



**Statement of**

**Edward J. DeMarco  
Acting Director  
Federal Housing Finance Agency**

**Before the  
Committee on Financial Services  
Subcommittee on Oversight and Investigations  
U.S. House of Representatives**

**“An Analysis Post-Conservatorship Legal Expenses of Fannie Mae and Freddie Mac”**

**February 15, 2011**

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Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee, today I will address matters relating to legal expenses of Fannie Mae and Freddie Mac and advancement of legal fees for certain former officers.

The Federal Housing Finance Agency (FHFA) has not altered its view regarding indemnification post-conservatorship as a prerequisite for attracting and retaining skilled officers and directors. Indemnification properly administered is in the best interest of the regulated entity and therefore fits within FHFA’s goal of preserving and conserving assets. At the same time, properly structured indemnification includes limitations for denying indemnification and repayment of advanced fees in certain circumstances. Overturning existing contracts or policies would be a determination with potential adverse consequences and would be inconsistent with standard business practice.

My testimony covers the policy and legal views of the FHFA regarding advancement of legal fees to former Enterprise officers and the management of legal expenses by the Enterprises operating in conservatorship.

**Background on Indemnification and Advancement of Legal Fees**

Indemnification refers to a final determination that a corporate officer or director is due funds for their payment of defense costs, judgments and settlements in public or government lawsuits, whether civil or criminal. Boards of Directors generally put in place such plans under state laws through their corporate bylaws and the administration of fee advancement is left to management.

Advancement of funds for legal fees and costs is the contingent payment of funds by a company on behalf of a covered officer or director and may occur throughout the course of a matter, including appeals. Payment is tied to “reasonable” incurred expenses. As a condition precedent to advancement, the party for whom funds are provided agrees to repay those funds to the company in the event it is later determined that indemnification does not apply to the matter.

The Board of Directors approves indemnification in an individual case when a lawsuit or administrative proceeding is concluded and there is final action. At such time, either the individual is indemnified and the contingency on advanced funds is removed or the individual is not indemnified and the funds must be repaid. Bylaws of corporations provide the circumstances under which funds must be repaid, but repayment occurs at the end of proceedings, not during them.

Courts have upheld the advancement of fees as proper, even in criminal cases. The most important recent decision involving advancement of fees came in *United States v. Stein* in the Southern District of New York in 2006. Here the court ruled that a Justice Department effort that would limit advancement of legal fees would run afoul of constitutional protections, even as the court recognized that such legal fees incurred by defendants may be substantial. Many times corporations have sought to cut off fees; they have been rebuked in the courts. Even where questions arise as to the issue of meeting fiduciary responsibilities, the obligation to advance fees remains.

FHFA supports, as did its predecessor, the Office of Federal Housing Enterprise Oversight (OFHEO), indemnification of officers and directors in line with general corporate principles that seek to protect officers, directors and other employees when acting within the scope of their authority for a corporation. Such indemnification greatly assists in a corporation's ability to attract and retain corporate personnel by protecting them from lawsuits. This determination was made as part of OFHEO's corporate governance rule in 2002. That rule directs the Enterprises to undertake their corporate governance by adopting the law of the state in which their principal place of business exists, Delaware corporate law or the Revised Model Business Corporation Act. The regulation specifically authorized indemnification under appropriate rules. That rule, which serves as the explanation of FHFA's authority and views on indemnification, remains unchanged to this day.

The Housing and Economic Recovery Act of 2008 (HERA), which created FHFA, provided clearer authority for the agency, based on concepts contained in the Federal Deposit Insurance Act. It made no major change in the fundamental concept of permitting indemnification or the advancement of legal fees, but rather provided greater expression of the criteria surrounding such indemnification and fee advancement.

At the time of the conservatorship, FHFA announced that it intended for the Enterprises to operate as going concerns with new CEOs and Boards of Directors and that they were to continue normal business operations in support of the mortgage markets. This included the need to attract and retain skilled professionals. These officers and directors, therefore, could be sued just as before conservatorship, thus the need for retaining indemnification.

The determination by FHFA not to interfere with indemnification and advancement of legal fees for former Fannie Mae executives was based on Fannie Mae's corporate by-laws, governing Delaware state law, the provisions of statute governing FHFA's oversight of Fannie Mae and court cases addressing such an action.

### **Background to Regulatory Reviews and Litigation**

In 2003, FHFA's predecessor agency OFHEO addressed serious problems relating to an accounting restatement that was underway at Freddie Mac. In an abundance of caution, OFHEO began its special examination of Fannie Mae which led to a restatement at the firm. Freddie Mac and Fannie Mae both reached settlements with OFHEO and the Securities and Exchange Commission (SEC) to address accounting problems and internal control matters uncovered in the course of the OFHEO reviews.

In September 2004, OFHEO issued a preliminary report regarding Fannie Mae. At that time, several cases were brought against the Fannie Mae involving securities law violations. These cases were consolidated into a multi-district litigation (MDL) in the District of Columbia. Former Fannie Mae CEO Franklin Raines, former CFO Timothy Howard and former Controller Leanne Spencer also were defendants in this litigation. Over time, the defendants brought OFHEO into the case, issuing a number of document subpoenas calling for the production of a wide assortment of OFHEO records and other information and by issuing subpoenas for the testimony of agency personnel.

OFHEO issued a final report in May 2006 highlighting problems with the culture at Fannie Mae, with the internal controls at the institution and with an overemphasis on meeting profit targets; the report detailed needed reforms. When the report was released, Fannie Mae agreed to a settlement with OFHEO and the SEC, paid a \$400 million penalty and began a program to implement corrective actions. The majority of the penalty amount went to an investor's fund that exists under the securities laws.

In December 2006, OFHEO issued an administrative Notice of Charges against Mr. Raines, Mr. Howard and Ms. Spencer, charging the former officers with a variety of violations of OFHEO's statute. The process was governed by OFHEO authorities and under its rules of procedures. In April 2008, with the uncertainty about securing a resolution that would bear a return commensurate with the effort, OFHEO determined to settle with the three former officers. While they did not admit to offenses that would have cost them their indemnification, they did waive certain claims and certain stock options.

Also, the SEC and other government reviews began to look into the events at Fannie Mae after publication of the OFHEO report. Other reviews were begun after the imposition of the conservatorship and as part of the government's consideration of the causes of the financial crisis.

### **Potential Denial of Indemnification— Pre- and Post-Conservatorship**

Indemnification can be denied for two reasons. In an administrative hearing, if the level of violation is determined to reach a level provided for in statute to deny indemnification or if a finding in an administrative action or in a judicial proceeding rises to the level that would violate the company's bylaws and the company denies indemnification. Second, indemnification in conservatorship could be terminated for the reasons set forth above as part of an administrative or judicial proceeding or, additionally, as part of the FHFA's conservatorship authority to repudiate contracts. It was the judgment of OFHEO and FHFA that neither action was practicable under our statute or under state laws under which the Enterprises operate.

In 2008 HERA enhanced FHFA's enforcement authorities. The language of HERA follows, almost identically, the provisions of the Federal Deposit Insurance Act on indemnification at 12 USC 1828 (k) and addressed by FDIC in its rule at 12 CFR 359. The FDIC statute and the rule provide for indemnification and advancement of fees and provide what terms would disqualify individuals from indemnification. Under HERA, FHFA's authority is limited to denying indemnification in certain agency administrative actions; it does not apply to regulatory investigations of other agencies or judicial proceedings.

Even if action were employed - under separate language on conservatorship relating to terminating contracts - HERA provides for a party's right to challenge in court for damages caused by such action. The result, therefore, would likely be more legal expenses and recovery by the parties of any denied advances. Such an outcome would be a direct cost to the taxpayers.

FHFA believed that continued advancement of funds was in line with the conservatorship and that actions to interfere would be counterproductive due to the ability of individuals denied to sue the agency for such actions. Also, such action would raise secondary issues relating to other employees and their view of the validity of indemnification of their legal expenses and their willingness to continue their employment.

At the time the Enterprises were placed into conservatorship, it was important to avoid losing personnel who could help reduce the costs to the taxpayer from their large portfolios and business activities and who could be distracted by an absence or potential absence of indemnification. Adding new employees to the staffs of the Enterprises would not be possible without indemnification. As FHFA Director Lockhart noted at the time of the conservatorships, "...Monday morning the businesses will open as normal...[and] it is very important to work with the current management teams and employees to encourage them to stay and continue to make important improvements to the Enterprise." Treasury Secretary Paulson added, "...we hope and expect that the vast majority of key professionals will remain in their jobs." [September 7, 2008 statements.] Finally, FHFA is seeking to recover billions of dollars due the Enterprises from their counterparties; altering indemnification could adversely affect the very Enterprise personnel vested with doing the work necessary to substantiate and advance such claims.

### **Background on Legal Expenses**

Even in ordinary times, the Enterprises are large corporations and incur significant legal expenses. Clearly, in conservatorship their legal expenses continue and the mortgage market crisis has led them to expend funds for legal matters that relate both to the advancement of fees for current and former officers in litigation and regulatory matters as described above. The Enterprises must also respond to lawsuits by homeowners, investigations by government agencies and expenses relating to securing recovery of damages from their counterparties. In all of these activities, the legal issues are very complex and litigation involves significant expenses associated with extensive discovery, expert witnesses and other costs involved in judicial proceedings. Further, the defense of lawsuits may occur in multiple jurisdictions.

For its part, FHFA has reminded the Enterprises operating in conservatorship that they need to manage legal expenses effectively and where possible seek to reduce such expenses as they operate with the support of the federal government.

Thank you.