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Fannie, Freddie Shareholders Remain in Limbo

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WASHINGTON (TheStreet) -- Holders of common stock of **Fannie Mae**(FNMA) and **Freddie Mac**(FMCC) are in an unenviable position, but even though the government hasn't given them any signs of support, it hasn't explicitly said they'll be wiped out, either.

Treasury Secretary Timothy Geithner discussed his housing-finance proposal at the Brookings Institution in Washington, D.C., on Friday, but didn't mention how shareholders will be treated.

Those investors have been holding on for more than two years, hoping that conventional wisdom is wrong. In the face of multibillion-dollar deficits in Fannie and Freddie's net worth each quarter -- and $150 billion in debt to taxpayers -- common shareholders are still hoping for signs that the government will take steps to bolster their position, rather than send them to the stock market doghouse.

The release of the Obama administration's white paper on housing-finance reform on Friday essentially asked them to hold on a little longer for a clear signal.

The U.S Treasury Department didn't address the question of how common shareholders should be treated, though it did criticize the "private shareholder structure," which "encouraged management to take on excessive risk" and, ultimately "caused them to fail." It also proposed "an orderly and deliberate wind down" of Fannie and Freddie while a new system is formulated and put into place.

Beyond that, shareholders have been getting mixed signals.

The Federal Housing Finance Agency delisted the stocks from the New York Stock Exchange last year but kept them trading on the pink sheets. On Wednesday, a Freddie Mac director said publicly that the company has no fiduciary duty to shareholders. But the companies appear have some modicum of political capital -- however minor -- with former presidential candidate Ralph Nader writing a testy op-ed in the *Wall Street Journal* that shareholders ought to be protected.

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Legal experts say that the government already has a wide array of options on the table to deal with Fannie Mae and Freddie Mac. Those options span the gamut from fully liquidating the firms -- thereby leaving shareholders with little or no recourse -- all the way to a "re-IPO," which would convert Treasury's preferred stakes into billions of new common shares that could be offered to private investors over a period of time, a la **American International Group**(AIG) or **Citigroup**(C).

"Legally speaking, the government can do whatever it wants as far as shareholders are concerned here," says Kevin Petrasic, a partner at the law firm Paul Hastings who specializes in banking and regulatory compliance from its Washington, D.C., office.

What the government *will* do is a bit harder to say.

For one thing, unlike AIG or Citi, Fannie and Freddie aren't worth much in the market's eye. Neither stock has been able to keep itself at more than $1 since the two firms were delisted last year. Private investors hold 1.8 billion shares of the two firms, with a combined market cap of just over $1 billion. Fannie and Freddie owe the government 150 times that much, and are predicted to owe a lot more by the time all is said and done.

Moving the two firms back onto the New York Stock Exchange to offer billions of shares to the market -- as the Treasury would have to do to exit its huge preferred stakes -- probably wouldn't do much to help taxpayers recoup their investment.

"The government does have a lot of authority with Fannie and Freddie, but this is a unique thing," says Brad Mahanay, a partner at Dallas-based Wick Phillips Gould Martin, who specializes in corporate finance law. "There are too many variables to predict what might happen, and it would take a lot of work to get to a point where they could list again on the NYSE."

Additionally, the Obama administration doesn't face the same pressures to portray the Fannie-Freddie bailout as a profitable "investment" as it did with the bailouts of big Wall Street firms. The moneys are being disbursed to assist homeowners and stabilize the housing market, and taxpayers don't align Fannie and Freddie with Wall Street the way they do, say, **Goldman Sachs**(GS).

"Fannie and Freddie are unique in enough ways to argue that they, in fact, should be treated differently," says David Reiss, a professor at Brooklyn Law School who specializes in real-estate finance. He thinks it's "very plausible that Fannie and Freddie shareholders will be wiped out -- as indeed they should be if they were treated like fully private entities."

For the time being, the Treasury Department plans to recover as much taxpayer money as it can through the wind-down process. Some moneys are being recouped by selling off the large legacy mortgage portfolios that the two firms have on their books. Regulators have also been pushing billions of dollars' worth of bad loans back onto big banks like **Bank of America**(BAC), **Wells Fargo**(WFC) and **JPMorgan Chase**(JPM), citing violations of representations and warranties that are part of purchase contracts.

Perhaps even more importantly, the Treasury said Friday that it plans to gradually introduce higher pricing for Fannie and Freddie guarantees. If done successfully, the guarantees could become a profit vehicle for the government during the transition period as the government reduces its exposure to the $10.6 trillion mortgage-backed securities market from a level of more than 90% of new originations today, to anywhere from 0% to 50%, depending on what plan Congress implements.

In its proposal on Friday, the Treasury Department says it could "ensure taxpayer losses are repaid through future assessments, such as higher fees."

Beyond the recoupment of bailout funds, there are also policy and political elements for Fannie and Freddie's common shareholders to consider.

While the Treasury's white paper was an important, long-awaited first step, the devil will be in the details of what lawmakers decide. The House of Representatives just started examining the topic of housing finance this week, and Democrats and Republicans remain far from a consensus on how to proceed.

It's hard to tell when the full Congress will get beyond the political brawls that will inevitably ensue and meld together a comprehensive housing-finance plan. That plan will take additional years to implement by regulators. Treasury Secretary Timothy Geithner said Friday that he expects the entire reform process to take five to seven years.

"There's politics and there's policy and then there's the law," says Petrasic. "I think it's going to be the intersection of those three areas that really dictate the course of events and how common and preferred shareholders really will fare."

For the time being, the Obama administration seems to be keeping all its options on the table.

Fannie Mae and Freddie Mac may trade on the pink sheets with a paltry market capitalization and a ticker infiltrated by speculators -- but, they still trade. Additionally, some smart-money investors have been pouring capital into their preferred stock, believing the government will cover private investors, even though former Treasury Secretary Henry Paulson explicitly said it would be wiped out when placing the two firms into conservatorship.

George W. Dent, a corporate lawyer by training who directs the Center for Business Law and Regulation at Case Western Reserve University, says that the usual process of "wiping out" shareholders doesn't take place until a company outlines a formal liquidation plan. In that process, a bankruptcy judge determines that there's no value left for common shareholders because they stand last in line in the capital structure, behind bondholders and preferred shareholders.

"The government can't just take property away any more than they can take your house away without compensation," says Dent. "But, if the company's insolvent, then the shareholders don't have any property."

It will probably take a very long time before Fannie Mae or Freddie Mac are solvent again, much less profitable enough to repay the government. Moody's analyst Brian Harris points out that, even in 2013, by which time the housing market should be on solid footing, the two firms will owe the government between $21.8 billion and $33.6 billion in dividends each year - far more than they've ever earned.

It may take quite a while for shareholders to get a more definitive answer on where they stand, but Dent thinks that's not necessarily such a bad thing.

"They might as well wait," says Dent. "Right now, they'd get nothing and it can't be any worse than that."

Additionally, the longer the reform process takes, the more time it will give the economy to heal. Once the housing market stabilizes, with their help, the two firms could seem more like heroes than villains. Throw in political uncertainty over who will be voted into the White House or Congress by the time reforms are implemented, and common shareholders' survival odds look even better.

Petrasic, the Paul Hastings partner, agrees that the likelihood of significant shareholder rewards is close to nil right now, given the two firms' basic economic fundamentals. But he says it would be "a little bit myopic" for the government to completely ignore the market impact of wiping out stockholders who believed that Fannie and Freddie were supported by the government and were told by government officials that the firms were in good condition, even days before they were placed into conservatorship.

Petrasic doesn't rule out the possibility that Congress might throw them a bone, eventually. But for now, "It's pretty much in limbo. The issues are unfortunately pretty black and white as far as the shareholders go, but the solution isn't so black and white."

-- Written by Lauren Tara LaCapra in New York.

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