FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

Evaluation of FHFA's Management of Legal Fees for Indemnified Executives

EVALUATION REPORT: EVL-2012-002 **DATED: February 22, 2012**

FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

AT A GLANCE

Evaluation of FHFA's Management of Legal Fees for Indemnified Executives

Why FHFA-OIG Did This Evaluation

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises) have spent considerable sums to defend themselves and former senior executives in class action lawsuits and other legal matters. Notably, in the case of three former Fannie Mae senior executives, between 2004 and October 31, 2011, the Enterprise paid out in advances $99.4 million in legal expenses for their defense in lawsuits, investigations, and administrative actions. The lawsuits, now consolidated in a single securities fraud case pending in the District of Columbia, allege that the three executives supported questionable accounting practices that produced inflated prices of Fannie Mae stock, ultimately resulting in substantial shareholder losses. Discovery is now complete and the case awaits trial. Further, of the $99.4 million, Fannie Mae has paid as advances $37 million since September 2008, when it was placed into conservatorship by the Federal Housing Finance Agency (FHFA or the Agency). Freddie Mac has paid as advances $10.2 million in legal defense costs for former senior executives since its conservatorship commenced. FHFA, as the Enterprises' conservator, has approved these payments.

More recently, on December 16, 2011, the Securities and Exchange Commission (SEC) filed suit in New York against six other former Fannie Mae and Freddie Mac senior executives. To date, the Enterprises have advanced and continue to advance the executives' legal expenses. Members of Congress and others have questioned the level and appropriateness of the legal expense payments, especially in light of the very large federal government investment in the Enterprises ($183 billion as of December 2011). FHFA, Fannie Mae, and Freddie Mac believe that based on applicable law the Enterprises are obliged to advance legal expenses of former and current executives, unless there is a final adjudication that they acted in bad faith.

The FHFA Office of Inspector General (FHFA-OIG) conducted this evaluation to assess FHFA's oversight of the Enterprises' payments of legal expenses incurred by former senior executives.

What FHFA-OIG Found

FHFA confronts a challenging balance of interests. On the one hand, it is interested in avoiding potential losses by effectively defending ongoing lawsuits against Fannie Mae and Freddie Mac. On the other hand, FHFA has an interest in controlling significant costs, particularly the tens of millions of dollars of payments made to attorneys and others involved in representing former senior executives.

FHFA has some, albeit limited, tools available to curtail litigation. For example, FHFA recently issued a regulation that makes shareholder claims arising out of successful class action litigation the lowest priority in any reorganization of FHFA's regulated entities, and that gives FHFA, the Enterprises' conservator, the discretion not to pay securities litigation claims during their conservatorships. Based on the new regulation, the Treasury Department's $183 billion investment in the Enterprises will be accorded repayment priority ahead of litigation claims. That, and the view that the Enterprises will not be able to earn enough to repay Treasury's investment and emerge from conservatorships, means that, for all practical purposes, it is unlikely that Fannie Mae and Freddie Mac will ever be in a position to pay litigation claims. FHFA recently made that argument in an effort to stay the pending District of Columbia securities fraud case. However, the effort was unsuccessful and the regulation is now the subject of legal challenge.

FHFA-OIG believes that, given the significant amounts of taxpayer money involved and the issue's high visibility, FHFA must continue to scrutinize intensively the Enterprises' advances in order to limit costs.

What FHFA-OIG Recommends

FHFA-OIG recommends that FHFA: (1) work to limit legal expenses to the extent possible and reasonable; and (2) continue to control costs of legal expenses.

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Federal Housing Finance Agency

Office of Inspector General

Washington, DC

PREFACE

FHFA-OIG was established by the Housing and Economic Recovery Act of 2008 (HERA),[1] which amended the Inspector General Act of 1978.[2] FHFA-OIG is authorized to conduct audits, evaluations, investigations, and other activities of the programs and operations of FHFA; to recommend policies that promote economy and efficiency in the administration of such programs and operations; and to prevent and detect fraud and abuse in them.

This evaluation is one in a series of audits, evaluations, and special reports published as part of FHFA-OIG's oversight responsibilities. It is intended to assess FHFA's supervision of the processes by which the Enterprises[3] advance payments for legal services provided to current and former senior executives. Advancing payment of legal fees gained significant attention when Fannie Mae's advances of legal defense costs for three former senior executives, Franklin D. Raines, J. Timothy Howard, and Leanne G. Spencer, became the focus of a hearing before the House Financial Services Subcommittee on February 15, 2011.[4]

This evaluation was led by Director of Special Projects David Z. Seide, and Investigative Counsel Stephen P. Learned contributed to its completion. FHFA-OIG appreciates the assistance of all those who contributed to the preparation of this report.

[1] Public Law No. 110-289.

[2] Public Law No. 95-452.

[3] On September 6, 2008, soon after HERA's enactment, Fannie Mae and Freddie Mac entered conservatorships overseen by FHFA, and Treasury committed to purchase preferred stock issued by the Enterprises to maintain their solvency. As of December 14, 2011, Treasury had provided $183 billion to the Enterprises.

[4] *See An Analysis of the Post-Conservatorship Legal Expenses of Fannie Mae and Freddie Mac: Hearing Before the H. Subcomm. on Oversight and Investigations of the Comm. on Financial Services*, 112th Cong., 2 (Feb. 15, 2011), available at http://financialservices.house.gov/UploadedFiles/112-4.PDF (hereinafter House Hearing).

This evaluation report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on FHFA-OIG's website, www.fhfaoig.gov.

George Grob
Deputy Inspector General for Evaluations

BACKGROUND

Overview of FHFA, the Enterprises, and the Conservatorships

Fannie Mae and Freddie Mac are government-sponsored enterprises that support the nation's housing finance system by purchasing mortgages from loan sellers, which can then use the sales proceeds to originate additional mortgages. The Enterprises retain investment portfolios that generally consist of whole mortgages, mortgage-backed securities (MBS) (their own and private-label MBS), and Treasury securities.[5]

In September 2008, due to the Enterprises' mounting mortgage-related losses, FHFA placed them into conservatorships. At the same time, Treasury agreed to provide financial support to the Enterprises to help stabilize their financial condition. As of December 31, 2011, Treasury has invested a total of $183 billion in the Enterprises in the form of purchases of shares of senior preferred stock.

As the Enterprises' conservator and regulator, FHFA is responsible for preserving their assets and minimizing taxpayer losses. FHFA has delegated day-to-day management responsibilities to Enterprise officers and oversight to their boards of directors. However, FHFA has retained the power to review and approve board decisions, including those that relate to legal expenses.

Before the commencement of the conservatorships, both Enterprises operated as public companies with shares trading on the New York Stock Exchange. Since the conservatorships began, the Enterprises have continued to operate in their same corporate form and to make periodic financial filings with the SEC, but they are no longer listed on the New York Stock Exchange.[6]

[5] Each Enterprise may hold its own MBS in its portfolio.

[6] In mid-2010, Fannie Mae and Freddie Mac shares were delisted from trading on the New York Stock Exchange; however, their shares continue to trade publicly on the Over-the-Counter Exchange. According to FHFA's Acting Director:

> 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.

Statement of Acting Director Edward J. DeMarco, House Hearing, at 3.

Enterprise Bylaws and Indemnification Agreements with Current and Former Senior Executives

Both Fannie Mae and Freddie Mac, as part of the compensation and benefits packages provided to their officers and directors, have obligations to indemnify officers and directors under Enterprise bylaws or individual agreements. These bylaws and agreements follow state laws that were adopted for corporate governance purposes by the Enterprises pursuant to regulation (Delaware for Fannie Mae, Virginia for Freddie Mac). In essence, **indemnification** obligates the Enterprises to pay all liabilities and expenses of the officers and directors – including legal expenses – provided the officers and directors were acting within the scope of their authorities. Moreover, the agreements obligate the Enterprises to **advance** the payments of legal expenses incurred during the course of legal proceedings.

For Freddie Mac, these obligations can be excused only if the indemnified officer or director is found to have engaged in reckless or willful misconduct or a knowing violation of a criminal statute. Fannie Mae agreed that if the officers or directors were made "a party or threatened to be made a party" or called as a witness "to any Proceeding," they would be indemnified for "[e]xpenses ... actually and reasonably incurred ... in connection with such Proceeding, if [they] acted in good faith and in a manner [they] reasonably believed to be in or not opposed to the best interests of Fannie Mae ...."

What Are Indemnification Agreements?

An indemnification agreement is a contract in which one party agrees to protect another party against certain future claims or losses. In the context of the Enterprises, indemnification obligates them to pay all liabilities and expenses – including legal expenses – of their officers and directors, to the extent not prohibited by applicable law, Enterprise bylaws (which set rules for corporate operations), or by an indemnification agreement. Indemnification occurs upon a final determination that it is merited after proceedings have ended. Until that time, fees are only "advanced" to officers and directors and are subject to requests for repayment.

What Are Advances?

Legal fees and expenses are "advanced" when they are paid prior to any final adjudication of a director's or officer's actions. A final adjudication of bad faith or breach of fiduciary duty would result in the obligation to repay any advances made.

Pertinent Pending Securities Litigation Involving the Enterprises and Former Senior Executives

The Enterprises, along with their former senior executives, have been named as defendants in a number of class action lawsuits alleging securities fraud and seeking billions of dollars in damages.[7] Once FHFA became conservator of Fannie Mae and Freddie Mac, it intervened in these cases

[7] Class action lawsuits are brought by one or more plaintiffs on behalf of a large group of other similarly-situated individuals and entities who share a common legal claim.

in its capacity as conservator.[8]

One significant pending multi-district case, filed against Fannie Mae in 2004 in the federal district court for the District of Columbia, concerns conduct by the Enterprise and its former senior officers (hereinafter District of Columbia class action). The complaint in this case alleges that from 2000 through 2004, Fannie Mae and three former senior executives – former Chief Executive Officer Franklin D. Raines, former Chief Financial Officer J. Timothy Howard, and former Controller Leanne G. Spencer – engaged in practices that artificially inflated the price of Fannie Mae's publicly traded stock. The lawsuit's allegations are based on a special examination undertaken by FHFA's predecessor agency, the Office of Federal Housing Enterprise Oversight (OFHEO).[9] In a report of its review, OFHEO found that the three former officers knowingly manipulated earnings to maximize their bonuses, while improperly neglecting accounting systems and internal controls and misleading the regulator and the public.

After issuing its report, OFHEO, along with the SEC, entered into settlements with Fannie Mae on May 23, 2006. Fannie Mae's settlement with the agencies included an agreement to pay $400 million in restitution and penalties and undertake a plan of corrective action. The Enterprise did not admit to liability, however. In December 2006, OFHEO instituted separate administrative actions against the three former senior executives, charging them with using improper accounting methods designed to generate unearned bonuses.

In April 2008, OFHEO agreed to settle the administrative actions against the three former senior executives prior to a final adjudication as to whether they had acted in bad faith.[10] Under the terms of the three stipulations and consent orders, the individuals agreed to make combined total payments of about $31 million.[11] Notably, the settlements did not include any admissions of wrongdoing by anyone and did not address the issue of indemnification of legal expenses by Fannie Mae. Although it is common practice for many federal government agencies to settle civil enforcement actions without admissions of liability, the practice has recently become the subject of substantially greater scrutiny in the aftermath of a federal district court opinion in

[8] "Intervened" refers to the legal procedure by which a third-party joins an on-going lawsuit.

[9] OFHEO issued its final report in May 2006. *See Report of Special Examination of Fannie Mae* (May 2006), available at www.fhfa.gov/webfiles/747/FNMSPECIALEXAM.pdf.

[10] *See* below for further discussion of this issue.

[11] Raines and Howard agreed to pay $24.5 million and $6.4 million, respectively; Spencer agreed to pay $275,000. The form of payment varied by individual, but included donations of proceeds from the sale of Fannie Mae stock, payments to the United States, surrender and relinquishment of claims related to Fannie Mae stock options, and the loss of other benefits.

November 2011. The decision in question was critical of the SEC entering into civil settlements without requiring admissions of guilt.[12]

The District of Columbia class action commenced in 2004, and the class was certified in 2008. FHFA intervened in the case in October 2008. Discovery recently concluded with 67 million pages of documents produced and over 120 depositions taken. Motions for **summary judgment** have been filed and briefing and court submissions have been completed.[13] As of February 13, 2012, a trial date had not been set.

What Is Summary Judgment?

A summary judgment motion is a request made to a judge, typically prior to the commencement of trial but after pre-trial discovery has been completed, for a ruling on the merits of a legal claim. It is granted only when a judge concludes there is no genuine dispute as to any material fact and that the moving party is entitled to a judgment as a matter of law.

Fannie Mae and Freddie Mac are also the subject of a number of additional class action lawsuits alleging securities fraud and other violations. For example, Freddie Mac and its former senior executives have been named as defendants in class action and shareholder derivative suits filed in Ohio and Virginia.[14] And Fannie Mae, Freddie Mac, and their former officers also face federal class action lawsuits in New York, alleging misrepresentations and omissions about the Enterprises' financial conditions during the period before the Enterprises entered conservatorships.[15]

On December 16, 2011, after conducting a multi-year investigation, the SEC filed suit against six former senior officers of Fannie Mae and Freddie Mac: Daniel H. Mudd, Enrico Dallavecchia, Thomas A. Lund, Richard F. Syron, Patricia L. Cook, and Donald J. Bisenius.[16] The SEC also announced that it had entered into non-prosecution agreements with both Enterprises.[17] The

[12] *See SEC v. Citigroup Global Markets, Inc.*, 11-cv-7387 (JSR) (S.D.N.Y. Nov. 28, 2011). On December 15, 2011, the SEC appealed the ruling.

[13] "Briefing" refers to the written legal documents provided to the judge in support of and in opposition to pleadings.

[14] *Ohio Public Employees Retirement System* v. *Freddie Mac*, *Syron, et al*, 4:08-cv-160 (N.D. Ohio); and *In re Freddie Mac*, Derivative Litigation, 1:08-cv-773 (E.D. Va) (dismissed on procedural grounds, 2011 WL 1691998 (4th Cir., May 5, 2011)).

[15] *In re Fannie Mae 2008 Securities Litigation*, 08-cv-07831-PAC (MDL-No.2013); *In re Fannie Mae ERISA Litigation*, 09-cv-01350-PAC (MDL No. 2013); and *Kuriakose* v. *Freddie Mac, Syron, et al*., 08-cv-7281 (S.D.N.Y.).

[16] *SEC* v. *Daniel H. Mudd, Enrico Dallavecchia & Thomas A. Lund*, 11-cv-9202 (RLC) (S.D.N.Y.);and *SEC* v. *Richard F. Syron, Patricia L. Cook & Donald J. Bisenius*, 11-cv-9201 (RJS) (S.D.N.Y.).

[17] SEC Press Release, *SEC Charges Former Fannie Mae and Freddie Mac Executives with Securities Fraud* (Dec. 16, 2011), available at http://www.sec.gov/news/press/2011/2011-267.htm. Non-prosecution agreements are agreements that the SEC enters into with parties in which the SEC agrees not to prosecute the particular party, and the party agrees to a series of undertakings, typically including cooperation with the SEC.

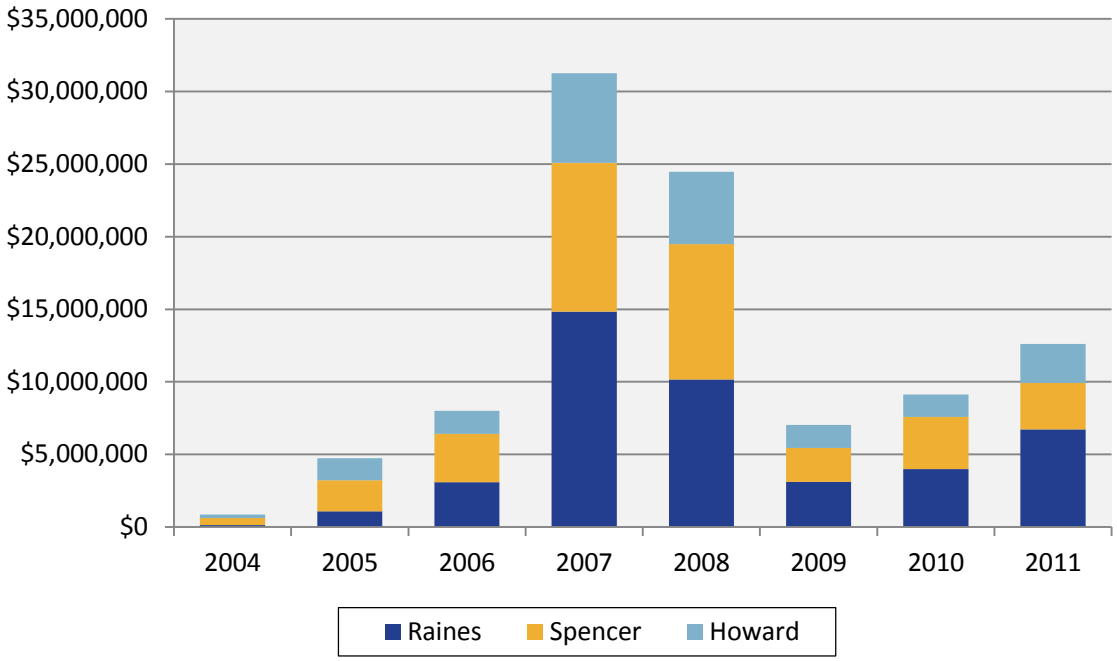
complaints allege that the six executives misrepresented the degree to which the Enterprises were exposed to subprime mortgages in violation of the federal securities laws.

Selected Advances to Former Senior Officers

Fannie Mae's Advances to Three Former Officers

Between 2004 and October 31, 2011, Fannie Mae advanced $99.4 million in legal expenses to cover the representation of Raines, Howard, and Spencer in connection with government investigations and lawsuits stemming from accounting irregularities uncovered in 2004. Included in that amount is $37 million that FHFA has permitted Fannie Mae to advance to the three since the beginning of the conservatorship. Figure 1 breaks down the $99.4 million in legal fee payments made to each executive over time.

Figure 1: Breakdown of $99.4 Million in Legal Expenses Paid on Behalf of Three Former Fannie Mae Executives, January 1, 2004, to October 31, 2011



The $99.4 million and $37 million sums do not include payments that Fannie Mae has made in other class action lawsuits alleging misconduct on the part of other former Fannie Mae officers who are also parties to indemnification agreements.

Freddie Mac Advances

From September 6, 2008, through October 31, 2011, Freddie Mac advanced approximately $10.2 million for the legal representation of its officers and directors in a variety of investigations and lawsuits, some of which are described herein.

Fannie Mae and Freddie Mac Advances to Six Former Officers

With respect to the securities enforcement lawsuits that the SEC recently filed against three former Fannie Mae senior officers (Mudd, Dallavecchia, and Lund) and three former Freddie Mac senior officers (Syron, Bisenius, and Cook), to date, the Enterprises have paid the six former executives' legal expenses pursuant to bylaws and indemnification agreements.

FHFA Rationales for Approving Legal Expenses

From the inception of the conservatorships, FHFA has approved advances of legal expenses incurred by directors and officers under Enterprise indemnification obligations. One rationale articulated by the Agency as justifying its decision to approve the advances is that paying defense costs reduces the likelihood of a successful claim against the Enterprises that could conceivably be borne by taxpayers. Indeed, during Congressional testimony on the topic of Fannie Mae legal expenses, FHFA's Acting Director said:

> the defense that is being put up here is defense against a suit that, if successful, would presumably result in a claim against Fannie Mae, Fannie Mae in conservatorship being backed by the taxpayer.[18]

The Acting Director has also emphasized that indemnification is needed as a recruitment and retention tool in order to attract and retain skilled officers and directors.[19] Fannie Mae's chief executive officer echoed these sentiments in his Congressional testimony.[20]

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[18] House Hearing, at 15.

[19] Statement of Acting Director Edward J. DeMarco, House Hearing, at 5. In his written statement, the Acting Director said:

> 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.

House Hearing, at 5.

[20] The chief executive officer testified that:

> [The] obligation [to advance legal expenses] derives from Article 6 of our bylaws, which Fannie Mae's shareholders adopted in 1987. It is also governed by the contracts that Fannie Mae's Board

FHFA also believes that existing indemnification agreements have been written so as to make the Enterprises contractually obligated to advance legal expenses. For example, in the District of Columbia class action, the plaintiffs allege that Raines, Howard, and Spencer engaged in misconduct while acting in their capacity as officers of Fannie Mae. In FHFA's and Fannie Mae's view, these allegations triggered Fannie Mae's obligation to advance legal expenses on behalf of the former officers under their indemnification agreements. The agreements provide that those officers are entitled to advances until a final disposition of such proceedings, including all appeals. They believe the presumption supporting advances remains until a determination is made that they are not entitled to indemnification, such as when they did not act in good faith or in a manner they reasonably believed was in the Enterprise's best interest. Notwithstanding the seriousness of OFHEO's allegations against the three former officers in its administrative action in 2006, all three officers settled with OFHEO in 2008 without admissions of guilt or findings of liability. Consequently, in light of applicable law and regulation, FHFA and Fannie Mae determined the officers were entitled to continued advances of legal fees absent a final adjudication that their conduct disqualified them.[21]

Tools for Managing Legal Expenses

Given the billions of dollars at risk in the pending class actions and the tens of millions of dollars expended to defend the cases, both FHFA and the Enterprises have strong interests in managing both the risks and costs. FHFA and the Enterprises possess a number of tools to manage legal expenses. Some are common to large companies, others are not. FHFA also confronts challenges in using some of these tools because their current or future availability is open to question and no one tool appears to resolve the issue fully.

> has entered into with each of its officers and directors. Our Conservator affirmed these contracts in 2008. Where they apply, the Company's obligation to advance legal expenses is always mandatory. If Fannie Mae were to refuse to honor this obligation, we would undoubtedly be sued and likely be subject to additional costs.
>
> Corporations throughout America make provisions similar to ours in order to attract and retain strong and experienced officers and directors.
>
> Since 2009, Fannie Mae has put in place a new Board of Directors and senior executive team. It would not have been possible for the Company to recruit and retain these professionals without offering advancement protections and applying them consistently.

House Hearing, at 7.

[21] Under its bylaws and Delaware law, Fannie Mae need not indemnify the officers if it is finally adjudicated that they did not "act in good faith and in a manner [that they] reasonably believed to be in or not opposed to the best interests of Fannie Mae." Under such circumstances, Fannie Mae may seek to recapture legal fees already advanced. To ensure repayment of legal fees advanced, the indemnification agreement between Fannie Mae and indemnified officers provides that they will "reimburse such amount if it is finally determined, after all appeals by a court of competent jurisdiction that [they are] not entitled to be indemnified against such Expenses by Fannie Mae as provided by this Agreement …."

Narrowing the Reach of Indemnification Agreements

As the conservator of Fannie Mae and Freddie Mac, FHFA is authorized by statute to reject or repudiate contracts. FHFA made a determination at the inception of the conservatorships not to repudiate any indemnification agreement or bylaw provision, and has not revisited the question since that time.[22] Although FHFA could have conceivably exercised this authority soon after the conservatorships commenced (in September 2008), its availability in at least some instances appears to be open to question as time progresses.

HERA authorizes a conservator of an Enterprise to repudiate contracts to which the Enterprise is a party when the conservator determines, in its sole discretion, that performance of the contract is burdensome and that disaffirmance or repudiation "will promote the orderly administration of the affairs" of the Enterprise.[23] However, HERA further requires the conservator to make a determination "within a reasonable period" of time after being appointed as conservator.[24] FHFA's recent conservatorship rule, adopted in mid-2011 and discussed further below, defines a reasonable period under HERA as 18 months following appointment of a conservator or receiver.[25] Given the passage of time, rejecting indemnification agreements that were operating at the time the conservatorship commenced could present legal risks. In addition, HERA permits parties to repudiated service contracts to sue to recover compensatory damages for work performed prior to repudiation *plus* their litigation costs.[26] FHFA, thus, has asserted that repudiating indemnification obligations could potentially be costly if former officers brought lawsuits challenging repudiation.[27]

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[22] FHFA's Acting Director testified about the determination at a Congressional hearing as follows:

> It was made at the time the conservatorship was established by my predecessor …. So the determination was made at that point, and that is not, at this point, a determination to be revisited.

House Hearing, at 8.

[23] 12 U.S.C. § 4617(d)(1).

[24] 12 U.S.C. § 4617(d)(2).

[25] 12 C.F.R. § 1237.5(b).

[26] 12 U.S.C. § 4617(d)(3) & (7). HERA contains a provision permitting the FHFA Director, under certain conditions, to prohibit indemnification payments, although the provision does not appear to apply to this situation. HERA's definition of "indemnification payment" is limited to a payment or reimbursement "for any liability or legal expense with regard to [an] administrative proceeding or civil action *instituted by the Agency* which results in a final order under which such person – (i) is assessed a civil money penalty; (ii) is removed or prohibited from participating in conduct of the affairs of the regulated entity; or (iii) is required to take any affirmative action to correct certain conditions resulting from violations or practices, by order of the Director." 12 U.S.C. § 4518(e)(1), (2) & (5) (italics added). According to FHFA's Acting Director, "[u]nder 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." *See* Statement of Acting Director Edward J. DeMarco, House Hearing, at 4.

[27] The Acting Director testified before Congress:

The Enterprises may also possess the ability to limit by contract the size and duration of future indemnification agreements. FHFA and the Enterprises could consider limiting the scope of future agreements by using techniques commonly employed to control costs in insurance programs. Those techniques include:

- Capping total or specific payments at pre-determined amounts;
- Using preferred providers who agree to manage their costs;
- Pre-approving payments;
- Electing to settle FHFA enforcement proceedings only if the officer or director admits to liability; and
- Modifying future indemnification agreements to permit denying indemnification in situations that fall short of final adjudications by a court.

With regard to the last option and by way of example, Department of Justice (DOJ) regulations allow, in certain situations, DOJ to pay for federal employees to be represented by private counsel in legal proceedings.[28] But these regulations further permit DOJ to cease payment of private legal expenses if the Department "[d]etermines that the employee's actions do not reasonably appear to have been performed within the scope of his employment."[29] In other words, DOJ does not necessarily wait to see whether an employee loses at trial and is finally adjudicated liable before deciding whether it shall bear the costs of the employee's defense.[30]

However, all of the foregoing approaches do not appear to address indemnification agreements already in place.

Making Greater Use of Directors and Officers Insurance

It is common for large companies to secure for their directors and officers insurance policies that sometimes include the payment of legal defense costs by the insurer. Although that option could conceivably limit ongoing legal expenses, it is not without its costs and limitations. Further, one

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> 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.

House Hearing, at 5.

[28] *See* 28 C.F.R. § 50.16.

[29] 28 C.F.R. § 50.16(c)(2)(ii).

[30] *See* 28 C.F.R. § 50.15(a).

Enterprise has secured a type of Directors' and Officers' Insurance Policy (D&O) that requires that it bear directly legal expenses.

Fannie Mae purchased limited D&O liability coverage. D&O coverage consists of three types: A-side, B-side, and C-side. A-side provides coverage to individual executives when they are not indemnified by the company (either because the company is legally prohibited from providing, the company refuses to provide, or the company is incapable of providing indemnification). B-side provides coverage for the corporation for its costs when it indemnifies a director or officer (Freddie Mac has purchased such coverage). C-side provides coverage to the company itself for securities claims brought against the company.

In the case of Raines, Howard, and Spencer, Fannie Mae's D&O policy consists of A-side coverage only. The policy provides that the insurer will pay the coverage but only when "the Company has not indemnified and is not permitted to indemnify the Insured Persons for such Loss." Since Fannie Mae has advanced funds to the officers and has been, to date, not prohibited from making such advances, it appears that this coverage has not been invoked.

In the future, FHFA could consider broadening the scope of the Enterprises' D&O coverage. For example, they could both procure B-side coverage, which may be available given that – according to FHFA's General Counsel – Freddie Mac has secured such coverage. But that step could entail higher short-term costs in the form of higher insurance premiums. FHFA and the Enterprises may determine that the long-term benefits in the form of savings on litigation advances outweigh shorter-term costs.[31]

Invoking the New FHFA Conservatorship Regulation

FHFA recently has published a new regulation that could, if successfully implemented, end certain litigation against the Enterprises. But the availability of the regulation is uncertain because it is currently the subject of legal challenge.

[31] By way of example, an analogous approach that is employed by DOJ includes reimbursing employees who elect to purchase professional liability insurance for the cost of extra premium payments. *See* Talking Points Regarding Professional Liability Insurance, available at http://hr.commerce.gov/Practitioners/EmployeeRelations/DEV01_006383.

On June 20, 2011, FHFA issued a final rule establishing a framework for conservatorship and receivership operations for the Enterprises.[32] The final rule, which became effective on July 20, 2011, provides that claims by current or former shareholders (including securities litigation claims) will receive the lowest priority in a receivership, on par with equity shareholders, behind: (1) administrative expenses of the receiver (or an immediately preceding conservator); (2) other general or senior liabilities of the regulated entity; and (3) obligations **subordinated** to those of general creditors. Moreover, the final rule also provides that FHFA, as conservator, will not pay securities litigation claims against a regulated entity during conservatorship, unless the Director of FHFA determines it is in the interest of the conservatorship.

What Are Subordinated Obligations?

An obligation that is "subordinated" is inferior to other obligations that have not been subordinated. In bankruptcy matters, subordinated claims are typically paid only after non-subordinated claims have been paid.

In other words, application of this regulation could mean that even if the plaintiffs in the pending District of Columbia class action win and obtain a monetary judgment against Fannie Mae, in any reorganization, such as receivership, that judgment would be subordinated to all other claims by all other creditors. That would appear to be especially significant because one popular view point is that the Enterprises will never earn sufficient amounts to repay current debts – which include the $183 billion owed to Treasury – let alone future ones. That point was made by the Acting FHFA Director in a recent speech:

> It ought to be clear to everyone at this point, given the Enterprises' losses since being placed into conservatorship and the terms of the Treasury's financial support agreements, that the Enterprises will <u>not</u> be able to earn their way back to a condition that allows them to emerge from conservatorship. (Emphasis added).[33]

Accordingly, if the Enterprises are unable to make any payments with respect to legacy securities claims, there would appear to be little value in having them continue to participate in ongoing litigation.[34]

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[32] 76 Fed. Reg. 35724 (June 20, 2011).

[33] *See* September 19, 2011, speech of FHFA Acting Director, at 5, available at http://www.fhfa.gov/webfiles/22617/NCSpeech91911.pdf.

[34] FHFA recently invoked this argument, albeit unsuccessfully, when it moved for a stay of the pending District of Columbia securities class action against Fannie Mae for the duration of FHFA's conservatorship of Fannie Mae, or alternatively until the suit challenging the Agency's conservatorship regulation is resolved. In legal proceedings, a "stay" is a court order stopping further legal action or proceedings until a future event occurs or the order is suspended or terminated. The district court denied FHFA's stay motion. *See In re Fannie Mae Securities Litigation*, 1:04-cv-01639 (D.D.C Nov. 14, 2011).

On the other hand, the validity of the regulation remains an open question because on August 26, 2011, the lead plaintiffs in the District of Columbia class action filed a complaint challenging the regulation on constitutional and statutory grounds.[35] FHFA has answered the complaint (denying the challenges), and the parties have filed summary judgment motions in the district court.

In summary, while FHFA's new regulation provides a possible legal avenue for ending litigation against the Enterprises and thereby limiting further legal expenditures, its uncertain legal status poses additional challenges for FHFA. At the same time, although the new regulation, if upheld, may effectively remove Fannie Mae as a defendant in the District of Columbia class action lawsuit, it will not by itself eliminate Fannie Mae's advances and indemnification obligations to former directors and officers. For example, the lawsuit could proceed against the individuals named as defendants even without Fannie Mae. Such is the case with the recent SEC lawsuits against six former executives of Fannie Mae and Freddie Mac, but not the Enterprises themselves. The new regulation does not address the Enterprises' obligations to indemnify the former executives.

Using Cost Control Measures

In the absence of a definitive approach that cuts off advances of legal expenses or ends ongoing litigation, Fannie Mae and Freddie Mac have taken steps to administer the payment of advances and otherwise manage the costs generated by lawsuits against their indemnification-eligible directors and officers. Although these programs have produced cost savings, FHFA has not independently evaluated them.

Fannie Mae's Program

Fannie Mae has implemented a set of billing guidelines by which the law firms representing it and its current and former employees have agreed to abide. The guidelines provide, among other things, that:

- The billing rate for each biller is assessed by the biller's experience level, tied to a particular geographic area;
- The minimum unit of billable time is one tenth of an hour (six minutes);
- Distinct tasks must be listed separately and timed individually. Block billing, in which tasks are aggregated, is not permitted;

[35] *Ohio Public Employees Retirement System* v. *Federal Housing Finance Agency*, 1:11-cv-01543-RJL (D.D.C.).

- The level of skill required to perform a task is determined by Fannie Mae's auditing firm;

- Document review must be billed in one of three ways:

    - Level 1 review: general relevance and sorting/organization;

    - Level 2 review: issue-spotting, degree of relevance, and privilege;

    - Level 3 review: targeted review of documents for use in deposition preparation,[36] production, motions, and for other purposes;

- Generally, Fannie Mae will pay for only one attorney at a deposition, status conference, or other hearing;[37]

- Fees for administrative tasks, such as technical and secretarial support, or tasks that employ, supervise, and evaluate the legal professionals of the firm or calculate or resolve billing issues, are disallowed; and

- Paralegals are expected to perform tasks commensurate with their skill level, thereby eliminating the need for attorneys to perform the same tasks.

Fannie Mae has retained an outside auditing firm to review advances that it makes to cover its directors' and officers' legal fees (*i.e.*, adherence to its legal fee guidelines). Fannie Mae provided FHFA-OIG with a report that states that, during the period from March 2007 to March 2011, Fannie Mae was billed $72.7 million by the law firms representing Raines, Howard, and Spencer. Fannie Mae's auditing firm reviewed these bills and recommended reductions in the amount of $12.1 million for an overall savings of 16.6% of the amount billed.[38]

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[36] A deposition is a judicial proceeding conducted outside the presence of the presiding judge during which counsel for a litigant may question a witness under oath in order to obtain information relevant to the litigation. *See* Fed. R. Civ. P. Rules 30 and 31.

[37] If more than one attorney attends and expects to be paid, then the law firm must justify its request for an exception to the policy. In this regard, Fannie Mae necessarily relies upon the judgment of its lawyers to approve a departure from its guidelines.

[38] The auditing firm has performed this service for a percentage charge on the gross amount of the audited bills. Fannie Mae's General Counsel advised that the auditing firm reviews each invoice line by line, flags questionable charges, and asks the submitting law firm for clarification of the highlighted items. In some cases the law firms abandon the questioned charges that the auditing firm had flagged. In other cases the law firms are successful in justifying the charges to the auditing firm. Sometimes the law firms are unsuccessful, and the auditing firm recommends that their charges be disallowed or paid at lower rates. In all cases, Fannie Mae makes the final decision. In a small percentage of cases, Fannie Mae either reinstates a charge that the auditing firm recommends should be disallowed or reduced or – just the opposite – declines to pay the full amount that the auditing firm approved. For a discussion of cost control guidance for a corporation faced with substantial legal fees, *see ACC*

Fannie Mae's cost control measures also include its active participation in the defense of the District of Columbia class action. Joint defense meetings are held at which tasks are allocated among the lawyers to reduce inefficiencies.[39] Fannie Mae also told FHFA-OIG that for the past two years it has largely frozen the billing rates for the law firms representing its indemnified parties.

Freddie Mac's Program

Like Fannie Mae, Freddie Mac has implemented a set of billing guidelines for law firms representing its indemnified current and former employees. Under its guidelines:

- Payment is made for attorney and paralegal services and not for administrative services, such as secretaries, word processors, librarians, technical, or administrative personnel;
- The billing rate for an attorney or paralegal is determined with reference to the attorney's or paralegal's experience level and tied to a particular geographic area;
- The minimum unit of billable time is one tenth of an hour;
- Distinct tasks must be listed separately and timed individually. Block billing is not permitted;
- The staffing of a project is left to the discretion of the firm, but Freddie Mac requires each project to be handled in the most effective and efficient manner; and
- Generally, Freddie Mac will pay for only one attorney at a deposition.

Freddie Mac has required indemnification firms to reduce their hourly rates and has retained a third party vendor to review bills submitted by such counsel, effective January 1, 2012. Freddie Mac's cost control measures also include joint defense agreements between Freddie Mac's outside attorneys and law firms retained to represent its current and former directors and officers. For example, in at least one of the recent class action lawsuits against Freddie Mac and its officers and directors, Freddie Mac obtained an agreement with counsel for the indemnified parties that Freddie Mac would take the lead in drafting a motion to dismiss to avoid duplication

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Value-Based Fee Primer, available at www.acc.com/advocacy/valuechallenge/toolkit/upload/acc-value-based-fee-primer.pdf.

[39] Because Fannie Mae's obligation to advance legal expenses of its current and former directors and officers is owed to each such director and officer, not to a claim or class of claims, each director and officer has been provided with separate legal counsel, presumably in order to avoid conflicts of interest. The attorneys representing Messrs. Raines and Howard share information and coordinate activities and strategies.

of effort.[40] Freddie Mac officials acknowledged, however, that beyond this early stage of the proceedings, more individualized defense work is necessary and that, as cases proceed, the Enterprise will face increasing legal fees for the indemnified defendants.

Freddie Mac's internal legal staff, prior to 2012, screened the bills submitted by law firms representing its indemnified parties. Freddie Mac told FHFA-OIG that, since the Enterprise was placed in conservatorship in 2008, its in-house screening reduced advances paid on behalf of directors and officers by approximately 3.1%.

FHFA Oversight

FHFA can enhance its oversight to provide reasonable assurance that the legal fees advanced for officers and directors are reasonable and supported. According to both the Government Accountability Office (GAO) and the Office of Management and Budget (OMB), the establishment of internal controls is essential to providing "reasonable assurance" that an agency's objectives are met, including "the safeguarding of assets."[41]

Much guidance exists in this area for FHFA to consider. For example, DOJ has issued billing guidelines for the Office of the United States Trustee that can be compared with the guidelines utilized by Fannie Mae and Freddie Mac.[42]

On September 7, 2011, FHFA responded to a Congressional inquiry concerning its oversight of Enterprise legal fees by noting that it maintains "weekly" contact with the Enterprises' legal

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[40] A motion to dismiss is a request made to a judge in a civil suit, typically prior to the commencement of trial and pre-trial discovery, for a ruling on the merits of a legal claim. It is granted only when a judge concludes the civil complaint fails to state a claim upon which relief can be granted. *See* Fed. R. Civ. P. 12(b)(6).

[41] *See* GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD–00.21.3.1 (Nov. 1999); and OMB, *Management's Responsibility for Internal Control*, OMB Circular No. A-123 Revised (Dec. 2004). For recent Inspectors General reports addressing controls on legal fees paid by government agencies, *see* Special Inspector General for the Troubled Asset Relief Program, *Treasury's Process for Contracting for Professional Services under TARP* (Apr. 14, 2011), available at http://www.sigtarp.gov/reports/audit/2011/Treasury's%20Process%20for%20Contracting%20for%20Professional%20Services%20under%20TARP%2004_14_11.pdf; and SEC Office of Inspector General, *SEC's Oversight of the Securities Investor Protection Corporation's Activities* (Mar. 30, 2011), available at www.sec-oig.gov/Reports/AuditsInspections/2011/495.pdf.

[42] The United States Trustee Program is a component of DOJ responsible for overseeing the administration of bankruptcy cases and private trustees under 28 U.S.C. § 586 and 11 U.S.C. § 101 *et seq*. The United States Trustee guidelines provide, in part, that: (1) time entries be kept "contemporaneously with the services rendered in time periods of tenths of an hour;" (2) services "be noted in detail and not combined or 'lumped' together, with each service showing a separate time entry;" (3) tasks "performed in a project which total a *de minimis* amount of time can be combined or lumped together if they do not exceed .5 hours on a daily aggregate;" (4) "[t]ime entries for telephone calls, letters, and other communications … give sufficient detail to identify the parties to and the nature of the communication;" and (5) "[i]f more than one professional from the applicant firm attends a hearing or conference, the applicant explain the need for multiple attendees."

departments to remind them of the need to contain legal costs. As a result, according to the Agency, the Enterprises:

> have taken steps including working to maintain legal fees at prior year levels, avoiding duplicative legal representation and assuring that reviews occur of legal expenses as permitted under state laws that have resulted in ongoing pressure on all outside counsel to restrain costs. Such reviews are permissible to determine whether fees are reasonable by reference to fees customarily charged, quality of legal representation, amount involved in litigation, time and labor required and novelty and complexity of questions presented.[43]

However, the Agency indicated that it has not provided "new guidelines at this time" because "the issue of reasonable legal fees remains a function of what courts consider to be appropriate and … what actions have been found to be acceptable to the courts to address reasonableness, such as review of fees by a third party."[44] Nonetheless, the Agency agreed that it "will look at guidance on appropriate actions that would conform to judicial standards and seek to restrain legal expenses."[45] FHFA-OIG believes that the recommendations contained in this report provide the Agency with models that should be considered to achieve these ends consistent with the nature of its authorities and the business form of the Enterprises.

[43] Letter to Chairman Neugebauer from FHFA's General Counsel, September 7, 2011.

[44] *Id.*

[45] *Id.*

FINDINGS

1. FHFA Confronts a Challenging Balance of Interests

In its role as conservator of Fannie Mae and Freddie Mac, FHFA has an interest in preserving and conserving the Enterprises' assets by avoiding potential financial and reputational losses. To that end, it has an ongoing interest in aggressively defending ongoing lawsuits against Fannie Mae and Freddie Mac, especially lawsuits seeking hundreds of millions or billions of dollars in damages.

On the other hand, FHFA has a potentially competing interest in controlling significant ongoing Enterprise costs. Without question, the tens of millions of dollars advanced to defend the three former Fannie Mae executives are very significant expenditures that demand intensive scrutiny by FHFA and Fannie Mae. Given the significant amounts of money involved – over $99 million in legal expenses for three former Fannie Mae officers alone – and the issue's high visibility, FHFA must continue to scrutinize intensively the issue in order to limit costs.

2. FHFA Has Limited Tools Available to Curtail Current Litigation Expenses

A variety of tools are available to FHFA to curtail legal expenses. However, it appears that no one tool is ideal, and using each tool has potential risks and costs.

- **Rejecting Contracts.** As conservator, FHFA could invoke HERA to disaffirm indemnification agreements it regards as burdensome to the Enterprises. But rejection has legal risks, particularly where it can be shown that FHFA did not act within a reasonable period of time after being appointed conservator. Moreover, under HERA the repudiated party has the right to sue to recover compensatory damages.

- **Directors' & Officers' Insurance.** FHFA could work with the Enterprises to seek more expansive forms of D&O insurance than they currently carry. But such insurance, even if available, may carry sufficiently high premiums to make it not cost effective. Further, it would not likely cover pre-existing legal claims.

- **New Conservatorship Regulation.** FHFA could continue to assert the argument that, because the Enterprises are in conservatorship and they are unlikely to fully satisfy their debts to Treasury, the new regulation empowers the conservator to deny payment of securities litigation judgments against the Enterprises; thus, the pending class action lawsuits are moot and should be dismissed. However, as discussed above, the regulation is subject to legal challenge.

- **Capping or Requiring Pre-Approval of Legal Expenses.** FHFA could exercise its authority as conservator and impose caps on or require pre-approval of Enterprise legal expenditures. But such measures could be subject to challenge.

- **Seeking Admissions of Liability.** Were FHFA and other government agencies to secure admissions of liability as conditions for settling civil enforcement proceedings, such admissions could be used as a basis for denying indemnification under existing indemnification agreements. But such admissions are yet to become common practice for FHFA or other agencies.

- **Non-Adjudicated Denials of Indemnification.** FHFA could consider including provisions in future indemnification agreements that allow FHFA to deny administratively indemnification based on determinations made short of a final adjudication by a court.

3. FHFA Can Do More to Oversee Ongoing Enterprise Legal Expenses

Beyond the foregoing tools, FHFA is in a position to ensure that the Enterprises are employing uniform standards and best practices to control future legal expenses. However, FHFA relies on Fannie Mae and Freddie Mac to administer their indemnification obligations. The Agency has never independently validated the Enterprises' processes for determining the reasonableness or validity of the legal services provided on behalf of their executives or the bills presented for such services.

To their credit, Fannie Mae and Freddie Mac have independently developed programs to administer their indemnification agreements. Freddie Mac claims to have downwardly "adjusted" its indemnified legal fees by 3.1%, and Fannie Mae's legal billing contractor has recommended reductions of approximately 16.6% of the amounts billed. The key feature of each Enterprise's program is its billing guidelines by which the Enterprise determines what is reasonable. Essentially, bills that meet the requirements of the guidelines and are appropriately justified are paid.[46]

The distinctions between the Enterprises' guidelines are most notable in two of their features: document review and representation at depositions. These features are crucial to controlling effectively the costs occasioned by civil litigation. Most of the cost of civil litigation is generated by the parties' efforts to gather evidence from each other in the pretrial arena. Evidence gathering is done primarily by the parties demanding documents from each other,

[46] Both guidelines contain similar baseline provisions and prohibitions. For example, both require law firms to bill in six minute increments. Both guidelines also prohibit law firms from "block" billing and billing for "administrative" services and "startup" legal time and for first or business class travel.

reviewing them, and then using the documents to conduct depositions of each other and third party witnesses. Fannie Mae's guidelines contain detailed controls on the type and amount of services for which directors' and officers' lawyers may bill in connection with their reviews of documents and attendance at depositions. Freddie Mac's guidelines, on the other hand, are less detailed, allowing counsel significantly wider latitude to bill for time and services in connection with document review and depositions. For example:

- The Fannie Mae system prescribes three different tiers for billing for document review, depending on the nature of review, with the suggestion that the most basic review (general relevancy/sorting) be conducted at the paralegal level, while more senior counsel be utilized for things like issue spotting and deposition preparation. Freddie Mac's system, by contrast, merely states that staffing is to be handled at minimal levels and that document review is to be conducted according to "applicable rules of procedure and/or customary and usual practice …."

- Fannie Mae presumes that only one attorney will attend a deposition. In fact the Fannie Mae guidelines warn that if a second attorney is billed, the firm will likely be questioned on the matter before payment is approved. The Fannie Mae guidelines devote two full paragraphs to the issue. In contrast, the Freddie Mac guidelines address the issue in one sentence, combining "depositions," with "hearings," "arguments," "meetings," and "trials," and stating (without further guidance) that "there may be a need [for] a 'second chair.'"

- Both Fannie Mae and Freddie Mac specify that firms may not bill for activities performed by administrative staff. But only Fannie Mae specifies that paralegals may not be utilized for tasks typically handled by administrative staff.

Considering only the likely billing differences in document review (where Fannie Mae's tiered approach leaves less discretion to the biller) and depositions (where Freddie Mac is more inclined to accept the necessity of a second chair), the anticipated cost savings realized by the Enterprises could be significant.

FHFA-OIG notes that FHFA is now in a position to compare and contrast the Enterprises' respective litigation management programs, to come to a conclusion about their relative effectiveness, and to determine where changes, including uniformity, would be productive.

CONCLUSION

Fannie Mae and Freddie Mac have made and continue to make advances of tens of millions of dollars to pay legal fees to defend former directors and officers in legal proceedings. The magnitude of these advances demand intensive and on-going scrutiny by FHFA and the Enterprises. As part of that scrutiny, FHFA needs to regularly review the tools it has available to ensure that it is making the best decisions.

In addition, since it became their conservator, FHFA has overseen the Enterprises' administration of their advances of fees and administration of bylaws and indemnification agreements in a manner that could be improved. Fannie Mae and Freddie Mac have independently developed similar, but distinct programs under which to administer their indemnification obligations. FHFA should consider steps to ensure that the Enterprises are employing uniform standards and best practices.

RECOMMENDATIONS

FHFA-OIG recommends that FHFA:

1. Work to limit legal expenses to the extent possible and reasonable by:

    a. Narrowing the reach of future indemnification agreements;

    b. Considering making greater use of D&O insurance; and

    c. Continuing to invoke the new FHFA regulation establishing the primacy of claims in a receivership, in an effort to curtail costly litigation.

2. Continue to control costs of legal expenses by:

    a. Identifying the best elements of Fannie Mae's and Freddie Mac's programs for administering advances and indemnification of legal expenses and developing standardized legal billing practices for both Enterprises; and

    b. Further developing FHFA oversight procedures.

SCOPE AND METHODOLOGY

Given the level of controversy associated with Fannie Mae's advancing fees to cover the legal expenses for its three former officers in the District of Columbia class action, FHFA-OIG initiated this evaluation to: (1) determine the process by which FHFA's Office of General Counsel decided, at the time of conservatorship, to recommend that the Agency continue to advance legal fees for the defense of the former officers; (2) identify the means by which the Enterprise has controlled such expenses; and (3) assess FHFA's oversight role in ensuring that such expenses are reasonable and justified. For comparison purposes, FHFA-OIG also sought and obtained information from Freddie Mac.

To address these issues, FHFA-OIG interviewed the General Counsels of Fannie Mae and Freddie Mac and members of their staffs. FHFA-OIG also interviewed FHFA's General Counsel. In addition, FHFA-OIG examined: (1) memoranda supplied by FHFA's Office of General Counsel; (2) Fannie Mae's and Freddie Mac's billing guidelines for law firms representing indemnified parties and other billing related documents, figures, and charts; (3) DOJ's United States Trustee Program's guidelines for similar legal services in overseeing bankruptcies; (4) indemnification agreements pertaining to Fannie Mae's three former officers; and (5) the pleadings, correspondence, and rulings in the securities class action lawsuit filed in the District of Columbia.

This evaluation was conducted under the authority of the Inspector General Act and in accordance with the *Quality Standards for Inspection and Evaluation* (Jan. 2011), which was promulgated by the Council of the Inspectors General on Integrity and Efficiency. These standards require FHFA-OIG to plan and perform an evaluation that obtains evidence sufficient to provide reasonable bases to support the findings and recommendations made herein. FHFA-OIG trusts that the findings and recommendations discussed in this report meet these standards.

The performance period for this evaluation was from February 2011 to November 2011.

FHFA-OIG provided FHFA an opportunity to respond to a draft report of this evaluation. FHFA's comments on FHFA-OIG's draft report are reprinted in their entirety as an appendix.

FHFA-OIG appreciates the efforts of FHFA, Fannie Mae, and Freddie Mac management and staff in providing information and access to necessary documents to accomplish this evaluation.

APPENDIX

FHFA Comments on Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: George Grob, Deputy Inspector General for Evaluations

FROM: Alfred Pollard, General Counsel

SUBJECT: Inspector General Evaluation Report on the Evaluation of FHFA's Management of Legal Fees for Indemnified Executives

DATE: February 13, 2012

This memorandum transmits the Federal Housing Finance Agency's (FHFA) response to the recommendations from the evaluation referenced above. The evaluation reviewed issues surrounding management of legal expenses related to officer and directors that are eligible for advancement of legal fees and indemnification.

The Federal Housing Finance Agency Office of General Counsel concurs with the FHFA-Office of Inspector General recommendations regarding initiatives to address legal expenses related to officers and director that are eligible for indemnification under applicable laws and under agreements pursuant to such laws.

FHFA and the Office of General Counsel, in particular, has and will continue its efforts to assure that legal expenses are undertaken in line with the particular situation of Fannie Mae and Freddie Mac operating in conservatorships. This will include greater standardized practices for the Enterprises and enhancing oversight. FHFA Office of General Counsel would add to the evaluation of the Office of Inspector General a notation that many expenses that require advancement of legal fees and potential indemnification are under the control of the judiciary in the conduct of individual cases or government agencies conducting investigations insofar as there may be limitations or expansion of the scope of such cases or investigations.

FHFA Office of General Counsel would note that in the course of this evaluation several constructive conversations occurred with the staff of FHFA Office of Inspector General personnel. These brought ideas, based on the professional background of OIG personnel, to the fore and enhanced FHFA Office of General Counsel considerations of this important issue.

FHFA's response to the recommendations follows:

Recommendation 1: "Work to limit legal expenses to the extent possible and reasonable by: a. Narrowing the reach of indemnification agreements; b. Considering making greater use of D&O insurance; and, c. Continuing to invoke the new FHFA regulation establishing the primacy of claims in a receivership, in an effort to curtail costly litigation."

Management Response: FHFA agrees with the recommendation and will undertake additional steps to address future indemnification agreements, in line with applicable law, to inquire as to greater use of D&O insurance with due attention to costs and benefits and continuing to advance its argument that conservatorship and receivership priorities (created in part by the large draws on the U.S. Treasury) make litigation a fruitless enterprise for plaintiffs. These actions can begin immediately and FHFA Office of General Counsel will document actions taken and provide a summary report to FHFA-OIG by June 30, 2012.

Recommendation 2: "Continue to control costs of legal expenses by: a. Identifying the best elements of Fannie Mae's and Freddie Mac's programs for administering indemnification of legal expenses, and developing standardized legal billing practices for both Enterprises; and b. Further developing FHFA oversight procedures."

Management Response: FHFA agrees with the recommendation to continue its efforts at cost controls and will work expeditiously to seek greater standardization in the administration of such legal costs by the Enterprises. At the same time, FHFA Office of General Counsel will increase is scrutiny of legal costs and will document oversight mechanisms and provide a summary report to FHFA-OIG by June 30, 2012.

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