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Mortgage Giants Leave Legal Bills to the Taxpayers

By GRETCHEN MORGENSON

Since the government took over [Fannie Mae](#) and [Freddie Mac](#), taxpayers have spent more than \$160 million defending the mortgage finance companies and their former top executives in civil lawsuits accusing them of fraud. The cost was a closely guarded secret until last week, when the companies and their regulator produced an accounting at the request of Congress.

The bulk of those expenditures — \$132 million — went to defend Fannie Mae and its officials in various securities suits and government investigations into accounting irregularities that occurred years before the subprime lending crisis erupted. The legal payments show no sign of abating.

Documents reviewed by The New York Times indicate that taxpayers have paid \$24.2 million to law firms defending three of Fannie's former top executives: [Franklin D. Raines](#), its former chief executive; Timothy Howard, its former chief financial officer; and Leanne Spencer, the former controller.

Late last year, Randy Neugebauer, Republican of Texas and now chairman of the oversight subcommittee of the House Financial Services Committee, requested the figures from the Federal Housing Finance Agency. It is the regulator charged with overseeing the mortgage finance companies and acts as their conservator, trying to preserve the company's assets on behalf of taxpayers.

“One of the things I feel very strongly about is we need to be doing everything we can to minimize any further exposure to the taxpayers associated with these companies,” Mr. Neugebauer said in an interview last week.

It is typical for corporations to cover such fees unless an executive is found to be at fault. In this case, if the former executives are found liable, the government can try to recoup the costs, but that could prove challenging.

Since Fannie Mae and Freddie Mac were taken over by the government in September 2008, their losses stemming from bad loans have mounted, totaling about \$150 billion in a recent reckoning. Because the financial regulatory overhaul passed last summer did not address how to resolve Fannie and Freddie, Congress is expected to take up that complex matter this year.

In the coming weeks, the [Treasury Department](#) is expected to publish a report outlining the administration’s recommendations regarding the future of the companies.

Well before the credit crisis compelled the government to rescue Fannie and Freddie, accounting irregularities had engulfed both companies. Shareholders of Fannie and Freddie sued to recover stock losses incurred after the improprieties came to light.

Freddie’s problems arose in 2003 when it disclosed that it had understated its income from 2000 to 2002; the company revised its results by an additional \$5 billion. In 2004, Fannie was found to have overstated its results for the preceding six years; conceding that its accounting was improper, it reduced its past earnings by \$6.3 billion.

Mr. Raines retired in December 2004 and Mr. Howard resigned at the same time. Ms. Spencer left her position as controller in early 2005. The following year, the [Office of Federal Housing Enterprise Oversight](#), then the company’s regulator, published an [in-depth report](#) on the company’s accounting practices, accusing Fannie’s top executives of taking actions to manipulate profits and generate \$115 million in improper bonuses.

The **office sued** Mr. Raines, Mr. Howard and Ms. Spencer in 2006, seeking \$100 million in fines and \$115 million in restitution. In 2008, the three former executives settled with the regulator, returning \$31.4 million in compensation. Without admitting or denying the regulator's allegations, Mr. Raines paid \$24.7 million and Mr. Howard paid \$6.4 million; Ms. Spencer returned \$275,000.

Fannie Mae also **settled a fraud suit** brought by the **Securities and Exchange Commission** without admitting or denying the allegations; the company paid \$400 million in penalties.

Lawyers for the three former Fannie executives did not respond to requests for comment. A company spokeswoman did not return a phone call or e-mail seeking comment.

In addition to the \$160 million in taxpayer money, Fannie and Freddie themselves spent millions of dollars to defend former executives and directors before the government takeover. Freddie Mac had spent a total of \$27.8 million. The expenses are significantly larger at Fannie Mae.

Legal costs incurred by Mr. Raines, Mr. Howard and Ms. Spencer in the roughly four and a half years prior to the government takeover totaled almost \$63 million. The total incurred before the bailout by other high-level executives and board members was around \$12 million, while an additional \$18 million covered fees for lawyers for Fannie Mae officials below the level of executive vice president. Many of these individuals are provided lawyers because they are witnesses in the matters.

Employment contracts and company by-laws usually protect, or indemnify, executives and directors against liabilities, including legal fees associated with defending against such suits.

After the government moved to back Fannie and Freddie, the Federal Housing Finance Agency agreed to continue paying to defend the executives, with the taxpayers covering the costs.

But indemnification does not apply across the board. As is the case with many companies, Fannie Mae's by-laws detail actions that bar indemnification for officers and directors. They include a person's breach of the duty of loyalty to the company or its stockholders, actions taken that are not in good faith

or intentional misconduct.

Richard S. Carnell, an associate professor at [Fordham University](#) Law School who was an assistant secretary of the Treasury for financial institutions during the 1990s, questions why Mr. Raines, Mr. Howard and others, given their conduct detailed in the Housing Enterprise Oversight report, are being held harmless by the government and receiving payment of legal bills as a result.

“Their duty of loyalty required them to put shareholders’ interests ahead of their own personal interests,” Mr. Carnell said. “Had they cared about the shareholders, they would not have staked Fannie’s reputation on dubious accounting. They defied their duty of loyalty and served themselves. At a moral level, they don’t deserve indemnification, much less payment of such princely sums.”

Asked why it has not cut off funding for these mounting legal bills, Edward J. DeMarco, the acting director of the Federal Housing Finance Agency, said: “I understand the frustration regarding the advancement of certain legal fees associated with ongoing litigation involving Fannie Mae and certain former employees. It is my responsibility to follow applicable federal and state law. Consequently, on the advice of counsel, I have concluded that the advancement of such fees is in the best interest of the conservatorship.”

If the former executives are found liable, they would be obligated to repay the government. But lawyers familiar with such disputes said it would be difficult to get individuals to repay sums as large as these. Lawyers for Mr. Raines, for example, have received almost \$38 million so far, while Ms. Spencer’s bills exceed \$31 million.

These individuals could bring further litigation to avoid repaying this money, legal specialists said.

Although the figures are not broken down by case, the largest costs are being generated by a lawsuit centering on accounting improprieties that erupted at Fannie Mae in 2004. This suit, a shareholder class action brought by the Ohio Public Employees Retirement System and the State Teachers Retirement System of Ohio, is being heard in federal court in Washington. Although it has been going

on for six years, the judge has not yet set a trial date. Depositions are still being taken in the case, suggesting that it has much further to go with many more fees to be paid.



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