

**UNITED STATES OF AMERICA
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT**

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In the Matter of:)	
)	Notice No. 2006-1
FRANKLIN D. RAINES)	
)	
J. TIMOTHY HOWARD)	
)	
LEANNE G. SPENCER)	
_____)	

**AFFIDAVIT OF DAVID S. KRAKOFF IN SUPPORT OF DISQUALIFYING
DIRECTOR LOCKHART FROM ADJUDICATING THE NOTICE OF CHARGES**

I, David S. Krakoff, hereby state and affirm as follows:

1. I am a partner in the law firm of Mayer, Brown, Rowe & Maw, and I represent Leanne G. Spencer in the above-captioned OFHEO proceeding. Pursuant to 5 U.S.C. § 556(b), I submit this affirmation, under penalty of perjury, in support of Leanne G. Spencer's motion to disqualify Director Lockhart from adjudicating the Notice of Charges, which was made by way of letter submitted to Director Lockhart on January 12, 2007.

2. OFHEO's enforcement procedures appoint Director Lockhart, as Director of the agency, to be the final arbiter of the charges that OFHEO filed against Ms. Spencer, Franklin D. Raines, and J. Timothy Howard. 12 U.S.C. § 4633(b) ("the Director shall render the decision"); *see also* 12 C.F.R. § 1780.5(b)(7) (stating that "only the Director shall have the power to ... make a final determination of the merits of the proceeding").

3. It is clear from Director Lockhart's own statements and those of his predecessors, as well as from the reports issued by OFHEO on September 17, 2004, and May 23, 2006, that he and the agency have already decided that Ms. Spencer is liable for the claims brought in this matter. Accordingly, as long as Director Lockhart continues to serve as both prosecutor and

adjudicator, it will be impossible for Ms. Spencer to receive a fair resolution of the Notice of Charges.

3. Director Lockhart's statements are based on a one-sided investigation by OFHEO whose outcome was predetermined without affording the respondents any opportunity to be heard. The Inspector General of the Department of Housing and Urban Development even found evidence that the OFHEO examination was "altered and made to appear much more egregious and significant." A true and correct copy of the Report of the Office of the Inspector General, U.S. Dep't of Housing & Urban Dev't, Investigation No. SID-04-0034-1 (Oct. 5, 2004) (hereinafter "OIG Report") is attached hereto as Exhibit 1.

4. The Supreme Court of the United States has stated repeatedly, a "fair trial in a fair tribunal is a basic requirement of due process. This applies to administrative agencies which adjudicate as well as to courts." *Withrow v. Larkin*, 421 U.S. 35, 46 (1975) (citations and internal quotation marks omitted). An adjudicator who has formed an opinion regarding the merits of the case before it is tried cannot provide a fair trial. *See, e.g., Cinderella Career & Finishing Schs., Inc. v. FTC*, 425 F.2d 583 (D.C. Cir. 1970); *Texaco, Inc. v. FTC*, 336 F.2d 739 (D.C. Cir. 1964), *vacated and remanded on other grounds*, 381 U.S. 754 (1965). Accordingly, whenever "a disinterested observer may conclude that (the agency) has in some measure adjudged the facts as well as the law of a particular case in advance of hearing it," the agency is disqualified from participating in the case. *Cinderella*, 425 F.2d at 591 (citation and internal quotation marks omitted).

5. On July 17, 2003, OFHEO commenced a Special Examination of Fannie Mae, one of only two Government Sponsored Enterprises regulated by the Agency. Ms. Spencer fully cooperated with the Special Examination, providing testimony on three separate occasions.

6. On September 17, 2004, OFHEO issued a preliminary report on the findings of examination. A true and correct copy of that report, the Report of Findings to Date, Special Examination of Fannie Mae (Sept. 17, 2004), is attached hereto as Exhibit 2. The 198-page report concluded, inter alia, “that the accounting used by Fannie Mae for amortizing purchase premiums and discounts on securities and loans as well as amortizing other deferred charges is not in accordance with GAAP” (*id.* at ii); that “management intentionally developed accounting policies and selected and applied accounting methods to inappropriately reduce earnings volatility and to provide themselves with inordinate flexibility in determining the amount of income and expense recognized in any accounting period” (*id.*); and that “Fannie Mae implemented SFAS 133 in a manner that placed minimizing earnings volatility and maintaining simplicity of operations above compliance with GAAP” (*id.* at v).

7. OFHEO continued its examination, culminating in a final report on May 23, 2006. A true and correct copy of that report, the Report on the Special Examination of Fannie Mae (May 23, 2006), is attached hereto as Exhibit 3. The report accuses Fannie Mae and the three respondents of manipulating earnings “in order to generate unjustified levels of compensation for themselves and other executives” (*id.* at 4); engaging in “a wide variety of unsafe and unsound practices” (*id.*); and “failing to establish a sound internal control system” (*id.* at 9), through the violation of at least eight different accounting standards.

8. As Acting Director of OFHEO, Director Lockhart announced in a press release: “As the OFHEO report shows, the image of Fannie Mae as one of the lowest-risk and ‘best in class’ institutions was a façade. In fact, it was just the opposite. They promoted unconstrained growth while undermining proper internal controls by under investing in systems, risk management and staff. Our examination found an environment where the ends justified the

means. There was a systematic effort by senior management to manipulate accounting, reap financial rewards, and prevent the rest of the world from knowing about it.” A true and correct copy of that press release, *OFHEO, SEC Reach Settlement With Fannie Mae; Penalty Imposed* (May 23, 2006), is attached hereto as Exhibit 4.

9. In another press release issued the same day, Director Lockhart stated that “Fannie Mae’s executives were precisely managing earnings to the one-hundredth of a penny.” A true and correct copy of that press release, *OFHEO Report: Fannie Mae Façade* (May 23, 2006), is attached hereto as Exhibit 5. Their conduct, Director Lockhart alleged, “resulted in an estimated \$10.6 billion of losses, well over a billion dollars in expenses to fix the problems, and ill-gotten bonuses in the hundreds of millions of dollars.” *Id.*

10. On the same day the report issued, OFHEO entered into an agreement with Fannie Mae in which the entity agreed to pay \$400 million to OFHEO and the Securities and Exchange Commission to resolve the allegations. Director Lockhart commented: “The penalty and settlements represent a major step in correcting a dangerous course that had been followed by one of the largest financial institutions in the world. Unprincipled corporate behavior and inadequate controls will simply not be tolerated.” A true and correct copy of that press release, *OFHEO, SEC Reach Settlement With Fannie Mae; Penalty Imposed* (May 23, 2006), is attached hereto as Exhibit 5.

11. On December 18, 2006, OFHEO issued the Notice of Charges against Mr. Raines, Mr. Howard and Ms. Spencer, which includes 101 different claims and seeks significant penalties from the respondents. A true and correct copy of the Notice of Charges, OFHEO Notice No. 2006-1, is attached hereto as Exhibit 6.

12. OFHEO's Rules of Practice and Procedure permit Director Lockhart to hand-pick an administrative law judge or "any other person" to hear evidence and make a recommendation to him on liability, restitution, and penalties of the respondents. 12 C.F.R. §§ 1780.3(h), 1780.5. Even after appointing such person, the Director may, "at any time during the pendency of a proceeding, perform, direct the performance of, or waive performance of any act that could be done or ordered by the presiding officer." *Id.* § 1780.4. Moreover, the Director retains the exclusive power "to grant any motion to dismiss the proceeding or make a final determination of the merits of the proceeding." *Id.* § 1780.5(b)(7). It is our view that a fair assessment of the evidence will demonstrate that the respondents are not liable for any of the claims in the Notice of Charges. However, under OFHEO procedure, the Director is free to reject a recommendation of the presiding officer in favor of the respondents. *Id.* §§ 1780.53-.55. Based upon the Director's unqualified statements, it is clear that he would do just that.

13. Director Lockhart's statements to the press throughout the course of OFHEO's investigation of Fannie Mae and its former officers demonstrate unequivocally that he has already determined that Ms. Spencer, Mr. Raines, and Mr. Howard are liable for all claims against them. For example, even before OFHEO issued the Notice of Charges, Director Lockhart told the press that these individuals "grossly mismanaged" Fannie Mae, "underspent dramatically on systems, internal controls, risk management—all the basic building blocks of a good corporation," and went "beyond mismanagement to manipulating earnings." *See* David S. Hilzenrath, *Fannie Mae Final Tally: \$6.3 Billion Overstated*, Washington Post (Dec. 7, 2006), a true and correct copy of which is attached hereto as Exhibit 7.

14. Moreover, Director Lockhart testified before Congress that "[b]y encouraging rapid growth, unconstrained by proper internal controls, risk management and other systems,"

these individuals “did serious harm to Fannie Mae while enriching themselves through earnings manipulation.” *See* Statement of James B. Lockhart III on OFHEO’s Report on the Special Examination of Fannie Mae Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, U.S. House of Representatives (June 6, 2006), a true and correct copy of which is attached hereto as Exhibit 8. He told Congress that the actions of these former Fannie Mae executives “were flat-out wrong, or, to use the proper regulatory phrase, they were managing Fannie Mae in an ‘unsafe and unsound’ manner. Senior management manipulated accounting; reaped maximum, undeserved bonuses; and prevented the rest of the world from knowing about it. They co-opted their internal auditors and other managers. They stonewalled OFHEO.” *Id.*

15. Director Lockhart further stated that “[i]n 1998, management *should* have recognized significant losses from the amortization of premiums and the impairment of guaranty-fee buy-ups, but much of the actual loss was deferred so that management could meet bonus targets, as well as the expectations of analysts.” *Id.* (emphasis in original). Among other things, Director Lockhart concluded that “senior management did not make adequate investments in accounting systems and staffing,” which helped them “to hide improper actions that smoothed earnings; that they implemented FAS 115 and 133 in a manner that “did not comport with GAAP”; that they “went to extraordinary lengths to avoid recording GAAP required impairment losses”; and that they used “cookie-jar reserves, income shifting transactions and inappropriate debt repurchases.” *Id.*

16. In a speech he delivered to the American Enterprise Institute on September 13, 2006, Director Lockhart announced OFHEO’s intention to sue the respondents, declaring: “I think we need to send a very strong message. We sent a strong message with the \$400 million

fine against Fannie Mae, but I think we also need to send a message about the mismanagement and—as the SEC says it—fraud committed by the former management.” A true and correct copy of the transcript of that statement to the American Enterprise Institute (Sept. 13, 2006) is attached hereto as Exhibit 9. Indeed, it appears that the Director anticipated overstepping the bounds of OFHEO’s lawful authority in his zeal to prosecute these individuals. He declared that OFHEO “will try to use our powers to the utmost,” noting: “In some cases we may end up being sued by Fannie and Freddie if we try to use some powers that we think we could possibly have. But we’ll try to do the best we can because that’s our job.” *Id.*

17. In a press release accompanying the Notice of Charges filed against Ms. Spencer, Mr. Raines, and Mr. Howard, Director Lockhart did not mince words. On behalf of the agency, he characterized the charges not as allegations that he would fairly evaluate, but rather as facts he had already determined to be true. He stated: “The Notice of Charges details the harm to Fannie Mae resulting from the conduct of these individuals from 1998 to 2004. The 101 charges reveal how the individuals improperly manipulated the earnings to maximize their bonuses, while knowingly neglecting accounting systems and internal controls, misapplying over twenty accounting principles and misleading the regulator and the public. The Notice explains how they submitted six years of misleading and inaccurate accounting statements and inaccurate capital reports that enabled them to grow Fannie Mae in an unsafe and unsound manner. The misconduct cost the Enterprise and shareholders many billions of dollars and damaged the public trust.” A true and correct copy of that press release, *OFHEO Files Notice of Charges Against Former Fannie Mae Executives Franklin Raines, Timothy Howard and Leanne Spencer* (Dec. 18, 2006), is attached hereto as Exhibit 10.

18. Similarly, in a subsequent press conference, Director Lockhart declared that OFHEO “believed as an agency that these three individuals, separately and together, did serious harm to the company. There is a long list of charges that show they allowed this company to grow out of control.” See Eric Dash, *Fannie Mae Ex-Officers Sued By U.S.*, New York Times (Dec. 19, 2006), a true and correct copy of which is attached hereto as Exhibit 11. See also, e.g., David S. Hilzenrath, *Fannie Mae Ex-Officials Are Sued For Disputed Pay*, Washington Post (Dec. 19, 2006), a true and correct copy of which is attached hereto as Exhibit 12.

19. Director Lockhart told reporters that Mr. Raines, Mr. Howard, and Ms. Spencer “knowingly” neglected “accounting systems and internal controls, misapplying over 20 accounting principles and misleading the regulator and the public.” See James Tyson, *Fannie Mae Regulator Sues Raines, Former Executives*, Bloomberg.com (Dec. 18, 2006), a true and correct copy of which is attached hereto as Exhibit 13.

20. Director Lockhart further stated: “This activity was so unsafe and unsound that we have to take this action. We have no choice, really. We have to send a message to the management ..., both present and previous, that this kind of activity cannot be allowed.” See Damien Paletta, *OFHEO Files Notice of Charges vs. Ex-Fannie Executives*, Dow Jones Newswires (Dec. 18, 2006), a true and correct copy of which is attached hereto as Exhibit 14.

21. These comments illustrate precisely the sort of bias that compels Director Lockhart’s recusal from participation in this case. Federal law requires an adjudicator to recuse himself from any proceeding in which his impartiality might reasonably be questioned. Director Lockhart’s public condemnations of Ms. Spencer, Mr. Raines, and Mr. Howard, which have been widely reported in every national newspaper, would cause any reasonable observer to question his impartiality.

22. Indeed, the Washington Post has already noted that “after the evidence has been heard, it is the accuser who will render judgment.” *See* David S. Hilzenrath, *Players Oddly Aligned in New Fannie Mae Case*, Washington Post (Dec. 20, 2006), a true and correct copy of which is attached hereto as Exhibit 15. *See also id.* (noting that “[t]he playing field is inhospitable”). The New York Times has observed that OFHEO “seems intent on sending a message to Capitol Hill, where legislation is to be debated that would give the office greater authority.” *See* Exhibit 11. As one commentator explained, “OFHEO basically may be trying to send a signal that they are going to be really tough under their jurisdiction. They traditionally have not had the clout compared to other regulators for banks. And by bringing this action, they may want to send the fear of God to these executives.” *Id.* (quoting Prof. Henry T. Hu, University of Texas Law School).

23. Moreover, the agency’s bitter and repeated criticisms of the respondents are premised on a perversion of the testimony and documents obtained in the Special Examination, where there was an institutional initiative to distort the evidence in order to marginalize Fannie Mae and damage the Respondents. Indeed, as early as April 2004, the Office of the Inspector General of the Department of Housing and Urban Development (“OIG”) launched an investigation at the request of Senator Christopher S. Bond into possible criminal misconduct stemming from improper leaks of confidential information by former Director Armando Falcon, based on OFHEO’s selective release to the press of “the results and partial recommendations of a confidential regulatory examination of Fannie Mae.” *See* Exhibit 1, at 2. While the U.S. Attorney’s Office ultimately declined to prosecute Director Falcon “in favor of administrative remedies,” *id.* at 92, the OIG Report well documents OFHEO’s overwhelming institutional bias.

24. For example, one member of OFHEO's examination staff reported to the OIG that OFHEO staff members were instructed "that it's our job, meaning all employees of OFHEO, to make the Director look good." *Id.* at 9. Employees were told that "the Enterprises should fear OFHEO when we come onto the premises and that our relationship is inherently acrimonious and adversarial." *Id.* According to this witness, OFHEO's Special Examination of Fannie Mae "was focused on finding a way to bring into question the propriety of Fannie Mae's approach," and thus examination results and conclusions "were then altered and made to appear much more significant and egregious." *Id.* at 84. The "ultimate objective on the part of the Director and the Deputy Director" was to force Fannie Mae "to recognize an increased level of impairment" and to "find a way to conclude that Fannie has misapplied the financial accounting standards." *Id.* at 85.

25. Another OFHEO employee told OIG that the agency's Special Examination was driven by the goal of "finding problems at Fannie Mae," and that employees were "rewarded for finding things versus saying that everything is okay." *Id.* at 80.

26. OFHEO's former Chief Examiner, Scott Calhoun, testified that "the attitude prevailing at OFHEO was one in which efforts would be made to find things wrong at Fannie Mae, then take strong enforcement action; 'when we find them, we'll hammer you hard.'" *Id.* at 82. Managers who "did not conform to this new approach" were "marginalized" by senior management. *Id.* at 82-83.

27. OFHEO's former Deputy Director, Stephen Blumenthal, acknowledged lecturing staff "about how public announcements by government officials could negatively impact the stock of Fannie Mae and could serve as a means for making the regulated entity ... 'submit to the will' of the regulator." *Id.* at 11.

28. Under these circumstances, the Director's dual role as prosecutor and adjudicator casts inescapable doubt on his impartiality. As the Supreme Court has held, the Constitution does not permit a judge who has "in effect bec[ome] part of the prosecution and assumed an adversary position" to adjudicate a case. *Withrow v. Larkin*, 421 U.S. at 53; *see also, e.g., Wildberger v. Am. Fed'n of Gov't Employees*, 86 F.3d 1188, 1190, 1195 (D.C. Cir. 1996) (holding that a disciplinary procedure in which the same individual "initiated the investigation, determined probable cause, and served as the final adjudicator" violated constitutional due process). In light of OFHEO's politically motivated investigation and prosecution of Ms. Spencer, Mr. Raines, and Mr. Howard, in which Director Lockhart personally has played a crucial role, the Director must be removed from any further involvement in this case.

29. The Due Process Clause of the United States Constitution requires that "an administrative hearing 'must be attended, not only with every element of fairness but with the very appearance of complete fairness.'" *Cinderella*, 425 F.2d at 591 (quoting *Amos Treat & Co. v. SEC*, 306 F.2d 260, 267 (1962)). Director Lockhart's statements are prima facie evidence that he has "adjudged the facts as well as the law ... in advance of hearing [*In re Raines et al.*]." *Id.* He cannot back off those public statements now. Decision-makers are without "license to make speeches [or statements] which give the appearance that the case has been prejudged." *Id.* As long as the Director continues to participate in this case, Ms. Spencer will be denied her fundamental constitutional right to due process.

30. Director Lockhart's involvement in the adjudication of this matter—including his appointment of a presiding officer on January 16, 2007—will irrevocably taint the proceedings.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed in Washington, D.C., this 24th day of January, 2007.


David S. Krakoff

The foregoing instrument was acknowledged before me on this 24th day of January, 2007, by David S. Krakoff, who personally appeared before me at the time of notarization and who is personally known to me.


Notary Public

SANDI A. MASON
Notary Public, District of Columbia
My Commission Expires March 14, 2011

District of Columbia

Subscribed and sworn to before me, in my presence,

this 24th day of January, 2007

by _____

Sandi Mason, Notary Public

My Commission Expires March 14, 2011

CERTIFICATE OF SERVICE

I hereby certify that on this 24th day of January, 2007, I caused to be served by hand delivery, true and correct copies of the Affidavit of David S. Krakoff in Support of Disqualifying Director Lockhart from Adjudicating the Notice of Charges and accompanying exhibits on:

Mr. Alfred M. Pollard, Esq.
Office of the General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street NW
Washington, DC 20552

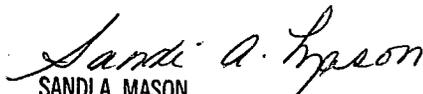
Mr. Steven M. Salky, Esq.
Zuckerman Spaeder LLP
1800 M St. NW, Suite 1000
Washington, DC 20036
Counsel for Respondent J. Timothy Howard

Mr. Kevin M. Downey
Williams & Connolly LLP
725 12th St. NW
Washington, DC 20005
Counsel for Respondent Franklin D. Raines



David S. Krakoff

District of Columbia
Subscribed and sworn to before me, in my presence,
this 24th day of January, 2007
by Sandi A. Mason Notary Public
My Commission Expires March 14, 2011


SANDI A. MASON
Notary Public, District of Columbia
My Commission Expires March 14 2011