

United States District Court
For the Northern District of California

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IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

PEOPLE OF THE STATE OF
CALIFORNIA, ex rel. KAMALA D.
HARRIS, ATTORNEY GENERAL,

Plaintiff,

v.

FEDERAL HOUSING FINANCE AGENCY;
EDWARD DeMARCO, in his capacity
as Acting Director of FEDERAL
HOUSING FINANCE AGENCY; FEDERAL
HOME LOAN MORTGAGE CORPORATION;
CHARLES E. HALDEMAN, Jr., in his
capacity as Chief Executive
Officer of FEDERAL HOME LOAN
MORTGAGE CORPORATION; FEDERAL
NATIONAL MORTGAGE ASSOCIATION;
and MICHAEL J. WILLIAMS, in his
capacity as Chief Executive
Officer of FEDERAL NATIONAL
MORTGAGE ASSOCIATION,

Defendants.

No. C 10-03084 CW
No. C 10-03270 CW
No. C 10-03317 CW
No. C 10-04482 CW

ORDER GRANTING
PLAINTIFFS' MOTION
FOR SUMMARY
JUDGMENT, Docket
No. 158, AND
DENYING
DEFENDANTS' CROSS-
MOTION FOR SUMMARY
JUDGMENT, Docket
No. 168.

_____ /

United States District Court
For the Northern District of California

1 SONOMA COUNTY and PLACER COUNTY,

2 Plaintiff and
3 Plaintiff-Intervener,

4 v.

5 FEDERAL HOUSING FINANCE AGENCY;
6 EDWARD DeMARCO, in his capacity
7 as Acting Director of FEDERAL
8 HOUSING FINANCE AGENCY; FEDERAL
9 HOME LOAN MORTGAGE CORPORATION;
10 CHARLES E. HALDEMAN, Jr., in his
11 capacity as Chief Executive
12 Officer of FEDERAL HOME LOAN
13 MORTGAGE CORPORATION; FEDERAL
14 NATIONAL MORTGAGE ASSOCIATION;
15 and MICHAEL J. WILLIAMS, in his
16 capacity as Chief Executive
17 Officer of FEDERAL NATIONAL
18 MORTGAGE ASSOCIATION,

19 Defendants.
20 _____/

21 SIERRA CLUB,

22 Plaintiff,

23 v.

24 FEDERAL HOUSING FINANCE AGENCY;
25 and EDWARD DeMARCO, in his
26 capacity as Acting Director of
27 FEDERAL HOUSING FINANCE AGENCY,

28 Defendants.
_____/

CITY OF PALM DESERT,

Plaintiff,

v.

FEDERAL HOUSING FINANCE AGENCY;
FEDERAL NATIONAL MORTGAGE
ASSOCIATION; and FEDERAL HOME
LOAN MORTGAGE CORPORATION,

Defendants.
_____/

1 California, Sonoma and Placer Counties, the City of Palm
2 Desert and the Sierra Club have sued the Federal Housing Finance
3 Agency (FHFA), its director, the Federal National Housing
4 Association (Fannie Mae) and the Federal Loan Mortgage Corporation
5 (Freddie Mac).¹ The lawsuits challenge actions by the FHFA,
6 Fannie Mae and Freddie Mac which have thwarted certain federally
7 funded, state and locally administered initiatives known as
8 Property Assessed Clean Energy (PACE) programs.² Through PACE
9 programs, state and local governments finance energy conservation
10 property improvements with debt obligations secured by the
11 retrofitted properties. The programs are intended to foster the
12 use of renewable energy, energy and water efficiency, and the
13 creation of jobs. Congress has allocated substantial federal
14 funding to support the expansion of PACE programs nation-wide, and
15 the executive branch of the federal government has engaged in
16 extensive inter-agency coordination efforts to advance the
17 implementation of PACE programs.
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21 ¹ The claims against Defendants Charles E. Halderman, Jr. and
22 Michael J. Williams, who were sued in their official capacities as
23 Chief Executive Officers for Fannie Mae and Freddie Mac, were
24 previously dismissed. No. C 10-03084, Docket No. 83; No. C 10-
25 03270, Docket No. 93.

26 ² Three similar cases have been filed in federal district
27 courts in Florida and New York: The Town of Babylon v. Federal
28 Housing Finance Agency, et al., 2:10-cv-04916 (E.D.N.Y.); Natural
Resource Defense Council, Inc. v. Federal Housing Finance
Authority, et al., 1:10-cv-07647-SAS (S.D.N.Y.); and Leon County
v. Federal Housing Finance Agency, et al., 4:10-cv-00436-RH (N.D.
Fla.). All three actions have been dismissed, and appeals are
pending.

1 Plaintiffs allege that Defendants have violated the
2 Administrative Procedures Act (APA) and the National Environmental
3 Policy Act (NEPA).³ The parties dispute the nature of the debt
4 obligations created by PACE programs, and the extent to which the
5 obligations create risks for secondary mortgage holders, such as
6 Fannie Mae and Freddie Mac, collectively referred to as the
7 Enterprises. The FHFA has taken the position that PACE programs
8 that result in lien obligations which take priority over mortgage
9 loans complicate and make more expensive alienation of the
10 encumbered properties and, thus, pose risk to the security
11 interests of entities that purchase the mortgages for investment
12 purposes. Plaintiffs claim that (1) Defendants disregarded
13 statutorily imposed procedural requirements in adopting rules
14 about the PACE debt obligations; (2) Defendants' rules were
15 substantively unlawful because they were arbitrary and capricious;
16 and (3) the rule-making process failed to comply with
17 environmental laws.
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20 Plaintiffs have jointly moved for summary judgment on all
21 claims. Defendants have opposed the motion and cross-moved for
22 summary judgment. Having considered all of the parties'
23 submissions and oral argument, the Court grants Plaintiffs' motion
24 for summary judgment that Defendants failed to comply with the
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27 ³ The Court previously dismissed Plaintiffs' claims under
28 various state laws and the Constitution's Tenth Amendment and
Spending Clause.

1 APA's notice and comment requirement and denies Defendants' cross-
2 motion for summary judgment.

3 BACKGROUND

4 In 2008, California approved legislation to allow cities and
5 counties to create PACE programs, through which property owners
6 may enter into contracts for assessments to finance the
7 installation of energy efficiency or renewable energy improvements
8 that are permanently fixed to residential (including multi-
9 family), commercial, industrial, or other real property.⁴ AB 811,
10 Ch. 159, Stats. 2008. In many, but not all, PACE programs,
11 property owners repay the assessments with their property taxes,
12 and the liens associated with the assessments are given priority
13 over previously-recorded private liens, such as mortgages.
14

15 Also in 2008, Congress enacted the Housing and Economic
16 Recovery Act of 2008 (HERA), Public Law 110-289, 122 Stat. 2654.
17 Through this law, Congress established the FHFA to regulate and
18 oversee the Enterprises, as well as the Federal Home Loan Banks
19 (FHL Banks), which together largely control the country's
20 secondary market for residential mortgages. The HERA amended the
21 Federal Housing Enterprises Financial Safety and Soundness Act of
22 1992, 12 U.S.C. § 4501 et seq. (Safety and Soundness Act). That
23 Act outlines the regulatory and oversight structure for the
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27 ⁴ In 2009, the state legislature expanded the law,
28 authorizing PACE financing for water efficiency improvements.
AB 474, Ch. 444, Stats. 2009.

1 Enterprises and the FHL Banks. 12 U.S.C. § 4502(20). As amended
2 by the HERA, the Safety and Soundness Act vests in the FHFA the
3 authority to act as a conservator and receiver for the Enterprises
4 and the FHL Banks, together referred to as the regulated entities.
5 12 U.S.C. §§ 4511(b); 4617(a).

6 The Safety and Soundness Act also establishes a tiered system
7 of classification of the capitalization of the regulated entities.
8 As of June 30, 2008, James B. Lockhart III, then director of the
9 FHFA, classified the Enterprises as undercapitalized, pursuant to
10 his discretionary authority under the statute. Pls.' Second
11 Request for Judicial Notice, Ex. 6 at 2. On September 7, 2008,
12 Lockhart placed the Enterprises in FHFA conservatorship. Id.

13 On February 17, 2009, Congress approved the American Recovery
14 and Reinvestment Act of 2009 (Recovery Act), Public Law 111-5, 123
15 Stat. 115, which, among other things, allocated eighty billion
16 dollars to projects related to energy and the environment.

17 Plaintiffs' Excerpts of Administrative Record (Plaintiffs'
18 Excerpts), Docket No. 182, Exhibit B, White House Middle Class
19 Task Force and White House Council on Environmental Quality,
20 "Recovery Through Retrofit" Report, October 2009 (Retrofit
21 Report), at 2. The Act provided state and local governments with
22 an "unprecedented opportunity to expand investments in energy
23 retrofits and develop community-based programs on a large scale."
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25 Id.
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1 The California Energy Commission was charged with
2 administering and distributing the Recovery Act funds allocated to
3 the state. According to Karen Douglas, the Chair of the
4 Commission from February 2009 to February 2011, the federal
5 Department of Energy (DOE) allocated \$49.6 million in Recovery Act
6 funds for an Energy Efficiency and Conservation Block Grant
7 Program. PACE programs, among other projects, were eligible for
8 block grant funding.
9

10 The DOE also allocated to the Energy Commission \$226 million
11 in Recovery Act funds for the State Energy Program (SEP). The DOE
12 encouraged states to develop energy strategies that align with the
13 national goals of increasing jobs, reducing the United States' oil
14 dependence through increases in energy efficiency and the
15 deployment of renewable energy technologies, promoting economic
16 vitality through an increase in "green jobs," and reducing
17 greenhouse gas emissions. On February 10, 2010, the Energy
18 Commission awarded thirty million dollars in SEP funding to five
19 municipal PACE programs. The awards for these PACE programs were
20 expected to leverage \$370 million, create 4,353 jobs, save over
21 336 million kilowatt-hours of energy, and avoid emissions of
22 187,264 tons of greenhouse gases over the contract period.
23
24 Douglas Dec. at ¶ 12.

25
26 High level federal and state officials participated in
27 efforts to advance the PACE program nation-wide. Beginning in May
28 2009, the White House Council on Environmental Quality (CEQ) and

1 the Office of the Vice President facilitated an interagency
2 process, involving eleven departments and agencies and six White
3 House Offices,⁵ to develop recommendations for federal action to
4 increase green job opportunities and boost energy savings by
5 retrofitting homes for energy efficiency. Retrofit Report at 5.

6 In a letter dated June 18, 2009, Director Lockhart advised
7 banking and creditor trade groups, as well as associations for
8 mortgage regulators, governors and state legislators, of "an
9 emerging trend in state and local financing for residential energy
10 efficiency home improvements." He explained the FHFA's belief
11 that the programs "will help improve our use of resources and, in
12 the long term, keep down the costs of home ownership," but that
13 "such programs must be carefully crafted to avoid unintended
14 consequences for homeowners and lenders." Plaintiffs' Excerpts,
15 Ex. A.
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18 On October 12, 2009, then California Attorney General Edmund
19 G. Brown, Jr., contacted Lockhart regarding his June 18, 2009
20 letter. The Attorney General emphasized that under California law
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22 _____
23 ⁵ The following departments and agencies participated: Office
24 of the Vice President, Department of Agriculture, Department of
25 Commerce, Department of Education, Department of Energy,
26 Department of Housing and Urban Development, Department of Labor,
27 Department of Treasury, Environmental Protection Agency, Equal
28 Employment Opportunity Commission, General Services Administration
and Small Business Administration, as well as Council of Economic
Advisers, Domestic Policy Council, National Economic Council,
Office of Management and Budget, Office of Public Engagement and
Intergovernmental Affairs and Office of Science and Technology
Policy from the Executive Office of the President.

1 the debt obligations were properly treated as assessments, and
2 asserted that "proper PACE program design" could overcome the
3 FHFA's concerns. Plaintiffs' Excerpts, Ex. C.

4 In October of that year, the White-House-led interagency
5 effort culminated in the release of a report entitled, "Recovery
6 Through Retrofit," announcing a federal proposal to expand PACE
7 programs. On October 18, 2009, the White House released its
8 "Policy Framework for PACE Financing Programs." Varma Dec., Ex.
9 20. The framework provided guidance to federally supported pilot
10 and demonstration level PACE programs.

11 With respect to homeowner protections, the framework
12 encouraged the voluntary adoption of three measures to ensure that
13 PACE-financed energy retrofits would pay for themselves within a
14 reasonable time, and that homeowners would be protected against
15 fraud or substandard work. First, the framework called for
16 "savings to investment ratios" for PACE program assessments to be
17 greater than one; that is, the expected average monthly utility
18 savings to homeowners should be greater than the expected monthly
19 increase in tax assessments due to the PACE energy efficiency or
20 renewable energy improvements. Second, the framework recommended
21 that PACE financing be limited to investments that have a high
22 return in terms of energy efficiency gains. Third, the framework
23 advised that PACE programs should ensure that the retrofits would
24 be constructed as intended. That is, the scope of the retrofit
25 should be determined by a list of presumptively efficient projects
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1 or should be based on an energy audit; licensed contractors or
2 installers should carry out the home improvements; and PACE
3 programs should institute a quality assurance protocol to verify
4 that the home improvements are completed and satisfy required
5 standards.

6 The framework also announced parameters to limit risks to
7 mortgage lenders. These elements of the framework recommended a
8 reserve fund established at the local level to protect against
9 late payments or non-payments of the assessment; a requirement
10 that the length of time for a homeowner to repay the PACE
11 assessments should not exceed the life expectancy of the energy
12 efficient improvements; a general limitation on the amount of PACE
13 financing to ten percent of the appraised value of the home;
14 assurances of clear title to the property, current property taxes
15 and mortgage payments, and an absence of outstanding or
16 unsatisfied tax liens, notices of default or other property-based
17 debt delinquencies; and an absence of existing mortgages or other
18 debt on the property in an amount that exceeds the value of the
19 property. Finally, the framework called for the imposition of
20 escrow payments for PACE assessments and precautions in
21 establishing PACE programs in areas experiencing large declines in
22 home prices.

23 On October 29, 2009, FHFA Acting Director Edward DeMarco
24 replied to the letter Attorney General Brown had sent to Lockhart.
25 Plaintiffs' Excerpts, Ex. D. DeMarco's letter did not mention the

1 White House Retrofit Report or policy framework released earlier
2 that month, but stated that the FHFA was working with other
3 federal departments and agencies to identify and promote best
4 practices so as to align improved energy efficiency, consumer
5 protection, and prudent lending goals. Id.

6 On February 16, 2010, the FHFA produced a document entitled,
7 "Market and Legal Issues Related to Energy Loan Tax Assessment
8 Programs (ELTAPs)/PACE (Property Assessed Clean Energy) Programs."
9 Varma Dec., Ex. 43. In the document, the FHFA discussed a number
10 of deficiencies in PACE programs, including the absence of any
11 national model for appropriate lending standards for PACE and
12 ELTAP programs, the creation of unnecessary market disruptions by
13 first liens, the absence of retrofit standards, complications
14 arising from the reliance of PACE programs on subsidies, such as
15 tax credits and utility firm rebates, to generate energy savings,
16 and, finally, the existence of alternatives to ELTAP, through
17 established leasing programs for residential solar energy systems.
18 The FHFA explained that the priority of PACE liens over mortgage
19 liens increased uncertainty and created difficulties in
20 determining the value of holdings impacted by PACE encumbrances.
21 Id. at 3.

22 The FHFA described the following scenario to explain that, in
23 a property sale triggered by an unpaid assessment, the mortgage
24 lender becomes the guarantor of the PACE assessment. Id. at 5.
25 In the event of the sale of a homeowner's property for a
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1 delinquent PACE lien, other liens, including the first mortgage,
2 are eliminated. When a homeowner becomes delinquent on the
3 payment of property tax assessments, the mortgage lender would
4 receive notice and would have to pay the arrearage to prevent a
5 tax sale and avoid losing its lien on the security property. The
6 lender would have to pay the PACE lien assessment for the same
7 reason. If the mortgage lender was not in control of the sale of
8 the property, the lender could lose its entire monetary interest
9 in the property; there would be no incentive in a tax sale to
10 garner more than the amount of the tax arrearage. Further, the
11 amount of the tax arrearages would be uncertain.

12
13 In addition, subsequent purchasers of a PACE-encumbered
14 property could discount their purchase offers to account for the
15 total assessments owed, affecting the lender's ability to recoup
16 the property value.

17
18 The FHFA noted that some municipalities required priority
19 liens for PACE and ELTAP loans. Id. at 3. The FHFA stated, "The
20 eighteen states that have authorized programs should engage with
21 the federal government in pilot programs that test various models
22 (including those without first liens and those that employ greater
23 private sector administration both of lending and energy
24 retrofitting)." Id. at 8. However, Defendants acknowledge that
25 Barclays Capital has explained to PACE advocates that bonds backed
26 by PACE liens without first-lien priority likely would be rated
27 "as non-investment grade and therefore will have limited buyer
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1 appeal while also demanding high interest rates." Varma Dec., Ex.
2 22.

3 On March 5, 2010, Freddie Mac sent a confidential letter to
4 the FHFA, highlighting the growing number of states approving
5 legislation to enable the establishment of PACE programs,
6 generally relying on a priority lien to secure the improvements.⁶
7 Freddie Mac reiterated its concerns about such programs. Varma
8 Dec., Ex. 26. The letter, copies of which were sent to DeMarco,
9 FHFA General Counsel Alfred Pollard and other agency executives,
10 discussed the first lien position of the assessments and explained
11 that the size of the loans could be substantial. Freddie Mac
12 further explained that, because the liens could be placed after
13 the first mortgage lien was created, the mortgage holder may not
14 be aware that its lien has been subordinated until it or the local
15 entity initiates foreclosure. In addition, Freddie Mac expressed
16 concern that the lack of required underwriting standards, along
17 with the failure to set loan-to-value limits, was likely to result
18 in many borrowers obtaining loans that they were unable to repay.
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21 Freddie Mac stated that no uniform set of best practices
22 existed to mitigate the risks it faced as a result of the
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24 ⁶ Freddie Mac noted that such laws had been approved in
25 California, Colorado, Florida, Hawaii, Illinois, Louisiana,
26 Maryland, Nevada, New Mexico, New York, North Carolina, Ohio,
27 Oklahoma, Oregon, Texas, Vermont, Virginia and Wisconsin, and
28 similar legislation had been introduced in Arkansas, Arizona,
Iowa, Maine, Michigan, Nebraska, New Hampshire, Rhode Island,
South Carolina, Washington and West Virginia.

1 programs, despite months of efforts it had undertaken, in
2 collaboration with the FHFA and other agencies, to develop such
3 standards. Accordingly, Freddie Mac requested FHFA approval to
4 take the following measures: (1) reinforce existing contractual
5 rights under the Freddie Mac Single-Family Seller/Servicer Guide
6 and the Freddie Mac/Fannie Mae Uniform Security Instrument;
7 (2) establish new due diligence requirements for servicers; and
8 (3) restrict Freddie-Mac-approved seller/servicers from financing
9 energy loans that would subordinate existing Freddie Mac
10 mortgages. Freddie Mac stated that the measures were warranted
11 given the proliferation of PACE programs, and were consistent with
12 the FHFA's goal as conservator to maintain Freddie Mac's assets
13 and minimize its losses during conservatorship.

14
15 On May 5, 2010, Fannie Mae and Freddie Mac both issued
16 letters to their mortgage sellers and servicers, again addressing
17 concerns about PACE programs.

18
19 On May 7, 2010, the DOE issued "Guidelines for Pilot PACE
20 Financing Programs," providing "best practices guidelines to
21 implement the Policy Framework for PACE Financing Programs
22 announced on October 18, 2009." Plaintiffs' Excerpts, Ex. H;
23 Varma Dec., Ex. 41. The best practices called for local
24 governments to consider the following requirements: (1) the
25 expected savings-to-investment ratio should be greater than one;
26 (2) the term of the assessment should not exceed the useful life
27 of the improvements; (3) the mortgage holder of record should
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1 receive notice when PACE liens are placed; (4) PACE liens should
2 not accelerate upon property owner default; (5) the assessments
3 should not exceed ten percent of a property's estimated value;
4 (6) quality assurance and anti-fraud measures should be
5 implemented, such as the use of validly licensed auditors and
6 contractors only; (7) rebates and tax credits should be considered
7 in determining the appropriate financing structure; (8) education
8 programs for PACE program participants should be carried out;
9 (9) a debt service reserve fund should be established; and
10 (10) data should be collected. The DOE also announced best
11 practices for underwriting PACE assessments. The DOE called for
12 (1) verification of property ownership, specifically, clear title,
13 location of the property in a financing district, and other
14 restrictions; (2) proper evaluation of existing property-based
15 debt and the worth of the property; and (3) a determination of the
16 property owner's ability to pay.
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19 In a May 24, 2010 letter, the DOE sought clarification from
20 the FHFA regarding Fannie Mae and Freddie Mac's May 5, 2010 lender
21 letters. The DOE requested from the FHFA "as soon as practicable
22 guidelines and parameters that experimental pilot PACE financing
23 programs should follow so that their operations can proceed
24 without encountering adverse action by the Government Sponsored
25 Entities (GSEs) under your conservatorship." Plaintiffs'
26 Excerpts, Ex. M. The DOE sought "specific criteria the financial
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1 regulatory community believes is necessary to enable these
2 experimental pilot PACE financing programs to proceed." Id.

3 On July 6, 2010, the FHFA issued a statement that the PACE
4 programs "present significant safety and soundness concerns that
5 must be addressed by Fannie Mae, Freddie Mac and the Federal Home
6 Loan Banks." The FHFA stated that first liens created by PACE
7 programs were different from "routine tax assessments," and posed
8 significant risks to lenders, servicers, and mortgage securities
9 investors. The FHFA "urged state and local governments to
10 reconsider these programs" and called "for a pause in such
11 programs so concerns can be addressed." The FHFA directed Fannie
12 Mae, Freddie Mac and the FHL Banks to undertake "prudential
13 actions," including reviewing their collateral policies to assure
14 no adverse impact by PACE programs. Although Defendants take the
15 position that the FHFA issued this statement in its capacity as
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1 conservator as well as that of regulator, the statement itself did
2 not say so, or cite any statutory or regulatory provision.⁷

3 On August 31, 2010, Fannie Mae and Freddie Mac, citing the
4 FHFA's July 2010 statement, announced to lenders that they would
5 not purchase mortgages originated on or after July 6, 2010, which
6 were secured by properties encumbered by PACE obligations.

7
8 On February 28, 2011, after the hearing on Defendants' motion
9 to dismiss the present actions but before the Court issued its
10 order, the FHFA's General Counsel sent a letter to General Counsel
11 for Fannie Mae and Freddie Mac, reaffirming that debts arising
12 from PACE programs pose significant risks to the Enterprises. The

13 ⁷ On August 16, 2010, the FHFA issued proposed guidance
14 regarding private transfer fee covenants. 75 Fed. Reg. 49932.
15 The proposed guidance would have advised the Enterprises not to
16 purchase or invest in any mortgages encumbered by private transfer
17 fee covenants or securities backed by such mortgages and
18 discouraged the FHL Banks from purchasing or investing in such
19 mortgages or securities or holding them as collateral for
20 advances. The FHFA did not adopt this guidance in final form.
21 After receiving several thousand comments on it, the FHFA decided
22 to address the issue through a regulation, rather than guidance.
23 76 Fed. Reg. 6702. On February 8, 2011, the FHFA proposed a
24 regulation narrower in scope than the proposed guidance. The
25 proposed regulation would have prohibited the regulated entities
26 from dealing in mortgages on properties encumbered by certain
27 types of private transfer fee covenants, rather than any such
28 covenant. The final rule, adopted March 16, 2012, prohibits
regulated entities from purchasing, investing or otherwise dealing
in any mortgages on properties encumbered by private transfer fee
covenants, securities backed by such mortgages, or securities
backed by the income stream from such covenants, except for
private transfer fee covenants that require payment of a fee to a
covered association, such as homeowner and condominium
associations, and that limit use of such transfer fees exclusively
to purposes which provide a direct benefit to the real property
encumbered by the private transfer fee covenant. 12 C.F.R.
§§ 1228.1 and 1228.2; 77 Fed. Reg. 15566-01.

1 FHFA invoked its statutory authority as conservator and directed
2 that the "Enterprises shall continue to refrain from purchasing
3 mortgage loans secured by properties with outstanding first-lien
4 PACE obligations." In addition, the letter ordered that the
5 "Enterprises shall continue to operate in accordance with the
6 Lender Letters and shall undertake other steps necessary to
7 protect their safe and sound operations from these first-lien PACE
8 programs."
9

10 FHFA General Counsel Pollard attested that the FHFA received
11 input from the Enterprises and PACE stakeholders, as well as
12 federal financial institution regulators, regarding the risks
13 posed by PACE programs. According to Pollard, the FHFA found that
14 the DOE best practices guidelines were an unsatisfactory response
15 to its concerns because they did not proscribe the use of priority
16 liens, they continued to allow collateral-based lending, and there
17 was no enforcement mechanism to ensure that PACE programs
18 throughout the country complied with the DOE guidelines. Pollard
19 did not attest that the FHFA had considered alternatives to its
20 blanket prohibition against the purchase of PACE-encumbered
21 mortgages or that it had considered the impact on the public
22 interest of blocking the PACE programs, other than minimizing
23 risks for the Enterprises. Nor have Defendants presented evidence
24 that the FHFA weighed the costs associated with the risk exposure
25 produced by PACE programs against the economic benefits of
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1 allowing PACE programs to continue to expand and build a market
2 for residential energy conservation projects.

3 LEGAL STANDARD

4 Summary judgment is properly granted when no genuine and
5 disputed issues of material fact remain, and when, viewing the
6 evidence most favorably to the non-moving party, the movant is
7 clearly entitled to prevail as a matter of law. Fed. R. Civ. P.
8 56; Celotex Corp. v. Catrett, 477 U.S. 317, 322-23 (1986);
9 Eisenberg v. Ins. Co. of N. Am., 815 F.2d 1285, 1288-89 (9th Cir.
10 1987).

11 The moving party bears the burden of showing that there is no
12 material factual dispute. Therefore, the court must regard as
13 true the opposing party's evidence, if supported by affidavits or
14 other evidentiary material. Celotex, 477 U.S. at 324; Eisenberg,
15 815 F.2d at 1289. The court must draw all reasonable inferences
16 in favor of the party against whom summary judgment is sought.
17 Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574,
18 587 (1986); Intel Corp. v. Hartford Accident & Indem. Co., 952
19 F.2d 1551, 1558 (9th Cir. 1991).

20 Material facts which would preclude entry of summary judgment
21 are those which, under applicable substantive law, may affect the
22 outcome of the case. The substantive law will identify which
23 facts are material. Anderson v. Liberty Lobby, Inc., 477 U.S.
24 242, 248 (1986).
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DISCUSSION

I. Statutory Preclusion of Judicial Review

Defendants argue that they are entitled to summary judgment because 12 U.S.C. §§ 4617(f) and 4623(d) preclude judicial review of Plaintiffs' claims for relief.

The courts have long recognized a presumption in favor of judicial review of administrative actions. Love v. Thomas, 858 F.2d 1347, 1356 (9th Cir. 1988) (citing Block v. Community Nutrition Inst., 467 U.S. 340, 349-51 (1984)). The presumption may be overcome by various means, including "specific language or specific legislative history that is a reliable indicator of congressional intent," or "by inference of intent drawn from the statutory scheme as a whole." Block, 467 U.S. at 349. Although "great weight" is ordinarily given to an agency's interpretation of a statute it is charged with enforcing, "that deference does not extend to the question of judicial review, a matter within the peculiar expertise of the courts." Love, 858 F.2d at 1352 n.9.

A. Section 4617(f)

Section 4617(a) authorizes under certain circumstances the discretionary or mandatory appointment of the FHFA as conservator or receiver for a regulated entity. 12 U.S.C. § 4617(a). As conservator, the FHFA immediately succeeds to "all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity" with respect to the entity and its assets. 12 U.S.C. § 4617(b)(2)(A).

1 It may take over assets and operate the regulated entity; conduct
2 all business of the regulated entity; collect all obligations and
3 money due; perform all functions of the regulated entity in its
4 name which are consistent with the FHFA's appointment as
5 conservator or receiver; preserve and conserve the entity's assets
6 and property; and provide by contract for assistance in fulfilling
7 any function, activity, action, or duty as conservator or
8 receiver. 12 U.S.C. § 4617(b)(2)(B)(i)-(v). In addition, the
9 FHFA's specifically enumerated powers as conservator authorize it
10 to take such action as may be "necessary to put the regulated
11 entity in a sound and solvent condition." 12 U.S.C.
12 § 4617(b)(2)(D)(i)-(ii).

14 Section 4617(f) limits judicial review of such actions,
15 stating that "no court may take any action to restrain or affect
16 the exercise of powers or functions of the Agency as a conservator
17 or a receiver." 12 U.S.C. § 4617(f).

19 Distinct from the FHFA's powers as a conservator or receiver,
20 it has supervisory and regulatory authority over the regulated
21 entities. See 12 U.S.C. §§ 4511(b); 4513b; 4513(a)(1)(A) and
22 (B)(i)-(v). It is clear from the statutory scheme overall and
23 other provisions of § 4617 that Congress distinguished between the
24 FHFA's powers as a conservator and its authority as a regulator,
25 and did not intend that the former would be limitless and subsume
26 the latter. Although Congress intended to ensure the FHFA's
27 ability to act freely as a conservator by preempting judicial
28

1 review under § 4617(f), as well as granting far-reaching powers,
2 the FHFA must show that it was acting as a conservator, rather
3 than a regulator. The appropriate characterization of the FHFA's
4 actions is a matter of degree.

5 Defendants contend that the FHFA issued its July 2010
6 statement and February 2011 letter as conservator of the
7 Enterprises. Defendants assert that the directives were a
8 business decision by the FHFA intended to minimize the
9 Enterprises' credit losses while in conservatorship. Plaintiffs
10 respond that the FHFA's actions amount to substantive rule-making,
11 which can only be done in the FHFA's role as regulator, rather
12 than as conservator. For the reasons discussed below, the Court
13 agrees with Plaintiffs.
14

15 The FHFA directed Fannie Mae, Freddie Mac and the FHL Banks
16 prospectively to refrain from purchasing a class of mortgage
17 loans, namely, those secured by property with an outstanding PACE
18 first lien. These directives did not involve succeeding to the
19 rights or powers of the Enterprises, taking over their assets,
20 collecting money due or operating their businesses, in keeping
21 with the FHFA's conservatorship authority.
22

23 Specific provisions of § 4617 include the phrase, "The agency
24 may, as conservator . . .," in reference to the FHFA's authority
25 in that role, while other provisions addressing the FHFA's
26 regulatory powers do not contain analogous language. Compare 12
27 U.S.C. § 4617(b)(1) and (2)(C) with § 4617(b)(2)(A), (B), (G),
28

1 (H), (I)(i)(I) and (J)⁸ and § 4617(b)(4). This supports that
2 Congress intended to enumerate the FHFA's powers and duties as a
3 conservator, while delegating other duties to the FHFA's
4 regulatory authority.

5 In Morrison-Knudsen Co., Inc. v. CHG International, Inc., 811
6 F.2d 1209 (9th Cir. 1987), the Ninth Circuit declined to hold that
7 the Federal Savings and Loan Insurance Corporation's authority to
8 adjudicate creditor claims was in keeping with the ordinary
9 functions of a receiver. The Ninth Circuit found that the
10 language in the relevant statute failed to enumerate, and the
11 statutory scheme did not support, a receivership power to
12 adjudicate creditor claims. Id. at 1218-20. Similarly here, the
13 Safety and Soundness Act does not enumerate, and its statutory
14 scheme does not support, the FHFA's authority as conservator to
15 establish broad, prospective rules regarding classes of mortgages
16 that are eligible for purchase by the regulated entities.

17
18
19 In other cases upon which Defendants rely, federal agencies
20 undertook the ordinary day-to-day functions of an entity acting as
21 conservator or receiver to wind up the affairs of the failed
22 financial institutions. See e.g., Ward v. Resolution Trust Corp.,
23 996 F.2d 99, 104 (5th Cir. 1993) (finding that the district court
24 was without jurisdiction to enjoin the sale of certain real
25

26 ⁸ Although § 4617(b)(2)(J) is a broad, catchall provision,
27 given the overall statutory scheme, it should not be read to
28 authorize the FHFA to do anything and everything, including
engaging in rule-making, as a conservator.

1 property because disposing of the assets of the failed bank was a
2 "routine 'receivership' function"); In re Landmark Land Co. of
3 Okla., Inc., 973 F.2d 283, 290 (4th Cir. 1992) (holding that the
4 Resolution Trust Corporation (RTC),⁹ as a conservator, had
5 authority, beyond the reach of the district court's injunctive
6 power, to call a meeting of the shareholders to elect new
7 management).

8
9 Defendants also cite Barrows v. Resolution Trust Corporation,
10 39 F.3d 1166 (1st Cir. 1994).¹⁰ There, the First Circuit held that
11 § 1821(j)¹¹ barred a district court from ordering the RTC, the
12 appointed receiver, to make certain loans to which the plaintiff
13 claimed he was entitled. Id. at *3. Barrows held that the RTC's
14 directive blocking a failed financial institution from extending a
15

16
17 ⁹ Through the Financial Institutions Reform, Recovery, and
18 Enforcement Act (FIRREA), Congress authorized the RTC "to take all
19 actions necessary to resolve the problems posed by a financial
20 institution in default." Gross v. Bell Sav. Bank PaSA, 974 F.2d
21 403, 406 (1992) (citing H.R. Rep. No. 101-54). Defendants cite
22 Kuriakose v. Federal Home Loan Mortgage Corporation, 674 F. Supp.
23 2d 483, 493 (S.D.N.Y. 2009), for the proposition that the courts
24 applying § 4617(f), may turn to precedent relating to the nearly
25 identical anti-injunction statute under the FIRREA.

26
27 ¹⁰ Barrows is an unpublished per curiam opinion referred to in
28 the Federal Reporter at 39 F.3d 1166, in a "Table of Decisions
Without Reported Opinions."

29
30 ¹¹ The parties agree that the language in § 4617(f) is similar
31 to that in 12 U.S.C. § 1821(j), which limits judicial review of
32 actions taken by the Federal Deposit Insurance Corporation
33 (FDIC) in its capacity as a conservator or receiver. Sahni v.
34 American Diversified Partners, 83 F.3d 1054, 1058-59 (9th Cir.
35 1996).

1 loan was an action of a conservator to preserve and conserve the
2 assets and property of the failed institution.

3 Defendants contend that, under Barrows, the FHFA's action
4 with respect to the PACE programs was akin to a business decision
5 preventing the institution from making a particular investment, as
6 necessary to conserve and preserve the assets of the Enterprises
7 while in conservatorship. The directives that the FHFA issued to
8 the Enterprises and the FHL Banks differ from the receiver's
9 decision in Barrows because the former broadly and prospectively
10 prohibited all three of the regulated entities from the purchase
11 of an entire class of mortgages, while the latter involved a
12 receiver's decision not to make a particular loan. Barrows does
13 not establish that the FHFA was acting as a conservator here.

14
15 The FHFA's directives here resemble an FHFA rule regarding
16 private transfer fee covenants. A property owner or another
17 private party may attach private fee covenants to real property,
18 providing for payment of a transfer fee to an identified third
19 party upon each resale of the property. Id. 76 Fed. Reg. 6702-
20 02, *6703. The fee typically is stated as a fixed amount or as a
21 percentage of the property's sales price and often exists for a
22 period of ninety-nine years. Id. As described above, the FHFA
23 initially sought public comment on proposed guidance to the
24 Enterprises and the FHL Banks that they should not purchase or
25 invest in mortgages on properties encumbered by private transfer
26 fee covenants. 75 Fed. Reg. 49932-01 at *49932. After receiving
27
28

1 extensive comments regarding the proposed guidance, the FHFA
2 decided to address the subject by regulation rather than through
3 guidance and filed a notice of proposed rule-making. 76 Fed. Reg.
4 6702-02, *6703. Among other concerns raised in its notice of
5 proposed rule-making, the FHFA pointed out the risk that private
6 transfer fees may not benefit homeowners or may not be disclosed
7 adequately, thus impeding the transferability, marketability and
8 valuation of the encumbered properties. Id. at *6703-04.
9

10 The FHFA then proposed a narrower regulation, received
11 further comment, and adopted, on March 16, 2012, a final rule
12 prohibiting the regulated entities, except in certain
13 circumstances, from purchasing, investing or otherwise dealing in
14 any mortgages on properties encumbered by private transfer fee
15 covenants, securities backed by such mortgages, or securities
16 backed by the income stream from such covenants, and barring the
17 FHL Banks from accepting such mortgages or securities as
18 collateral. 12 C.F.R. § 1228; 77 Fed. Reg. 15566-01 (March 16,
19 2012).
20

21 Because private transfer fee covenants and PACE first liens
22 are analogous, the fact that the FHFA followed notice and comment
23 rule-making procedures when regulating the former makes it
24 reasonable to infer that it was acting as a regulator when it
25 issued its directives about the latter.
26

27 Furthermore, the FHFA's directives applied to the FHL Banks,
28 as well the Enterprises. The fact that they bound all three

1 regulated entities, rather than just the entities in
2 conservatorship, supports the conclusion that the FHFA was acting
3 as a regulator, rather than a conservator.

4 The FHFA's February 2011 letter, asserting that it was acting
5 as a conservator, was created during the pendency of this
6 litigation and was addressed to general counsel for the
7 Enterprises. The letter is a post-hoc effort by the FHFA to
8 characterize its July 6, 2010 statement.

9
10 Contrary to Defendants' argument, National Trust for Historic
11 Preservation v. FDIC, 21 F.3d 469 (D.C. Cir. 1994), does not
12 establish that the FHFA has discretion to decide whether it acts
13 in its capacity as conservator or as regulator. There, the D.C.
14 Circuit held that the FDIC had discretion to determine whether it
15 acted in its capacity as a receiver or its capacity as a corporate
16 insurer. Id. at 471. It does not follow that Congress intended
17 the FHFA to have similar discretion because the scope of the
18 FHFA's powers as regulator is different from, and substantially
19 greater than, the FDIC's authority as a corporate insurer.
20 Furthermore, even if the FHFA had discretion to act as a
21 conservator or regulator with respect to a given issue, the FHFA
22 may not decide arbitrarily to act in different capacities for two
23 decisions that are substantially similar.
24

25
26 Given the presumption in favor of judicial review, to invoke
27 § 4617(f), Defendants bear the burden to establish that the FHFA
28 was acting as conservator, to restore or protect the solvency of

1 the Enterprises. Defendants have not carried this burden.

2 Section 4617 does not preclude judicial review here.

3 B. Section 4623(d)

4 Defendants also argue that their actions in connection with
5 the PACE programs are exempt from judicial review pursuant to 12
6 U.S.C. § 4623(d). This provision restricts judicial review of any
7 action taken under § 4616(b)(4). Section 4616(b)(1) through (4)
8 describes supervisory actions that the FHFA Director may take with
9 respect to "significantly undercapitalized" regulated entities.
10

11 Section 4616(b)(4) authorizes the Director to require a
12 "significantly undercapitalized" regulated entity "to terminate,
13 reduce, or modify any activity that the Director determines
14 creates excessive risk to the regulated entity." As noted
15 earlier, the Safety and Soundness Act establishes a tiered system
16 of classification of the capitalization of the regulated entities;
17 "significantly undercapitalized" is the second lowest of the four
18 tiers. See 12 U.S.C. § 4614(a) and (b)(1)(C).
19

20 Defendants have not produced evidence that prior to, or even
21 contemporaneously with, the July 2010 statement or the February
22 2011 letter, the Enterprises were categorized as significantly
23 undercapitalized within the meaning of § 4614. Nothing in the
24 July 2010 statement refers to § 4616(b)(4), or makes reference to
25 undercapitalization.
26

27 Furthermore, on October 9, 2008, the FHFA had issued a press
28 release announcing that the FHFA Director "had determined that it

1 [was] prudent and in the best interests of the market to suspend
2 capital classifications of Fannie Mae and Freddie Mac during the
3 conservatorship, in light of the United States Treasury's Senior
4 Preferred Stock Purchase Agreement." Pls.' Second Request for
5 Judicial Notice, Ex. 6 at 2. The FHFA explained, "The Director
6 has the authority to make a discretionary downgrade of the capital
7 adequacy classification should certain safety and soundness
8 conditions arise that could impact future capital adequacy. This
9 classification requirement serves no purpose once an Enterprise
10 has been placed into conservatorship." Id. at 2-3.

11
12 Neither Defendants' interrogatory responses nor Pollard's
13 declaration establishes that, at the time of the FHFA's
14 directives, the Enterprises had been categorized as significantly
15 undercapitalized based on their "negative core capital," "negative
16 total equity" or their positions below the "Requirement Minimum
17 Capital." The responses and the declaration only show that,
18 looking back at the financial metrics, the FHFA believes that the
19 Enterprises at the relevant time met the statutory definition of
20 "significantly undercapitalized."
21

22 Thus, the FHFA has not presented evidence that it acted
23 pursuant to its conservatorship powers authorized under
24 § 4616(b)(4). Section 4623(d) does not limit the Court's
25 jurisdiction to hear Plaintiffs' claims.
26
27
28

1 In sum, neither § 4617(f) nor § 4623(d) of Title 12 of the
2 United States Code bars judicial review of Defendants' directive
3 on PACE financing.

4 II. Administrative Procedures Act

5 Plaintiffs allege that Defendants' rule on PACE obligations
6 failed to comply with the notice and comment requirements of, and
7 was arbitrary and capricious in violation of, the APA, 5 U.S.C.
8 §§ 553, 706(2)(D).

10 A. Requirements for judicial review under the APA

11 To invoke judicial review of agency action under the APA,
12 Plaintiffs must demonstrate prudential standing. Prudential
13 standing is a "purely statutory inquiry," rather than a
14 constitutional test, and determines "whether a particular
15 plaintiff has been granted a right to sue by the statute under
16 which he or she brings suit." City of Sausalito v. O'Neil, 386
17 F.3d 1186, 1199 (9th Cir. 2004). "For a plaintiff to have
18 prudential standing under the APA, 'the interest sought to be
19 protected by the complainant [must be] arguably within the zone of
20 interests to be protected or regulated by the statute . . . in
21 question.'" Nat'l Credit Union Admin. v. First National Bank &
22 Trust Co., 522 U.S. 479, 488 (1998) (alteration in original). The
23 test requires that "we first discern the interest 'arguably . . .
24 to be protected' by the statutory provision at issue; we then
25 inquire whether the plaintiff's interests affected by the agency
26 action in question are among them." Id. at 492. A plaintiff is

1 outside a provision's zone of interest where "the plaintiff's
2 interests are so marginally related to or inconsistent with the
3 purposes implicit in the statute that it cannot reasonably be
4 assumed that Congress intended to permit the suit." Clarke v.
5 Securities Industry Ass'n, 479 U.S. 388, 399 (1987).

6 The governmental Plaintiffs satisfy the requirements for
7 prudential standing. The parties agree that the paramount goal of
8 the Safety and Soundness Act is to protect the stability and
9 ongoing operation of the residential mortgage market, and the
10 interests of the state and municipalities depend on its stability.
11 California and its municipalities have created a system of state
12 and local laws and assessments, and they establish budgets that
13 hinge on a functional real estate market. A healthy mortgage
14 market is a foundational element of the real estate market.
15 Although Congress has not expressed a specific purpose to benefit
16 state and local governments through the Safety and Soundness Act,
17 the governmental Plaintiffs share an interest in a safe and
18 sustainable secondary mortgage market and suffer as a result of a
19 faltering mortgage market. Defendants' contention that Plaintiffs
20 have improperly sued under a theory of parens patriae is not
21 persuasive because the governmental Plaintiffs are representing
22 their own state and municipal interests, not the interests of
23 particular residents. The governmental Plaintiffs are within the
24 zone of interests of the Safety and Soundness Act.
25
26
27
28

1 Under the APA, judicial review is only permissible for final
2 agency action. 5 U.S.C. § 704. Defendants contend that the
3 FHFA's actions amounted to informal, non-final guidance. "For an
4 agency action to be final, the action must (1) 'mark the
5 consummation of the agency's decisionmaking process' and (2) 'be
6 one by which rights or obligations have been determined, or from
7 which legal consequences will flow.'" Ore. Natural Desert Ass'n
8 v. U.S. Forest Serv., 465 F.3d 977 (9th Cir. 2006). To determine
9 whether the consummation prong of the test has been satisfied, the
10 court must make a pragmatic consideration of the effect of the
11 action, not its label. Id. at 982, 985. The finality requirement
12 is satisfied when an agency action imposes an obligation, denies a
13 right, or fixes some legal relationship as a consummation of the
14 administrative process. Id. at 986-87. "An agency action may be
15 final if it has a 'direct and immediate . . . effect on the day-
16 to-day business' of the subject party." Id. at 987 (alteration in
17 original).

18
19
20 In its July 2010 statement, the FHFA adopted the view that
21 PACE programs that establish first liens are inconsistent with
22 requirements contained in Fannie Mae's and Freddie Mac's Uniform
23 Security Instruments. FAC, Ex. A, at 10. The FHFA announced that
24 mortgages with such encumbrances were not suitable for purchase by
25 the regulated entities. Its statement affirmed that the prior
26 lender letters issued by Fannie Mae and Freddie Mac, alerting
27 sellers and servicers that first liens run contrary to their
28

1 Uniform Security Instruments, would "remain in effect." The FHFA
2 arrived at this conclusion after "careful review" and "over a year
3 of working with federal and state government agencies." Indeed,
4 the FHFA expressly conveyed its intent to "pause" PACE programs
5 that include first liens. See id. The statement had a legal
6 effect because it immediately imposed on the regulated entities
7 obligations to take certain actions and it could reasonably be
8 read to provide a basis for an enforcement action should the
9 entities have chosen to continue purchasing mortgages encumbered
10 by PACE liens. The Safety and Soundness Act authorizes the FHFA
11 Director to take enforcement action against regulated entities to
12 police their lawful operation. See e.g., 12 U.S.C. § 4631(a)(1).
13 The FHFA's July 2010 statement constituted a final action.
14

15 B. Notice and comment requirement

16 Any regulations issued by the FHFA Director pursuant to the
17 agency's general regulatory authority shall comply with the APA's
18 requirements for notice and comment. 12 U.S.C. § 4526(b).
19

20 "Interpretative rules" are exempt from the notice and comment
21 requirements. 5 U.S.C. § 553(b)(3)(A). The interpretive rule
22 exemption is narrowly construed. Flagstaff Medical Center, Inc.
23 v. Sullivan, 962 F.2d 879, 885 (9th Cir. 1992). A court need not
24 accept an agency's characterization of its rule. Hemp Industries
25 Ass'n v. DEA, 333 F.3d 1082, 1087 (9th Cir. 2003). "There is no
26 bright-line distinction between interpretative and substantive
27 rules." Flagstaff, 962 F.2d at 886.
28

1 An interpretive rule is one "'issued by an agency to advise
2 the public of the agency's construction of the statutes and rules
3 which it administers.'" Erringer v. Thompson, 371 F.3d 625, 630
4 (9th Cir. 2004) (citing Shalala v. Guernsey Mem'l Hosp., 514 U.S.
5 87, 88 (1995)). "Because they generally clarify the application
6 of a law in a specific situation, they are used more for
7 discretionary fine-tuning than for general law making."
8 Flagstaff, 962 F.2d at 886.

9
10 "If the rule cannot fairly be seen as interpreting a statute
11 or a regulation," and if it is enforced, it is not an interpretive
12 rule. Catholic Health Initiatives v. Sebelius, 617 F.3d 490, 494
13 (9th Cir. 2010). "To fall within the category of interpretive,
14 the rule must derive a proposition from an existing document whose
15 meaning compels or logically justifies the proposition. The
16 substance of the derived proposition must flow fairly from the
17 substance of the existing document." Id. (internal quotation
18 marks omitted). If the relevant statute or regulation consists of
19 "vague or vacuous terms--such as 'fair and equitable,' 'just and
20 reasonable,' 'in the public interest,' and the like--the process
21 of announcing propositions that specify applications of those
22 terms is not ordinarily one of interpretation, because those terms
23 in themselves do not supply substance from which the propositions
24 can be derived." Id. at 494-95.

25
26
27 Substantive rules, sometimes referred to as legislative
28 rules, "create rights, impose obligations, or effect a change in

1 existing law pursuant to authority delegated by Congress."
2 Erringer, 371 F.3d at 630. The Ninth Circuit explains that
3 substantive rules have the "force of law," while interpretive
4 rules do not, and has adopted a three-part test for determining
5 whether a rule has the "force of law":

- 6 (1) when, in the absence of the rule, there would not
7 be an adequate legislative basis for enforcement
8 action;
- 9 (2) when the agency has explicitly invoked its
10 general legislative authority; or
- 11 (3) when the rule effectively amends a prior
12 legislative rule.

12 Erringer, 371 F.3d at 630 (citing Hemp Indust., 333 F.3d at 1087).

13 Plaintiffs argue that the FHFA's directives against PACE
14 programs with a first lien feature constitute a substantive rule
15 because (1) they announced a "flat ban" against such encumbrances
16 and thus amounted to general-lawmaking; (2) they had the force of
17 law and created a basis for enforcement; (3) they were issued
18 pursuant to statutory authority; and (4) they changed a prior
19 policy.
20

21 Plaintiffs rely on Catholic Health Initiatives, 617 F.3d at
22 490. There, a non-profit charitable corporation and its
23 affiliated non-profit hospitals challenged a rule describing
24 "reasonable costs" related to the care of Medicare beneficiaries.
25 In general, malpractice, workers' compensation and other liability
26 insurance premiums are considered by the Department of Health and
27 Human Services (HHS) to be part of a hospital's "reasonable costs"
28

1 incurred in providing services to Medicare beneficiaries and, as
2 such, are reimbursable. Id. at 491. The Secretary of HHS had
3 issued a Provider Reimbursement Manual containing guidelines and
4 policies to implement Medicare regulations setting forth
5 principles for determining the reasonable cost of provider
6 services. A provision in the manual disallowed reimbursements for
7 insurance premiums paid to certain off-shore insurance
8 corporations, known as "captives," often established by health
9 care providers, where the corporations' investments failed to
10 comply with certain requirements, such as a ten percent limit on
11 equity investments and other restrictions. Id. at 492. Assuming
12 without deciding that the manual's investment limitations were an
13 "extension" of and consistent with the reasonable cost provisions
14 of the Medicare Act and its regulations, the court concluded that
15 the limitations did not represent an interpretation of the statute
16 or its regulations. Id. at 496. The court noted that it might
17 have been "a closer case if the Secretary's Manual had indicated
18 that premiums paid to financially unstable captive offshore (or
19 domestic) insurance companies do not represent 'reasonable costs.'
20 But [the provision] embodies a 'flat' rule, and the 'flatter' a
21 rule is, the harder it is to conceive of it as merely spelling out
22 what is in some sense latent in the statute or regulation." Id.
23 at 496 n.6. The manual's investment requirements were "simply too
24 attenuated" from the reasonable cost provisions of the Medicare
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1 Act to represent an interpretation of the statutory terms. Id. at
2 496.

3 The "safe and sound" operation of the Enterprises' business
4 is likewise a vague phrase. The FHFA's July 2010 statement gives
5 substance to the duties of the regulated entities to conduct their
6 operations in a "safe and sound" manner because the statutory
7 language alone does not compel a rule barring the purchase of all
8 mortgages with PACE first liens. The FHFA's statement that PACE
9 first liens "present significant safety and soundness concerns,"
10 such that mortgages encumbered by them are not suitable for
11 purchase, is a categorical ban. The rule is flat in the sense
12 that it is a bright-line standard.

13
14 Without the FHFA's July 2010 pronouncement it is unlikely
15 that the agency would have a basis for an enforcement action
16 against the regulated entities because the safety and soundness
17 duty is vague and non-specific.

18
19 This case is distinguishable from Erringer, where the Ninth
20 Circuit held that the Medicare Act contained a standard of
21 approval for Medicare beneficiaries' claims and that HHS
22 guidelines issued to claims-processing contractors were
23 interpretive. In Erringer, a class of Medicare beneficiaries
24 challenged rules issued by the Secretary of HHS giving criteria to
25 contractors in creating Local Coverage Determinations (LCDs). The
26 Secretary issued National Coverage Determinations (NCDs),
27 excluding certain items and services from Medicare coverage that
28

1 were not "reasonable and necessary" under the Secretary's
2 interpretation. The contractors generally relied on the NCDs in
3 processing claims. However, the contractors were required to
4 create and use LCDs to determine what claims were covered under
5 Medicare, and at what amounts, when no NCD applied to a claim.
6 The beneficiaries argued that the Secretary's criteria governing
7 the creation of LCDs should be subject to the APA's notice and
8 comment requirement. The Ninth Circuit reasoned that the
9 guidelines were interpretive because, even without them, the
10 contractors would have an over-arching duty to provide Medicare
11 coverage that was reasonable and necessary.
12

13 The holding that the Secretary's general guidelines for the
14 creation of the LCDs were interpretative does not establish that
15 the specific directives made by the FHFA here were interpretive.
16 As noted earlier, the requirement that the regulated entities
17 operate in a safe and sound manner is a non-specific mandate; it
18 is a less precise requirement than Medicare contractors' statutory
19 duty to provide coverage for treatments that are reasonable and
20 necessary to cure disease and alleviate illness. A given medical
21 diagnosis or condition is bound to compel certain reasonable and
22 necessary treatment as determined by medical professionals. In
23 comparison to the guidelines for approving Medicare claims, the
24 FHFA's directives barring the purchase of mortgages encumbered by
25 PACE first liens is not compelled by the statutory mandate that
26
27
28

1 the FHFA ensure that the regulated entities operate in a safe and
2 sound manner.

3 Furthermore, as the Court previously noted in connection with
4 its conclusion that the FHFA acted as a regulator, here the FHFA's
5 handling of its rule-making pertaining to private transfer fee
6 covenants supports a finding that the FHFA's PACE directives
7 amounted to substantive rule-making. The FHFA utilized the notice
8 and comment process with respect to its proposed rule restricting
9 the regulated entities from purchasing mortgages on properties
10 encumbered by private transfer fee covenants because such
11 covenants were deemed to undermine the safety and soundness of
12 their investments. 75 Fed. Reg. 49932 (Aug. 16, 2010). In that
13 analogous instance, the FHFA deemed it appropriate to comply with
14 the APA notice and comment requirements.
15

16 The FHFA's directives on PACE obligations amount to
17 substantive rule-making, not an interpretation of rules that would
18 be exempt from the notice and comment requirement. The notice and
19 comment process must be followed.
20

21 C. Arbitrary and capricious action

22 In addition to their procedural notice and comment claim
23 under the APA, Plaintiffs allege a substantive claim that the
24 FHFA's directives are arbitrary and capricious. Under § 706(2)(A)
25 of the Act, "an agency action may be found unlawful by a reviewing
26 court and set aside, if it is found to be arbitrary, capricious,
27 an abuse of discretion or otherwise not in accordance with law."
28

1 5 U.S.C. § 706(2)(A). Plaintiffs have stated that, if the Court
2 rules that the FHFA violated the APA by failing to carry out the
3 notice and comment process, as the Court has done above, it need
4 not reach their claim that the directives were arbitrary and
5 capricious. See Sprint Corp. v. FCC, 315 F.3d 369, 377 (D.C. Cir.
6 2003).

7
8 The Court notes that the FHFA has begun the notice and
9 comment process pursuant to the preliminary injunction that the
10 Court granted earlier in this case. On January 26, 2012, the FHFA
11 issued an Advance Notice of Proposed Rulemaking seeking comment on
12 whether the restriction set forth in the July 2010 statement and
13 the February 2011 letter should be maintained. 77 Fed. Reg. 3958.
14 The FHFA received 33,000 comments in response to the notice. 77
15 Fed. Reg. 36086. On June 15, 2012, the FHFA issued a Notice of
16 Proposed Rulemaking and Proposed Rule concerning underwriting
17 standards for Fannie Mae and Freddie Mac related to PACE programs.
18 Id. The ninety-day comment period ends on September 13, 2012.

19
20 Docket No. 193. In turn, the FHFA is required to issue a
21 regulation within a reasonable time. Thus, on Plaintiffs'
22 suggestion, the Court declines to rule on the arbitrariness of the
23 FHFA's directives.

24 III. NEPA Claims

25
26 As with their claim of arbitrariness under the APA,
27 Plaintiffs assert that the Court need not resolve the merits of
28 their NEPA claim if the Court holds that the FHFA was required to

1 pursue the notice and comment process prior to issuing its
2 directives as to the PACE loans. Given the Court's order that the
3 ongoing notice and comment process continue, the Court declines to
4 resolve the NEPA claim in this case.

5 CONCLUSION

6 Plaintiffs' motion for summary judgment is granted with
7 respect to their notice and comment claim under the APA, and
8 Defendants' cross-motion for summary judgment on the claim is
9 denied. For the reasons explained above, the Court finds it
10 unnecessary to rule on the remaining claims under the APA and the
11 NEPA.

12 Accordingly, the FHFA shall complete the notice and comment
13 process and publish a final rule to consummate that process. The
14 parties shall attempt to agree to an appropriate deadline for
15 publication of the final rule and notify the Court of that date,
16 or, if the parties cannot agree, Plaintiffs shall submit an
17 administrative motion, pursuant to the Northern District of
18 California's Local Rule 7-11, for the Court to impose a deadline.
19 Defendants shall respond in accordance with the Local Rule. The
20 Court retains jurisdiction of this action as necessary to ensure
21 compliance with this order.

22 IT IS SO ORDERED.

23 Dated: 8/9/2012

24
25 
26 CLAUDIA WILKEN
27 United States District Judge
28