conference on Fannie and Freddie which we held on September 20th. And generally speaking, people who represent the government never feel free enough to speak in public to defend their position. And if they don't want to speak at forums, they're not going to speak after the discovery takes place.

So I think it's a question of what you can pry out of them. And I don't believe in this particular case that since the government is now in a contractual dispute that it can essentially argue that you can't get discovery on this stuff which means, of course, that the motion to dismiss should be dead in the water. And I think it will be dead in the water. In fact, it's quite clear that the government didn't even write this thing with a recognition of the procedural posture in which the case is actually being undertaken.

MR. TEDDY DOWNEY: Okay, perfect. We've got another great question. Could you please comment on the APA case that the government overreached, breached fiduciary duties to minority shareholders, et cetera. The case you described is in Claims Court. I would be interested in your thoughts about the cases in District Court.

MR. RICHARD EPSTEIN: Okay. Well, I mean, you know, I have not studied those in great detail. But the basic claim here is what can you do with respect to this case under the Administrative Procedure Act? And here, let's start with the simplest fact and then you can take it forward.

One is that you have here a contract which limits the scope of the government power to making transactions up to the end, I think it is, of 2009. What happens is the APA or rather the third amendment takes place in 2012. They clearly do not have the authority to issue any new paper or do anything after that date.

And so the argument would be that you've exceeded the authority that you're given under the operating statute and

therefore suspect to challenges under the APA when you kind of treat this new transformative situation as though it's simply an amendment of an earlier agreement.

There is all sorts of places for amendments. And so, for example, if what the government says is the reporting requirements under this thing don't work particularly well. What we want to do is to change filing from this system to that system where everybody going forward can comply with the new system as well as with the old. Nobody is going to say it's the kind of contract modification that really matters because there's no necessary wealth transfer between the parties.

But in this particular case, it turns out that the so-called contract modification could be understood in the following way. What we've done is we've taken back all of the senior preferred that we've had and now we're making a new issue of senior preferred which we're not authorized to do and we're taking back the farm in the form of dividends against that.

And if you treat this as a recapitalization, which is the correct way in which to do it, it's on such unbalanced terms that it can't happen.

Now, with respect to breach of fiduciary duty, this is the kind of claim that's found sort of everywhere. It's at the heart of the constitutional claim, and it's also at the heart of the private law claims for breach of contract. And with respect to the Administrative Procedure Act.

But what happened is there's a general claim that when the government regulates you and when it deals with you in one form or another, it has to treat you in a fair and impartial fashion. And it's absolutely done nothing whatsoever about that.

This can then be tied up, as Chuck Cooper likes to do it, by showing the specific obligations that are imposed upon a conservatorship, saying in effect under the APA, these

things obviously are the basis of all that goes forward. And so therefore, to the extent that you are not meeting those particular standards, you are vulnerable even if you didn't think there was a constitutional case.

And the reason for bringing it as an APA case is that you hope that if you're going to find yourself in a situation where you get rational basis back of the hand on the constitutional claims, you will find that there's a clarity in the statute which means that they will not apply Chevron deference.

My view about it is that the correlation coefficient between all three cases, common law type actions, administrative actions and constitutional actions are likely to prove very hard because in all cases, the ultimate argument is that this is a completely unbalanced transaction in which we give a penny and we take back $100 billion, and that cannot be regarded as a fair trade. It cannot be regarded as constitutionally other than as a taking. And it can't be regarded as anything other than an administrative outrage. So I think in fact, the balance across these cases is the dominant theme, not the differences amongst them.

MR. TEDDY DOWNEY: Very interesting. And I think we're out of audience questions, but I'll throw one last out there and then maybe ask if you have anything to say that we haven't covered. But from a legislative standpoint – not looking at sort of the comprehensive reform that they're trying to look at - but Senators Corker and some of the other Senators have been adamant that no one but the taxpayer get any basic money out of Fannie and Freddie, with suggestions that they might try to codify the sweep or engage in some other sort of legislation that would prevent money going to anyone but the Treasury. How would passage of provisions like that complicate the court cases? Are those dangerous at all, or would they not affect the current litigation?

MR. RICHARD EPSTEIN: Well, I mean, first of all, to the extent that the claims are based upon past actions, the only way

future legislation would alter them is if what they did was to undo the effect. And this is in effect only going to basically turn the screws one step closer. So if anything, what now happens is you've got more reasons to sue the government rather than less, if in fact the basic pattern of expropriation can be established.

So if they're trying to do this in order to legitimate what happened, I think what they do is they de-legitimate themselves and increase the liabilities running on the opposite risk.

The other thing I think which is very important is that one has to note the way in which the language that will benefit the taxpayer was actually introduced into FHFA. And this is something which is completely misunderstood and wholly ignored in the government's briefs.

The way in which this is done is the FHFA was passed on the assumption that there would be a deal between the Treasury and Fannie and Freddie. But there was no understanding at the time that the deal would be between Fannie and Freddie through its conservator. It was thought it would be through its own people.

Now, at this particular point when you tell the government to act for the benefit of the taxpayer, you already have a party sitting on the other side of this transaction, the trustees who were supposed to have fiduciary duty.

So it's an arm's length deal. And what they're trying to do is to make sure that the government does not get snookered by lending out a lot of money at a very low rate of interest which doesn't cover the way in which the system breaks under the market. And that's an exactly correct way in which to do it. What you're saying is this is not a disguised bailout in the form of the creation of a senior preferred.

But what's happened now is they're using the same thing to describe not only the position of the government, but the

position of the conservator as well. So they're saying the conservator has to act only for the benefit of the taxpayer. Well, that's crazy because you now no longer have the risk in this particular situation of the government letting this company off too cheaply. What you do is you have a systematic pattern of expropriation.

So one of the striking things about the government's brief, both of them in fact, is they never bothered to give you the full statutory text in the thing so you could actually see what's going on. You have to sort of download themselves and put it into it.

And every time they announce that this is solely for the benefit of the taxpayer, they think they get heroic points in the populous press, which I suspect they do. But I think in effect they hurt their own legal case because they basically are making it clear that they are deliberately avoiding the appropriate fiduciary duties, the appropriate obligations, that are associated with this kind of an interactive situation.

So this is common what happens. If you are a character who sits there and are sure that you don't have a legal problem, then what you do is you kind get to be George Costanza. You boast about all the tough things that you've done to other people. But these are very dangerous strategies for government people to do. Because if in fact, they are held to account in court, the political posturing, which is very legion in this case, now becomes the potential source of additional risk in the same case.

So that essentially becomes the sort of issue that they have to have. And I think it's a part of a piece that neither the government in the defense of the case nor the Congressmen and the Senators who are lined up behind taxpayers get every dollar are aware of the fact that their case is much weaker than it turns out to be. They're writing like they have a 95 percent chance or higher of winning this case, so why worry about the spillover from the political talk into the legal talk? That itself is a

most unwise position because I think that the spillover is likely to be much, much heavier than they think.

So my view is if I were sitting out there in any of the forty suits that are doing this, I would get my legal stenographers together, and I would keep a record of all of these particular statements and turn it against them.

Let me give you an example. Do you like your health plan, Teddy? If so, you can keep it.

MR. TEDDY DOWNEY: That's not a bad idea. So you're saying keep track of all the comments from Corker and others about giving money that's taxpayers' and using that in the court case?

MR. RICHARD EPSTEIN: Yeah, I mean, my view about it is what they're doing is they're making admissions that they don't want the government to follow its fiduciary duties through the conservatorship. They can try and explain it away when they get into court, but they'll sound as effective as Ezekiel Emanuel did when he tried to say what the President really meant is that if you want to pay extra to keep the current plan that you have, you're free to do so. And that's supposed to be under a health care system which is going to give you better care for less. It turns out what it's going to give you is less care for more. Small deviation. And that's what's going on here.

MR. TEDDY DOWNEY: That's very interesting. I actually had not considered that as a possibility. So that's fascinating. And I guess the last question just to wrap up, anything that we haven't covered that you really think we should be focused on in the near-term here?

MR. RICHARD EPSTEIN: Yeah, I mean, look, one of the key features about this case that I'd like to expand upon a little bit is the distinction between the physical taking and the regulatory taking. It is characteristic of the government's brief that what it does is it argues that the very broad standards for regulatory takings take over in

this case. And let me see if you can think of what the examples ought to be and how they ought to be lined up.

The most important cases for these first purposes of a financial taking is the Armstrong case from 1960 which I mentioned in which Justice Black makes the famous sentence which says that the takings clause is designed to prevent the government from forcing on a single individual all the losses that in all truth and justice ought to be borne by the public as a whole.

And in that particular case, what happened is the Navy went into Maine, and it asked for a boat to be repaired. The general contractor did not pay one of the subs. And the sub put what they call a materialman's lien on the boat, saying in effect since you got the value of this lien and I can't get paid by the general, you have to pay me off.

And what the government did is it dissolved the lien by sailing its boat out of Maine waters so it could no longer hold. And his position was quite simply this. You want this boat. There's nothing which says that from this particular boat, this materialman, which represents .00001 percent of the population should bear three percent of the total loss.

So what happened is the government can sail the boat out of the harbor. And it now becomes a general creditor instead of a secured borrower, right? I mean, it's broken the lien, but it has to pay the amount. And that gets you to the right social result. And at that point, once it's clear, they're not going to sail the boat out of the harbor because they have no strategic advantage to do so.

And in this particular case, what the government has really done is to say remember this preferred? Well, it had a value of X. And now what we're doing is we're making that value 10X. And we get that. Well, where do you get that? There's no particular reason that you should do it.

So the correct way to look at this is not to say that there's just a loss in value. It's to say that the government put a lien higher than the ones that other parties have on the assets in question.

And if they could do it here, then you could go up to any company and say, you know what? Here's $10. By the way, we're taking back, against your will, a preferred stock which will pay us this huge dividend and all your common stock goes down because of the change in the capital structure. This is not just a diminution in market value case. This is a radical change in the capital structure of the company.

And, you know, if I went to you and I said I know you own your home, Teddy. You're really a great guy. By the way, here's $100. Now give me a lien on your premises, first lien on the house for $1,000. And not only would the equity holder, you, be in a position to object, but anyone who's now a junior lienholder would be in a position to object as well.

The government doesn't talk about this. What the government does is it refers to a bunch of cases which are rightly understood as land use regulation cases. You look at this land and you want to use it for a tower, we think about all the aesthetic externalities it has for the rest of New York. And we therefore can decide that even without full compensation, some cases without compensation at all, in order to preserve the character of the neighborhood, we don't have to pay you when we prevent you from building.

Even in that case, the Penn Central case, they didn't actually take money from people or put a lien on the station. They just simply said you can't use it in the way in which you would like.

Now, from my view, the distinction between a restriction on use and the occupation of property is a constitutional non-starter. But in the real world, it is a constitutional imperative. And what the government keeps arguing is that

this case is a general form of regulation and so it's covered by the Penn Central case.

One of its components is that if you do not have an investment backed expectation of keeping your wealth, the government can have it. And the government says, well, you know, the government always regulates private businesses, so you cannot have an investment backed expectation that you'll be free from this particular imposition.

Now, there's no question that you do take risk subject to the general law. So if they change the law with respect to mortgages and you happen to have company shares in a mortgage stock which is worth less, you can't challenge it.

But that's very different from having a specific lien on a particular piece of property put in violation of every known principle of contractual interpretation. And the government never when it talks about this case does anything other than reciting the three prongs of the Penn Central test and the deference that it does to explain why the lien analogy is not much more precise, given the fact that we are dealing with capital structures and not about aesthetic externalities.

MR. TEDDY DOWNEY: All right. Well, got a lot of things to keep an eye out for and look into. This has been extremely insightful, extraordinarily interesting and we can't thank you enough for taking the time to do this.

MR. RICHARD EPSTEIN: My pleasure.

MR. TEDDY DOWNEY: All right. Everyone have a good day. Thanks for joining us on the conference call.

MR. RICHARD EPSTEIN: Thank you all for listening if you're still there.

**(END OF TRANSCRIPT)**