APPENDIX B

Legal Analysis of Section 1710.31 of Proposed OFHEO Corporate Governance Regulations

This memorandum addresses Section 1710.31 of the Office of Federal Housing Enterprise Oversight ("OFHEO") proposed Corporate Governance regulations, 66 Fed. Reg. 47,557 (proposed Sept. 12, 2001) (to be codified at 12 C.F.R. pt. 1710), which would prohibit Fannie Mae and Freddie Mac from indemnifying a board member or executive officer for any legal expense incurred in connection with an OFHEO administrative proceeding that results in a final order or settlement under which that person is assessed a civil money penalty or ordered to cease and desist from any activities. As explained below, Fannie Mae respectfully believes that OFHEO cannot restrict indemnification in this way because Congress legislated that indemnification would only be prohibited for so-called "Third Tier" violations. Moreover, Fannie Mae believes that OFHEO's interpretation in the proposed regulation would not be entitled to *Chevron* deference by a reviewing court because the statute's indemnification restriction is unambiguous.

A. OFHEO's Proposal Contradicts The Language Of The Statute.

OFHEO's proposed corporate governance rule includes a provision, Section 1710.31, which would prohibit Fannie Mae (with two exceptions that are irrelevant to this memo) from making any payment to indemnify a board member or executive officer for any legal expense associated with an OFHEO administrative proceeding that results in a final order or settlement requiring the member or officer to pay a civil money penalty. However, this provision contradicts the governing statute, which only prohibits indemnification for the most serious "Third Tier" violations.

Section 1376 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the "1992 Act"), 12 U.S.C. § 4636, governs the assessment of civil money penalties against any enterprise, board member, or executive officer that engages in prohibited conduct. Subsection (a) defines the prohibited conduct for which OFHEO may impose a civil money penalty, and subsection (b) establishes three tiers of penalties that vary in severity according to the nature of the misconduct. First Tier misconduct, described in subsection (b)(1), is punishable only against an enterprise itself, by an amount not to exceed $5,000 for each day the violation continues. Second Tier misconduct, described in subsection (b)(2), is punishable against an officer or director in an amount up to $10,000 per day (and against an enterprise for an amount up to $25,000 per day) and requires a finding that the misconduct "is part of a pattern of misconduct" or "involved recklessness and caused or would be likely to cause a material loss to the enterprise." Third Tier misconduct, described in subsection (b)(3), is punishable against an officer or director by an amount up to $100,000 per day (and against an enterprise for an amount up to $1,000,000 per day) and requires a finding that the misconduct "was knowing and caused or would be likely to cause a material loss to the enterprise."

Section 1376(g), titled "Prohibition of reimbursement or indemnification," provides: "An enterprise may not reimburse or indemnify any individual for any penalty imposed under subsection (b)(3) of this section." This provision, read in the context of the three-tier penalty scheme outlined in subsection (b), specifies the <u>complete</u> range of penalties or expenses for which indemnification is prohibited. By singling out Third Tier misconduct in section 1376(g), Congress made a conscious policy choice to reserve especially harsh punishment for individuals whose misconduct was <u>intentional</u>.

OFHEO's proposal to prohibit indemnification for both tiers of violations that are punishable against officers and directors – including Second Tier violations which involve

unintentional misconduct – clearly contradicts the letter and spirit of the 1992 Act. Under the well established, common-sense canon of statutory construction, known as *expressio unius est exclusio alterius*, the "mention [by Congress] of one thing [in a statute] implies exclusion of another thing." *Ethyl Corp. v. EPA*, 51 F.3d 1053 (D.C. Cir. 1995). Here, Congress explicitly banned indemnification for Third Tier violations and only those violations – it did not ban indemnification for Second Tier violations; thus, under the *expressio unius* canon, Congress must be understood to have intended that indemnification should be allowed for other violations. *See Mich. Citizens v. Thornburgh*, 868 F.2d 1285, 1292 (D.C. Cir. 1989) ("if Congress banned the importation of apples, oranges and bananas from a particular country, the canon of *expressio unius est exclusio alterius* might well indicate that Congress did not intend to ban the importation of grapefruits. In that event, an agency decision to ban grapefruits would be contrary to Congress' specific intent."); *Halverson v. Slater*, 129 F.3d 180, 185-86 (D.C. Cir. 1997) (under statutory construction principle known as "*expressio unius est exclusio alterius*," Congress' statement that certain functions could be delegated to the Coast Guard implied that they could not be delegated to non-Coast Guard officials); *Tennessee Valley Auth. v. Hill*, 437 U.S. 153 (1978) ("under the maxim *expressio unius est exclusio alterius*," one must presume that if Congress includes certain exceptions in a statute, those are the only exceptions that Congress intended).

Moreover, the application of this logic is particularly appropriate here for several reasons. First, two years prior to enacting section 1376, Congress passed similar legislation, which amended the Federal Deposit Insurance Act to prohibit indemnification payments to, *inter alia*, directors of banks and savings-and-loan institutions, for legal expenses and penalties related to any administrative proceeding or civil action in which the director is assessed a civil money penalty. *See* 12 U.S.C. § 1828(k) (added to section 1828 by Pub. L. 101-647, § 2523(a)) (FDIC

"may prohibit or limit, by regulation or order, any . . . indemnification payment," which is defined in the statute to include "any payment" to reimburse a director for "any liability or legal expense" related to an administrative proceeding or civil action in which the person is "assessed a civil money penalty"). Against this legislative backdrop, it is clear that Congress, when it enacted the indemnification prohibition in section 1376, knew how to hold corporate directors and officers personally liable for all civil penalties – whether they resulted from intentional or unintentional misconduct – if it wished to do so. Yet, section 1376 covers only intentional misconduct, reinforcing the *expressio-unius* based conclusion that Congress meant to exclude unintentional misconduct from the indemnification prohibition.

Second, this inference is strengthened by the fact that the penalties excluded from section 1376 are not left unspecified in the statute. Rather, they are plainly listed in subsection (b). In other words, the statute leaves no uncertainty as to what Congress sought to exclude when it chose to include Third Tier misconduct – and only Third Tier misconduct – within the scope of section 1376(g). Not surprisingly, the *expressio unius* maxim has particular force where – as here – "a thing is provided in one part of the statute and omitted in another." 2A Norman J. Singer, Statutes and Statutory Construction § 47:23, at 316 (6th ed. 2000). "[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Russello v. United States*, 464 U.S. 16, 23 (1983). The intention and purpose behind Congress's choice of language in section 1376(g) is no mystery: Congress sought to prohibit indemnification for penalties arising from intentional but not unintentional misconduct.

Third, section 1376 is a penal law. Although subsection (g) is not the provision defining the prerequisites for liability, it does define when individuals must bear the full practical

consequence of a civil money penalty. The meaning of subsection (g) is thus subject to the well established rule of lenity in the construction of penal statutes. *See United States v. Wiltberger*, 18 U.S. 76, 105 (1820) ("The rule that penal laws are to be construed strictly, is perhaps not much less old than construction itself. It is founded on the tenderness of the law for the rights of individuals; and on the plain principle that the power of punishment is vested in the legislative . . . department."); *United States v. One 1973 Rolls Royce*, 43 F.3d 794, 819 (3d Cir. 1994) (applying rule of lenity to a civil forfeiture statute with a punitive purpose). The risk of penal liability facing board members and executive officers under section 1376 thus further justifies a narrow construction of subsection (g).

Finally, this construction of the statute comports with the most logical understanding of Congress' intent. After all, why would Congress, having established a carefully calibrated three-tier penalty scheme, single out "any penalty imposed under subsection (b)(3)" if it intended that indemnification should be prohibited for (b)(2) violations as well? Clearly Congress intended that directors be required to pay out of their pockets only for the most serious violations. It is difficult to imagine that Congress would have prohibited indemnification for the most serious – intentional – violations with the intention that OFHEO would then promulgate regulations to make directors pay out of their own pockets for less serious violations as well.

B. OFHEO's Interpretation Of The Indemnification Provision Would Not Be Entitled To Chevron Deference.

Fannie Mae also believes that OFHEO's interpretation of Section 1376 would not be subject to judicial deference. Although an agency is generally afforded deference in interpreting its own statute, *see Chevron v. NRDC*, 467 U.S. 837 (1984), such deference only applies when a statute is ambiguous. If the statute can be interpreted simply by reading it and applying statutory interpretation tools (such as the *expressio unius* canon), courts – not agencies – have the necessary expertise, and deference is therefore inappropriate:

> The interpretation put on the statute by the agency charged with administering it is entitled to deference . . . but the courts are the final authorities on issues of statutory construction. They must reject administrative constructions of the statute, whether reached by adjudication or by rulemaking, that are inconsistent with the statutory mandate or that frustrate the policy that Congress sought to implement.

Federal Election Comm'n v. Democratic Senatorial Campaign Comm., 454 U.S. 27, 31-32 (1981); *see also Chevron* 467 U.S. at 848 (courts should first attempt to interpret statute using "traditional tools of statutory construction," deference is only appropriate if statute is unclear or Congress left gaps to fill).[1] Here, as noted above, Congress made its intentions clear in the statute: Indemnification is prohibited only for Third Tier violations – and nothing else. Thus, it would be inappropriate for a court to defer to an agency's interpretation regarding the scope of its authority. *See Dole v. United Steelworkers*, 494 U.S. 26, 42 (1990) ("Because we find that the statute, as a whole, clearly expresses Congress' intention, we decline to defer to [the agency's] interpretation."); *Michigan Citizens*, 868 F.2d at 1292-93 (if court can discern the intent of Congress using an accepted canon of statutory interpretation, then deference under second step of *Chevron* is not necessary); *MCI Telcoms. Corp.* v. *AT &T Co.*, 512 U.S. 218, 231 (1994); *FDA* v. *Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 159-160 (2000). In this instance, the language of the statute, and not the pronouncement of OFHEO, is supreme.

Conclusion

In sum, Fannie Mae respectfully believes that the indemnification prohibition proposed by OFHEO is premised on an unreasonable construction of the governing statute. Section 1376(g) limits the prohibition on indemnification to "any penalty imposed under subsection (b)(3)." Expanding the prohibition to encompass penalties imposed under subsection (b)(2), or

[1] *See also Pub. Employees Ret. Sys. v. Betts*, 492 U.S. 158, 171 (1989) ("of course, no deference is due to agency interpretations at odds with the plain language of the statute itself").

legal expenses associated with Second Tier penalties, would contravene the language chosen by Congress and would negate the plain implication of Congress's choice. Accordingly, we believe that OFHEO's interpretation would not be sustained by a court of law.