The Government Shareholder: Regulating Public Ownership of Private Enterprise

Benjamin A. Templin, *Thomas Jefferson School of Law*
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Benjamin A. Templin†

During the subprime financial crisis of 2007-2009,1 the U.S. transformed its policies from a focus on privatization and deregulation to one where the government plays an active role as a market participant.2 By the end of the 2009 fiscal year, the U.S. government became one of the largest shareholders in the world owning a portfolio of investments valued at $959 billion.3 The investments made in response to the financial crisis alone were valued at $512.3 billion.4 Some political pundits condemned the

† Associate Professor, Thomas Jefferson School of Law. The author wishes to thank Wade Pfau, Hirokazu Takizawa, Bryan Wildenthal, Julie Greenberg, Richard Winchester, Susan Duncan, David Fortner, Kara Shacket, Shahrad Mobasseri, Peter Goatz, Julie Kulas, Stephanie Sciarani, and Joan Jiang. Any errors are those of the author, and the opinions expressed here are not necessarily those of the people who graciously gave their time to share ideas and comment on this article. Earlier versions of this article were presented as works in progress at the Japan Economic Policy Association annual meeting and the Canadian Law & Economic Association annual meeting.

1 Throughout this article, the term “financial crisis” refers to the credit crisis that is generally acknowledged to have started in early 2007 as subprime lenders began to fail and which started to stabilize by the end of 2009. At publication, it’s far from clear that the financial crisis is truly over, given continued high unemployment rates and volatility in the markets. Steven M. Davidoff & David Zaring, Regulation by Deal: The Government’s Response to the Financial Crisis, 61 Admin. L. Rev. 463, 471 (2009).


3 Government Accountability Office, 2009 Financial Report of the U.S. Government, 49 (November 2009) This figure takes into account assets on the government’s balance sheet that consist of Loans receivable and mortgage backed securities ($538.9 billion), TARP direct loans and equity investments ($239.7 billion), Beneficial interest in trust ($23.5 billion), Securities and investments ($93.1 billion), and Investments in Government sponsored enterprises ($64.7 billion). Id.

4 Id. This figure consists of the following assets: GSE Mortgage Backed Securities ($184.4 billion), TARP direct loans and equity investments ($239.7 billion), Beneficial interest in trust ($23.5 billion), and Investments in Government sponsored enterprises ($64.7 billion). Id.
investments as socialism. Yet, the mere ownership of stock in a private enterprise by the U.S. government does not indicate a socialist political economy; nor is it the first time that the U.S. had an ownership interest in financial institution. Historically, the U.S. government has taken an ownership interest in national banks in order to further the country’s economic interests.

The sudden increase in the government portfolio is better understood as a Keynesian response to market failure rather than a change in the political economy. The growth in government ownership was driven by the government’s deal-making approach to the financial crisis that started with a series of forced sales of financial institutions supported by government loans and evolved into direct equity investments by the U.S. Department of Treasury. However, given the pace at which the government operated in response to the evolving crisis, the dramatic increase in the government portfolio strained the capacity of the U.S. political and bureaucratic establishments to effectively and efficiently make and manage the investments.

While the federal investments are credited in part with restoring confidence in the financial markets, the government ownership of large stakes in private enterprise raises numerous legal, ethical and policy issues. Can the government effectively

Government sponsored enterprises ($64.7 billion). Id. at 49 & 65.
10 OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, SIGTARP: APRIL 10, 2010 QUARTERLY REPORT TO THE CONGRESS 5 (2010). Although stability in the financial markets was attained by 2010, there were still concerns about the long viability of the recovery given high unemployment, continuing problems at regional banks and a struggling real estate market. Id.
and ethically manage a portfolio of investments in companies as a shareholder when it is also charged with regulating those same companies? To what extent does the government mandate to pursue the public interest, such as reducing unemployment, conflict with corporate duties to maximize shareholder value? Have the bailouts created an implicit government guarantee that creates a new set of moral hazards? Has a political economy in which entrepreneurial capitalism plays a central role been irrevocably harmed by government bailouts of inefficient firms?

The Obama administration promise a swift exit from the government investments, however estimates suggest that Treasury will hold some stock bought through the Housing and Economic Recovery Act of 2008 (HERA), the Emergency Economic Stabilization Act of 2008 (EESA) and the American Recovery and Reinvestment Act of 2009 (ARRA) for the next decade. The need to prior to the government response to the financial crisis, a need existed to address problems posed by government investment. Over the last 30s, the U.S. government on both a state and federal level have significantly increased public investment in private firms in order to advance policy goals in economic and technology development.

As a prescriptive goal, this article attempts to define institutional norms and rules of the game that allow and encourage government investment while preserving the free market economic principles that drive growth and foster innovation. The article attempts to reconcile the reality of massive government investment

090909-report.pdf: (Raising questions over the conflict of interest apparent when the government owns shares in two competitors – i.e. Chrysler and General Motors. Id.


with the liberal market economy that provide for private incentive and entrepreneurial innovation. In this proposed model, the state would participate as a market actor according to the rules of a liberal market economy. This article uses the term “state entrepreneurism”\textsuperscript{17} to differentiate such a model from one of state capitalism or coordinated market economies.\textsuperscript{18} At the core of the prescriptive regulatory proposal are three principles: (1) there must be political insulation of the investment decision and management of assets by creating an independent investment authority, (2) ethical walls should be created between the investment authority and the regulatory agencies overseeing private enterprise and (3) the investment authority should be required to act as a prudent investor with the goal of maximizing the return on any given investment (ROI). In applying these principles, this article defines a typology of government investments that includes five categories: (1) infrastructure investments, (2) social investments, (3) political investments, (4) economic investments and (5) financial investments. The typology helps define the measures of success of a particular investment. The ROI of a financial investment should be measured by the amount of wealth created; whereas the ROI of a social investment should be measured by the degree to which the social goal is achieved. This does not mean that social investments are those where the government can squander taxpayer dollars without regard to cost. Regardless of the investment type, the government should be constrained to act as a prudent investor according to the context.

Any discussion of a regulatory regime for government investment necessarily requires a discussion of the nature and evolution of the political economy. Section I of this article discusses the political economy of government investment by drawing upon the theories of comparative capitalism put forward

\textsuperscript{17} Peter K. Eisinger was perhaps the first to identify the state’s emergence as an entrepreneurial market participant in an influential study of government investment, \textit{Peter K. Eisinger, The Rise of the Entrepreneurial State: State and Local Economic Development Policy in the United States} 257 (Univ. of Wis. Press 1988).

\textsuperscript{18} This article does not attempt to define an entirely new typology of capitalism, rather, the attempt here is to describe institutional norms surrounding government investment, how those institutions are undergoing a redefinition and how new norms might be put into place that would comport with well-accepted models of capitalism in order to achieve agreed upon social goals of funding social welfare programs without adversely affecting innovation and growth.
by the new institutionalism school. New institutionalism provides the theoretical framework for discussing the formal and informal norms that constrain a particular type of economy and how those norms are subject to change. Given the analytic tools provided by new institutionalism, Section III assesses U.S. government investment normatively – evaluating the successes and failures and establishing the institutional norms by which the U.S. government manages its investments. Section II offers a prescriptive solution to the problems posed by government investments in the form of a set of institutional norms meant to maximize the efficiency of government investments within liberal market economies while reducing the risks of ethical misconduct.

I. Capitalism and the Political Economy of Government Investment

In recent years, there has been much research in the area of comparative capitalism. Since the end of the Cold War, many economists have focused on the differing forms of capitalism that emerged in Eastern Europe and Asia in comparison to those that exist among developed countries. Attempts have been made to understand why different forms of political economy flourish in different cultures. The role and degree of government investment has been an important factor in comparative capitalism studies. Some form of government investment exists in every type of political economy, though differences occur in the scope, type and manner of investment.

As a preliminary matter, the field of comparative capitalism attempts to describe the make-up of the different types of capitalism. While numerous typologies surfaced, there has been little agreement among scholars as to how to label capitalist systems or how many different varieties exist. A number of

21 Mary Nolan, Anti-Americanism and Americanization in Germany, 33 POL. & SOC’Y 88-122, 88, 103 (2005).

Most economists involved in comparative capitalism studies are interested not only in descriptive typologies, but also seek to understand why different types of political economies emerge, the process by which economies change and the normative implication of various types of capitalism. To accomplish this task, economists examine the institutions – i.e. the rules of the game – by which political economies operate. These normative models and the study of institutional change are important to understanding how and why government investment emerged during the financial crisis and also to developing a set of institutions that shape the

32 ANDREAS G. PAPENDREOU, PATERNALISTIC CAPITALISM (Univ. of Minnesota Press 1972) (1956).
role of government investment in a liberal market economy.

One important development in comparative capitalism studies was Hall and Soskice’s “varieties of capitalism” school. In this model, political economies tend to gravitate to one of two types – either a liberal market economy (LME) or a coordinated market economy (CME). Neither type is normatively superior; rather the existence of one type depends on cultural and historical forces. Moreover, the varieties of capitalism school suggests that path dependence makes it inefficient for a political economy to shift significantly from one form to another. Recently, the dualist notion of two polar opposites has been challenged, and a more nuanced model has emerged that blends different attributes and recognizes that political economies are neither static nor path dependent. This section first discusses comparative capitalism literature in order to give a theoretical foundation to understanding how government investment changed in the U.S. The article then considers the economic policies of the U.S. and the political debate between monetarism and Keynesianism.

A. The Varieties of Capitalism Approach and New Institutionalism

Hall & Soskice’s varieties of capitalism model is considered the dominant paradigm for comparative capitalism studies. The varieties of capitalism approach draws deeply upon the new institutionalism school of thought, where political economies are thought to be comprised of a series of institutions or rules that govern market actors. To consider varieties of capitalism, one must also delve into new institutionalism. New institutionalism attempts to explain the development of rules of the

36 Id. at 20-21.
37 Id. at 12-14.
game – both formal and informal – that constrain the behavior of people and firms. New institutionalism theory has found support among socioeconomists, sociologists, political scientists and law and economics scholars, though differences exist between the disciplines.\textsuperscript{41}

Economists differ on how they define “institution” though certain themes have emerged. Hall and Soskice rely on Douglas North’s seminal definition of an institution “as a set of rules, formal or informal, that actors generally follow, whether for normative, cognitive, or material reasons.”\textsuperscript{42} Organizations are distinguished from institutions and are defined as “durable entities with formally recognized members, whose rules also contribute to the institutions of the political economy.”\textsuperscript{43} Aoki broadly defines institution as a “rule of the game” that includes both exogenously and endogenously-generated codified laws and social norms, but he adds an insight that the rules consist of “\textit{shared beliefs about the ways how the game is to be played}.”\textsuperscript{44} Crouch defines institutions as “patterns of human action and relationships that persist and reproduce themselves over time, independently of the identity of the biological individuals performing within them.”\textsuperscript{45}

Despite different definitions, economists generally agree that institutions include both formal rules (constitutions, codified laws, regulations, judicial decisions, etc. regarding both public and private law) that actors must follow or risk legal penalties (both civil and criminal) and informal rules (norms, customs, etc.) that actors are not legally bound to follow but which they comply with because to do otherwise could result in a non-official penalty. Institutions constrain behavior in that firms are bound to act according to the dictates of the institution. The bulk of new

\textsuperscript{41} New institutionalism in the study of economics differs from new institutional theories in sociology, political science, etc. \textit{Id}. at 5-6. This article is limited to a discussion of new institutionalism in the socioeconomics literature surrounding comparative capitalism studies. The paper does not consider the law and economics approach to new institutionalism.

\textsuperscript{42} \textit{Peter A. Hall & David Soskice, Varieties of Capitalism: The Institutional Foundations of Comparative Advantage} 1, 9 (Oxford Univ. Press 2001).

\textsuperscript{43} \textit{Id}.


\textsuperscript{45} \textit{Colin Crouch, Capitalist Diversity and Change: Recombinant Governance and Institutional Entrepreneurs} 10 (Oxford Univ. Press 2005).
institutional literature focuses on institutional change in order to understand how a society might modify the rules of the game that govern the political economy.

Hall & Soskice use new institutionalism to explain the mechanisms by which different political economies operate. Through a rigorous analysis of political economies, Hall & Soskice divided developed capitalist systems into two primary types—liberal market economies (LMEs), such as the United States and the United Kingdom, and coordinated market economies (CMEs), such as those found in Germany and Japan. The emergence of a particular type of capitalism in a country depends upon its culture, informal rules and history. While the dualist analysis to comparative capitalism preceded their approach, Hall & Soskice conclude that neither type is normatively superior to the other in terms of producing lower inflation and higher rates of growth and employment. Rather, each type displays a comparative institutional advantage as to developing certain types of industries and products. According to Hall & Soskice, the institutional make-up of each type allows firms within a particular economy “to produce some kinds of goods more efficiently than others because of the institutional support they receive for those activities in the political economy.”

LMEs are characterized by a neoclassical economic model where transactions occur in a competitive market. The institutions that characterize an LME include open competition, arm’s length negotiations between actors and formal contracting.

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46 Peter A. Hall & David Soskice, Varieties of Capitalism: The Institutional Foundations of Comparative Advantage 1, 8 (Oxford Univ. Press 2001). Hall & Soskice sought to explain the differences in political economies by studying the firm as the primary actor in any given economy and how the firm, in defining core competencies, develops relationships in five spheres – industrial relations, education, corporate governance, inter-firm relationships and employee relations. Id. at 1-7. By linking microeconomic game theory analysis of the firm into macroeconomics, Hall & Soskice merged business studies with the study of comparative political economies. Id. at 5.

47 Id. at 12-14.

48 Id. at 20-21. Hall & Soskice note that the two forms also display differences in the distribution of incomes (LMEs have a high income disparity) and employment (CMEs usually have a shorter working week). Id.

49 Id. at 37. This insight provided a scholarly basis for challenging the assumptions of globalization – i.e. that by opening markets, the world’s economies would converge and evolve to neoliberal political economies. Colin Crouch, Capitalist Diversity and Change: Recombinant Governance and Institutional Entrepreneurs 25-26 (Oxford Univ. Press 2005).

50 Id. at 8.
markets are fluid in an LME and labor unions are generally not as strong as in CMEs.\footnote{Hall, supra note 47, at 29-30.} In an LME, corporate governance is considered an ‘outsider’ system where there is dispersed ownership of a firm and a liquid securities market contributing to diversified portfolios.\footnote{Beth Ahlering & Simon Deakin, Labor Regulation, Corporate Governance, and Legal Origin: A Case of Institutional Complementarity?, 41 LAW & SOC’Y REV. 865, 872-3 (2007).} Since shareholders can diversify their risk, outsider systems are more conducive to financing companies that engage in entrepreneurial risk-taking ventures, which results in a higher degree of radical innovation in areas such as financial services and technology.\footnote{Alan Dignam & Michael Galanis, Corporate Governance and the Importance of Macroeconomic Context, OXFORD J. LEGAL STUD. (June 18, 2008).} Under this model, the role of government investment in an LME would be minimal – occurring when there is market failure rather than as a regular course of business.

CMEs differ from LMEs in that “firms depend more heavily on non-market relationships” to shape economic relationships.\footnote{Id.} In CMEs, the various actors work collaboratively rather than competitively.\footnote{Beth Ahlering & Simon Deakin, Labor Regulation, Corporate Governance, and Legal Origin: A Case of Institutional Complementarity?, 41 LAW & SOC’Y REV. 865, 872-3 (2007).} CMEs are typically considered “insider” systems as to corporate governance. Ownership is concentrated so there is not as much separation of ownership and control as in LMEs. Maximization of profit is less important in CMEs than in LMEs. CMEs adopt a stakeholder theory of the firm where labor unions coordinate with both government and managers.\footnote{Id.} The economy of a CME gravitates towards capital intensive industries where innovation is incremental.\footnote{Id.} Government investment is more likely to thrive in a CME given that the state is seen as a partner with firms. CMEs occur in political systems characterized as social democracies where Keynesian economic policies predominate, whereas LMEs are associated with neoliberalism\footnote{Colin Crouch, Capitalist Diversity and Change: Recombinant Governance and Institutional Entrepreneurs 27-29 (Oxford Univ. Press 2005).} and the neoclassical, free-market approach.\footnote{Mary Nolan, Anti-Americanism and Americanization in Germany, Politics &}
One of the most intriguing questions to surface in comparative capitalism studies is the degree to which a particular form of capitalism can thrive by adopting the institutional rules of the game normally found in other types of capitalism. In other words, is there an adverse effect on the long-term economic output as well as the integrity of the political economy if a LME adopts an institution normally found in a CME? This question is central to this article’s analysis given that the U.S. government used the rules of the game of a CME in response to the financial crisis by choosing the winners and losers.

Hall & Soskice conclude that political economies suffer when adapting institutions not normally found within its type because of the theory of institutional complementarities. Institutions are “complementary if the presence (or efficiency) of one increases the returns from (or efficiency) of the other.” Hall & Soskice argue that LMEs will likely have market driven rules of the games in all spheres of the economy, and that CMEs will have coordinated rules of the games across the economy. For example, a labor force subject to market governance will more likely thrive if there is also a financial system governed by the market since the fluidity of capital creates new jobs thus keeping demand for workers high. Thus, Hall & Soskice argue that the tendency is for political economies to develop either as an LME or CME. A more mixed economy would underperform given that the institutions of a coordinated economy would not complement (or make more efficient) the institutions of a liberal market economy. Critics of the Obama administration’s investment in the Chrysler and General Motors (GM) might have used the theory of 12 complementarities to argue that such a coordinated approach has and will continue to damage the efficiency of the neoliberal financial markets. Under this analysis, the government’s attempted bailout and subsequent ownership of a large stake in GM preempted the bondholders from seeing a return on their investment given the inevitable bankruptcy of the firm. This will likely make money managers less willing to invest in a company’s bonds if they think that the government may seek to take away their right to ownership in case of a bankruptcy. With less fluid financial markets, businesses cannot access capital, thus affecting job growth and the labor markets.

Society; vol. 33; p. 88,103 (2005).

60 Hall, supra note 47, at 17-21.

61 Id. at 18.

62 Id.
Economists differ on how an institution develops. Some new institutionalists use path dependence theory to describe how an institution gains dominance. Path dependence theory suggests that actors in an economy adopt certain rules of the game that become ingrained in their behavior. Actors might initially be presented with two equally viable rules, but the adoption of one rule increases the probability of the actor choosing the same rule when presented with the choice again. Formal institutions – whether constitutional, legislative, administrative or judicial – are influenced by the political process “with its conflicts of interest, mobilizations of coalitions, and arbitrary trade-offs.” Likewise, informal social institutions may gain dominance through a power dynamic as well. A certain group of actors benefits by the adoption of a particular rule of the game. Through a self-reinforcement mechanism, the group that benefits will seek to make the adoption of the rule permanent in order to continue to reap the rewards of the rule. An institution may also gain dominance because the “learning curve” to take an alternate route serves to reinforce prior behavior. When presented with two equally viable paths – both of which require that an actor learn a procedure – it is more efficient for an actor to choose the path with which he is already familiar since he does not have to learn a new procedure. After repeated iterations, an actor may continue with the known path even if it begins to fail since “all competence at the discarded approach has been lost.” Because of path dependence, some new institutionalists contend a particular form of capitalism will not transmute or evolve into another form once it gains dominance.

The rule of the game that comprises a particular institution are distinguished from its governance. Governance of an institution consists of enforcement mechanisms used to constrain actors to follow the rule. The constraint on behavior which characterizes a

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64 Id. at 75-76. This can be understood as the first-mover advantage. An actor is more likely to use the same rules that he is already familiar with. Id. at 75.
65 Id. at 7.
66 Id. at 80.
67 Id.
68 Id. at 78-80.
69 Id. at 79.
70 Id.
71 Id. at 74.
72 Id. at 12.
rule as an institution may be enforced externally through formal laws and through informal “normative pressures and expectations” put upon each actor to follow the rules of the game.\(^7\) Governance might include “the state, the market, corporate hierarchies, associations, communities, clans, networks, and formal law.”\(^7\) Thus, “government is a subset...of governance” and both public and private enforcement may constrain an actor’s choice.\(^7\) Yet it is the constraining nature of an institution coupled with external enforcement mechanisms – both formal and informal – that leads to an underlying tension and “pressure for change” to rules of the game given that “there is always friction between a general rule and its application to individual cases.”\(^7\) In other words, an actor who wishes to maximize his economic benefit may be unable to do so because of the constraints imposed by an institution through governance – i.e. laws and expectations fostered through belief systems and other mechanisms.\(^7\) Such an actor would seek to change the governance in order to change the institution.

How does an institution change? Although the focus here is on the constraint that an institution places on actors, institutions also facilitate actors and “can often be adjusted.” However, such adjustment is not a matter that is “fully subject to human will.”\(^7\) For some new institutionalists, no change can occur once a path is set even if it is economically rational for an actor to adopt different rules.\(^7\) Over time, a particular institution can become so dominant that the path an actor takes becomes predetermined and any attempt to change the behavior meets great resistance.\(^7\) For example, if strict path dependence theory is correct then it would be very difficult for an LME to adopt a rule that is characteristic of a CME, and vice versa, even if such a change were “in all actors’ long-term best interests.”\(^7\) Thus, the strict path dependence theorist stands in sharp contrast to a rational choice theory, which contends that “an institution always needs to be useful to the specific actors who choose to have it, otherwise they would reject it.”\(^7\)

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\(^7\) Id.
\(^7\) Id. at 21.
\(^7\) Id. at 20-21.
\(^7\) Id. at 13.
\(^7\) Id. at 18.
\(^7\) Id.
\(^7\) Id. at 74.
\(^7\) Id. at 1-2.
\(^7\) Id. at 74.
\(^7\) Id. at 13.
A more sophisticated analysis suggests that radical shifts in institutions only occur when there is a profound crisis.\(^{83}\) Institutional innovation occurs when there is a conflict between periods of stability (times when there is “specialization and differentiation”) and periods of change (where institutions recombine and barriers are overcome).\(^{84}\) Clearly, the financial crisis was a period of great and rapid change where the rules of the game suddenly changed. Faced with a collapse of the credit markets, the government adopted the rules and techniques of a CME, which would have likely met considerable resistance in the presence of a healthy economy.

Other theorists contend that major change can occur incrementally over longer periods of time.\(^{85}\) The degree to which an institution may be susceptible to change depends upon the degree an institution is embedded within the “cognitive, cultural, social, structural, [and] political” contexts of a society.\(^{86}\) Some institutions may be strongly embedded (resistant to change even though the rule has outlived its usefulness) or weakly embedded and thus easy to change.\(^{87}\) The key to changing an institution is changing its governance.\(^{88}\) A rule of the game no longer enforced by the state, stakeholders or the community will no longer be considered an institution.\(^{89}\) An institutional entrepreneur who wishes to foster change will seek to change the governing mechanisms that enforce the rule of the game.

An example of attempted institutional entrepreneurism occurred during the Clinton administration with the debate over Social Security reform. In 1999, there was serious discussion that some portion of the Social Security Trust Fund should be moved into a more diversified portfolio that included stocks.\(^{90}\) The move would have been the rational choice since stocks outperform a bond only portfolio over the long term, and there was support from

\(^{83}\) *Id.* at 3. Significant changes that occur in short periods of time are typically followed by long periods where subsequent change is limited to a “closely bounded” range. *Id.* at 74-75.

\(^{84}\) *Id.* at 4.

\(^{85}\) *Id.* at 75.

\(^{86}\) *Id.* at 14-16.

\(^{87}\) *Id.* at 16.

\(^{88}\) *Id.* at 24.

\(^{89}\) *Id.* at 22.

various politicians, think tanks and committees.\footnote{This loose coalition of politicians, analysts and citizens is designated as a collective actor, as opposed to an individual actor.” COLIN CROUCH, CAPITALIST DIVERSITY AND CHANGE: RECOMBINANT GOVERNANCE AND INSTITUTIONAL ENTREPRENEURS 18 (Oxford Univ. Press 2005).} The change would have required changes to both the formal law\footnote{42 U.S.C.A. § 401} and the informal institutional constraint proscribing government investment in anything but government bonds. The governance of this institutional constraint included two strongly held beliefs: (1) that if the government becomes an investor in private enterprise, then it will interfere in corporate governance and (2) that fluctuations in the stock market would affect the ability of the government to pay out benefits.\footnote{Benjamin A. Templin, Full Funding: The Future of Social Security, 52 J. L. & POL. 395, 433 (2006).} President Clinton attempted to change the institution by changing its governance. He and others introduced the idea of addressing Social Security funding through investment in index funds so that the government would not exercise any shareholder vote, thus removing the fear of state meddling in corporate governance. Given the bull market during the late 1990s, there was likely never a better a time to overcome fears of systemic risk. Yet, President Clinton’s attempt failed. Why?

A new institutionalism and path dependence theorist might explain that government investment is not complementary with the neo-liberal stock market. If path dependence theory is correct and if government investment is an institution that aligns with a coordinated market economy, then, barring some cataclysmic event, the implementation of government investment in a LME is unlikely to be successful given the entrenched values and beliefs concerning the practice in the United States. Clinton could not create the political will to effect the change given the embeddedness of the institutions constraining government investment. An alternative explanation is that President Clinton lost political capital to move his policy agenda forward once the Monica Lewinsky scandal broke.\footnote{Michael D.Tanner, Clinton Wanted Social Security Privatized, CATO INSTITUTE, July 13, 2001, available at http://www.cato.org/dailys/07-13-01.html.}

B. Beyond Dualism: Blended Forms of Capitalism

Not surprisingly, the varieties of capitalism approach has its
critics. Crouch contends that the varieties of capitalism school is overly simplistic and deterministic. He sets forth a methodology to move new institutional analysis away from “gloomy determinism and inflexibility” and towards a heterogeneous view of rules that allows institutional entrepreneurs to foster innovation. Crouch argues that breaking the typologies into two dominant forms of capitalism overly simplifies the complexity of political economies and the numerous forms of institutions. Moreover, the varieties of capitalism analysis can also be “over-deterministic, tending to irrevocably characterize certain national systems in particular ways.”

Crouch poses the question of whether models can be developed that allow particular types of capitalism to use and benefit from the institutions and rules used in other types of capitalism. In other words, could an LME benefit from and use the tools characteristics of a CME? To put it in terms of this article, can a model be developed for the United States to adopt a vibrant program of government investment without destroying the traits and innovation characteristic of its liberal market economy? Crouch is optimistic and has lofty goals. He writes, “that in all such work we are ourselves engaging in the construction of paradigms that might (if we are fortunate) start to influence some actors in the real world.”

Crouch lays out his argument empirically and theoretically. From an empirical point of view, Crouch challenges path dependence by documenting “institutional innovation” in California’s high tech industry and the United Kingdom’s transformation “from neocorporatism and Keynesianism towards monetarism and neoliberalism.” Crouch attacks the characterization that LMEs produce radical innovation in future-
oriented industries and CMEs as only producing incremental innovation in traditional industries by pointing to the leadership of Finland and Sweden (both CMEs) in telecommunications “and the Nordic countries generally in medical technologies.”

As a theoretical matter, Crouch proposes a different view of path dependence by advancing a theory of recombinant governance, whereby institutional entrepreneurs can recombine elements of different institutions in order to address economic issues. Crouch demonstrates that “institutional heterogeneity may facilitate innovation, both by presenting actors with alternative strategies when existing paths seem blocked and by making it possible for them to make new combinations among elements of various paths.” Institutional entrepreneurs who are “mindful” of the degree of embeddedness of an institution and have a belief in an alternative rule as creating better results despite imperfect knowledge about the result, have the capacity to improve the probability of the alternative rule succeeding. Given that governance schemes are fragmented between state regulation, the market and society, it becomes easier for institutional entrepreneurs to break down the governance mechanisms and recombine existing elements of an institution to form a new and innovative approach. Crouch is realistic about the ability of institutional entrepreneurs to foster change given that “power asymmetries” may exist to enforce an institution. The existence of functional equivalents – i.e. the availability of many different solutions – can also hamper the introduction of an innovation.

Within the legal academy, there have similarly been attempts to synthesize a theory of governance that embraces the market-based concepts prevalent in law and economics with the top-down regulatory approach advocated by critical legal scholars. Lobel envisions a legal paradigm called “Renew Deal governance” that promotes collaboration among state and non-state actors and leverages new institutional norms to address what he sees as a new form – or at least “the new realities” – of political

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103 Id. at 31.
104 Id. at 3.
105 Id. at 73.
106 Id. at 99-100.
107 Id. at 110-126.
108 Id. at 128.
Lobel and Crouch share a vision in that both advocate and value a heterogeneous view towards institutions and that greater participation of non-state and state actors in governance will yield a more diverse set of tools with which to address economic and social problems. Another important alternative to the dualist approach in comparative capitalism studies is the expanded set of typologies adopted by Baumol, Litan & Schramm. The authors posit that four distinct archetypes of capitalism emerged after the fall of the Berlin Wall in 1989: (1) entrepreneurial capitalism, (2) big-firm capitalism, (3) state-directed capitalism and (4) oligarchic capitalism. Rather than being constrained to just one typology, Baumol, Litan & Schramm argue that in different stages of development, a state might be classified as leaning towards one of the four, but the classification is not static.

Of the four archetypes, Baumol, Litan & Schramm consider entrepreneurial capitalism as having the best chance of exhibiting strong economic growth and fostering innovation. Increasingly some economists have challenged the premise that unrestrained economic growth is desirable or even attainable. Sometimes, unrestrained economic growth results in displacements in the labor workforce, bankruptcies of inefficient firms, harm to the environment and, of course, the tumultuous markets experienced during the financial crisis as the market corrects itself. However,

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110 Id. at 344-349.
111 Id. COLIN CROUCH, CAPITALIST DIVERSITY AND CHANGE: RECOMBINANT GOVERNANCE AND INSTITUTIONAL ENTREPRENEURS 110-126 (Oxford Univ. Press 2005).
113 Id.
114 Id.
115 BILL MCKIBBEN, DEEP ECONOMY: THE WEALTH OF COMMUNITIES AND THE DURABLE FUTURE (Henry Holt 2008). (Arguing that economic growth is not sustainable given the limits of natural resources and environmental concerns over pollution.) Recently much work has been done by policy analysts, government statisticians and economics scholars to develop measures other than GDP to gauge a society’s social advancement. See Jon Gertner, The Rise and Fall of the G.D.P., N. Y. TIMES, May 10, 2010, at MM60. (Noting that some developed nations have worked on measures other than GDP to indicate a nation’s prosperity by gauging overall human development rather than just economic output.) Id. Mark A. Cohen & Michael P. Vandenbergh, Consumption, Happiness, and Climate Change, 38 ENVTL. L. REP. NEWS & ANALYSIS 10834-10837 (2008).
the dominant metric is still gross domestic product.

To achieve economic growth and innovation, Baumol, Litan & Schramm set out four institutional norms of a successful entrepreneurial economy: (1) The creation and dissolution of a business must be simple, efficient and without too much cost or “time-consuming bureaucratic red tape.” In addition, there must be a “well-functioning financial system” providing capital to entrepreneurs and a “flexible labor market” which allows firms to “fire nonperforming workers or shed workers they no longer need.” (2) The institutional rules within the political economy must support property and contract rights so that entrepreneurs are confident that nationalization of their efforts does not occur. Without those assurances, entrepreneurs are unlikely to take on the risk of a new venture. (3) The government must adopt institutional norms that promote Pareto improvement rather than rent-seeking behavior, such as “political lobbying or the filing of frivolous lawsuits designed to transfer wealth from one pocket to another.” (4) The economy should incentivize both entrepreneurs and large firms to “innovate and grow, or else economies will sink into stagnation” by adopting “effective antitrust laws” and promoting free trade.

Baumol, Litan & Schramm describe the U.S. economy as having a blend of big firm and entrepreneurial capitalism thereby blending innovation in business with a strong presence in international trade. The institutions that make up the economy include fluid labor and capital markets, strong contract and property rights, and a regulatory system that favors the market rather than coordination by the government. In such an economy, government investment is typically minimal. Rather than choosing winners and losers, the government’s primary role is as a regulator and not as an owner. However, the recent financial crisis and rise of Keynesian interventionism shifted the institutional balance to include aspects of state-directed capitalism.

In the Baumol, Litan & Schramm model state directed capitalism, or state capitalism, consists of a centrally-controlled

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117 Id.
118 Id.
119 Id.
120 Id.
121 Id.
economy where the government, rather than private investors and entrepreneurs, determines which industries will be pursued within the country and which firms will get the capital to build those industries.\textsuperscript{122} Baumol, Litan & Schramm dismiss communism and socialism as viable economic models and maintain that those political economies disappeared by the end of the Cold War.\textsuperscript{123} Everything remaining, in their view, is a form of capitalism. Although the government may choose the winners, such support does not necessarily mean those industries and firms will be economically successful or efficient without further government support. State capitalism under this view is consistent with Hall & Soskice’s CME category.

In the case of China, state-guided capitalism has worked well to propel what was once a third world country into one of the world’s leading economies, with predictions that it will overtake Japan in 2010 as the world’s second largest economy.\textsuperscript{124} Yet, state-guided capitalism that owns the means of production may stifle innovation. In addition, state capitalism is marred by insider dealings and corruption, thus setting the stage for rent-seeking behavior.\textsuperscript{125} While China has been successful in producing products with cheap labor, the growth has not come without corruption and technological innovation is still elusive in the People’s Republic.\textsuperscript{126} Sometimes, state capitalism is coercive, as when Venezuela nationalized private assets and compensated the owners with less than the fair market value compensation to the owners. Venezuela Hugo Chavez justified his nationalization of foreign owned oil companies in the country by contending that corrupt practices from previous administrations had given favorable contracts to foreign companies holding interests in Venezuela.\textsuperscript{127}

The massive increase in the government portfolio of private

\begin{itemize}
  \item \textsuperscript{122} Id.
  \item \textsuperscript{123} Id.
  \item \textsuperscript{125} WILLIAM J. BAUMOL, ROBERT LITAN & CARL J. SCHRAMM, GOOD CAPITALISM, BAD CAPITALISM, AND THE ECONOMICS OF GROWTH AND PROSPERITY 61-71 (Yale Univ. Press 2007).
  \item \textsuperscript{126} Id.
  \item \textsuperscript{127} Venezuela’s Hugo Chavez Targets Major Foreign Oil Companies in Nationalization Fight, REUTERS, Jan. 16, 2007, available at http://www.foxnews.com/printer_friendly_story/0,3566,243901,00.html. Oil companies such as BP, Chevron, Conoco, Exxon Mobil, Norway's Statoil and France's Total invested $20 billion in projects that were nationalized. Id.
\end{itemize}
investments creates dissonance between the actions of the government and the U.S. political and economic philosophy of a LME. Although the U.S. did not nationalize the banks during the financial crisis, some of the initial EESA investments made under TARP were coercive in that the preferred stock sales were forced on healthy banks. Moreover, the pre-bankruptcy loans to GM and Chrysler were likely politically-driven and subsequent management of the investment amounted to the centralized planning inherent in a state capitalist model. Some commentators suggest the dissonance has been present well before the subprime financial crisis. Block contends that a “hidden development state” funding technology research and development existed since the 1980s and the state’s political rhetoric committing to the free market merely hid that form of state guided capitalism from the public.  

The swings in U.S. economic policy between monetarism and Keynesianism illustrate the way in which the political economy uses institutions from both LMEs and CMEs.


Although U.S. economic policy is classified as neoliberal, it swings on a continuum where the dominant policy sometimes favors Keynesian state interventionism, such as that found in CMEs, and at other times monetarism, which embodies the neoclassical economic theories found in LMEs. Monetarists support small government and minimal regulation under the theory that a market which is allowed to “flourish unhindered will grow and prosper.” To stimulate growth, monetarists contend that a strong monetary policy is the most effective tool against inflation and to

130 Richard P. F. Holt & Steven Pressman, The Role of the State and the State Budget, in A NEW GUIDE TO POST-KEYNESIAN ECONOMICS 103 (Routledge 2001).
spur economic growth. Monetarists think that state intervention results in inefficiencies and reduces personal freedom. Keynesians, however, dispute the efficiency of the markets, and advocate government intervention in the economy through a strong economic policy in order to maximize the utility of capital and labor.

One major dispute between monetarists and Keynesians is the degree to which the market self-corrects. Neo-classical economists believe that wages and prices in the market self-correct such that GDP will find its natural level. Under neo-classical economic theory, a decrease in aggregate demand results in a drop in real GDP that is below its natural level. In other words, there are workers who want to be employed and resources that may be exploited, but prices are too high. Under neoclassical theory, wages will drop naturally arguing that the workforce will accept a lower wage in order to keep employed. Since wages are lower, the cost of producing goods also drops, thus driving down prices. Thus, while aggregate demand decreases, the market self-regulates and corrects with a decrease in price. Real GDP remains the same even though prices have dropped.

Keynes challenged the neoclassical theory that wages and prices adjust to reach a natural level of GDP. Keynes reasoned that prices and wages are “sticky” – i.e. react too slowly – and are not reliable in readjusting imbalances in equilibrium. Prices are slow to adjust because of “rigidities introduced into markets by

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131 MILTON FRIEDMAN, MONETARIST ECONOMICS 11 (Blackwell Publishing 1991).
132 Id.
134 Real GDP is at its natural level when all of the economy’s resources are employed.
135 This article uses the well-accepted definition of aggregate demand as consisting of consumption, investment, government spending and net exports.
137 Id. at 237-238.
producer organizations, the variability of business confidence, and a variety of other common phenomenon." As to wages, Keynes maintained that workers would not be willing to accept lower wages; therefore prices would not reduce in response to lower demand. Since the unemployed workers have no income and are not purchasing goods and services, aggregate demand remains stagnant at a decreased level without a correlated adjustment in supply. Since prices and wages are slow to adjust, the decreased demand results in "unnecessarily low levels of employment" and longer than necessary recession. As a policy matter, Keynes argued that governments should intervene by increasing government spending in order to maintain aggregate demand. Keynes argued that it did not matter what government spent the funds so long as the spending balanced the decrease in consumption. However, Keynes thought the "agenda" for the state should not include "activities which private individuals are already fulfilling, but to those functions which fall outside the sphere of the individual, to those decisions which are made by no one if the State does not make them." In that respect, Keynes preferred that government spend on areas where there was a need, which in the 1930s was "more houses, hospitals, schools and roads." Keynes sought to "[improve] the technique of modern Capitalism by the agency of collective action," but he did not think the collectivist nature of his theories was "seriously incompatible" with the profit motive of capitalism. Indeed, Keynes was a critic of socialism and thought capitalism, although imperfect, was the best foundation for a political

139 PETER A. HALL & DAVID SOKSKE, VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE 1, 6-7 (Oxford Univ. Press 2001).
140 Keynes at 237-238.
141 PETER A. HALL & DAVID SOKSKE, VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE 1, 6-7 (Oxford Univ. Press 2001).
142 Keynes at 374-381.
143 Id. at 218-220.
147 Id.
148 Id. at 39-40.
That said, Keynes held hope that through thought, rather than revolution, an economic system without the ills of capitalism could eventually be developed. Keynesian economics dominated U.S. economic policy from the 1930s until the early 1980s when monetarism and neoclassical economics took hold. Milton Friedman’s theories epitomize the monetarist approach and were embraced by the Reagan administration as well as other countries during the early 1980s. Friedman contended that monetary policy rather than fiscal policy was the most effective tool in maintaining economic growth in a low inflationary environment. Friedman maintained that there is a positive relationship “between the rate of growth of the quantity of money and the rate of growth of nominal income.” Changes in nominal income affect output in the short-term and prices in the long-term. Inflation occurs when there is “a more rapid increase in the quantity of money than in output.” Friedman argues that monetary policy that provides for a steady, automatic growth in the money supply will result in a “stable monetary framework for economic growth without itself being a source of instability and disturbance.” Keynesians squared off with monetarists over the importance of monetary policy versus fiscal policy. Keynesians view monetary policy as a tool that can be useful – especially negatively – to lower investment in times of an over-heated economy. However, Keynesians think fiscal policy, rather than monetary policy, is more effective at controlling inflation.

149 Id. at 44.
150 Id.
151 Richard P. F. Holt & Steven Pressman, The Role of the State and the State Budget, in A NEW GUIDE TO POST-KEYNESIAN ECONOMICS 102 (Routledge 2001). The shift away from Keynesian policies in the 1980s was largely because the application of the policy proved to be inflationary during the 1970s at a time when GDP was falling, government budget deficits were growing and price of oil spiked. Stagflation coupled with large budget deficits suggested that the Keynesian model was ineffective at managing the economy. Id.
152 MILTON FRIEDMAN, MONETARIST ECONOMICS 11 (Blackwell Publishing 1991).
153 Id. at 14.
154 Id. at 15-16.
155 Id. at 2-19.
156 Id. at 18.
158 Id. at 163-4.
159 Id.
By the mid-1990s, monetarism dominated U.S. economic policy and was thought to have eclipsed Keynesian economics.\textsuperscript{160} Debates will always exist over which is the better approach – Keynesian economics or monetarism. The shifts in economic policy are aligned with political ideology; consequently policy is likely to shift as the political cycle changes. The “social democratic left” use Keynes’s theories to defend “government intervention in the economy,”\textsuperscript{161} whereas, the “conservative right” vilify Keynes for “undermin[ing] the traditional belief in laissez-faire during the Great Depression.”\textsuperscript{162} The Obama administration’s ARRA stimulus package was classic Keynesian economics in that it authorized $787 billion in spending for jobs, infrastructure investments, research and other projects in order to restart economic growth.\textsuperscript{163} However, the EESA that authorized TARP investments was not so easily categorized as Keynesian. In some respects, the government purchase of equity in a company is not unlike the government purchase of goods in that the government stepped in and made purchases when the market failed to do so. However, the initial TARP investments did not have the desired result of jumpstarting lending. The intervention of the state into the management of American companies led to widespread concern about the nature of American capitalism. The February 16, 2009 cover of Newsweek declared, “We Are All Socialists Now,” lamenting the move from free market capitalism to more of a “modern European state.”\textsuperscript{164}

\textbf{II. U.S. Government Investments: An Institutional Analysis}

From 2008 to 2009, the U.S. investment portfolio more than doubled. For purposes of this article, the government investment portfolio will be considered those financial assets reported on the U.S. government’s consolidated balance sheet. Of the $959.9 billion in the government portfolio at the end of the

\textsuperscript{160} Id. at 179.
\textsuperscript{162} Id.
\textsuperscript{164} John Meacham & Evan Thomas, \textit{We Are All Socialists Now}, NEWSWEEK, Feb. 16, 2009, \texttt{http://www.newsweek.com/2009/02/06/we-are-all-socialists-now.html}.

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2009 fiscal year, investments made in an effort to ease the financial crisis alone were valued at $512.3 billion. The remainder of the portfolio consisted of $354.5 billion in direct loans other than those made in response to the crisis and $93.1 billion in securities held in a mix of special purpose funds. The valuation does not reflect the total amount the government invested during the financial crisis given that some investments have been paid back, some were already written down in value by the end of the 2009 fiscal year and other investments were made after the close of the 2009 fiscal year. Additionally, the figure does not take into account securities held by the Federal Reserve and its member banks since the Federal Reserve reports financial results separately as an independent entity. Some analysts combine the Federal Reserve portfolio with Treasury’s portfolio to reflect a portfolio of financial crisis investments valued at $2.02 trillion.

Even though the government’s 2009 balance sheet only gives a snapshot in time of the government portfolio, the increase in government holdings from 2008 to 2009 was dramatic. In a little over one year, the U.S. transformed itself into one of the largest shareholders in the world. By way of comparison, the world’s largest sovereign wealth fund, the Abu Dhabi Investment Authority, held an estimated $627 billion in assets. The sudden

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165 Government Accountability Office, 2009 Financial Report of the U.S. Government, 49 (November 2009) This figure takes into account assets on the government’s balance sheet that consist of Loans receivable and mortgage backed securities ($538.9 billion), TARP direct loans and equity investments ($239.7 billion), Beneficial interest in trust ($23.5 billion), Securities and investments ($93.1 billion), and Investments in Government sponsored enterprises ($64.7 billion). Id.

166 Id. This figure consists of the following assets: GSE Mortgage Backed Securities ($184.4 billion), TARP direct loans and equity investments ($239.7 billion), Beneficial interest in trust ($23.5 billion), and Investments in Government sponsored enterprises ($64.7 billion). Id. at 49 & 65.

167 Historically, the government has been the lender of last resort to certain populations when private institutions fail to provide credit. Id. at 66. For example, the Federal Direct Student Loans for education is the largest of these programs and the government portfolio held a face value of $153.3 billion in such loans at the end of the 2009 fiscal year taking into account the value of defaulted loans. Id. at 65-66.

168 Id. at vii, note 2.

169 SourceWatch, Total Wall Street Bailout Cost, (last visited June 28, 2010), http://www.sourcewatch.org/index.php?title=Total_Wall_Street_Bailout_Cost

170 Sovereign Wealth Fund Institute, Largest Funds by Assets Under Management (February 22, 2010) available at http://www.swfinstitute.org/funds.php. Other analysts claim that the size of the
increase in the government’s portfolio highlighted the government’s portfolio management practices. Much criticism arose not only over the sudden increase in the government portfolio, but also the way in which taxpayer dollars were invested and managed. While it is dangerous to generalize about management practices that span over many agencies and different types of investments, some consistent themes emerge not only from the practices highlighted during the financial crisis but also in the management of the government portfolio before the crisis. This section will address the general institutional constraints on government investments that currently exist.

As a preliminary matter, and for purposes of this article, the term “investment” will be defined as portfolio type investments of the sort that would normally be purchased by private investors (e.g. hedge funds, private trusts, banks and insurance companies) in the ordinary course of business. Such investments would normally include: (1) debt the government lends to an entity or person with the expectation of repayment, (2) equity the government purchases in a private enterprise which has a tangible economic value and (3) other property rights on an asset (e.g. deed, patent rights, etc.) that will yield economic value which can be bought and sold on the market. In other words, the government investments discussed here typically include stocks, bonds and other assets. One key distinguishing characteristic of a government investment is either the expectation of repayment of the loan or an ownership interest (either as a shareholder or through other property rights) in the enterprise or asset where there is an expected return on the investment. While an investment need not be immediately tradable, it should be able to be made liquid at some point in the future.

Government investment should be distinguished from government subsidies in that subsidies are considered the funding of programs where the government does not expect a tangible return on the investment. For example, subsidies to farmers are paid out in an attempt to affect the supply of a good. There is no expected return on investment to the government from such

Abu Dhabi fund is only $300 billion. Nadim Kawach, *Gulf Sovereign Wealth Funds See Further Fall*, EMIRATES BUSINESS 24/7, March 29, 2009, http://www.business24-7.ae/banking-finance/investment/gulf-sovereign-wealth-funds-see-further-fall-2009-03-29-1.95439. Comparing the U.S. total of investments to Sovereign Wealth Funds is admittedly problematic since the U.S. figure presented here includes investments spread out over several agencies. If similar investments made by foreign governments were taken into account, a different picture of comparative government investment would emerge.
Likewise, when the government gives a company a tax break if the company pursues a certain business plan, this is sometimes thought to be an “investment” in that the government forgoes its revenue (taxes) in favor of some other goal. This is better categorized as part of the larger fiscal policy rather than an investment. Additionally, government guarantees on loans are not strictly an investment. The government guarantees loans as a matter of policy in order to encourage banks to make loans to underserved communities. Although a default of the borrowers usually leads to government ownership of a security or an interest in some asset, guarantees only have an indirect benefit to the government as an advancement of some policy if the loan is successfully repaid. That said, government guarantees – both implicit and explicit – have been largely blamed as creating the moral hazards that led to the financial crisis. While guarantees are not generally considered investments, the market-driven proposals in this article could help regulate the issuance of high-risk government guarantees which are routinely made as a matter of policy.

Given the controversy over government investment during the subprime financial crisis, the article emphasizes investments made under the TARP program; however, it will also consider investments made under other programs both prior to and after the financial crisis. Some of the government investments discussed here include loans and security purchases made by the Federal Reserve rather than Treasury. During the financial crisis, Treasury coordinated with the Federal Reserve in many government-brokered deals in order to stabilize the markets, such as the sale of Bear Stearns to J.P. Morgan. In that deal, the government acted

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171 The return on investment in a subsidy is indirect. In the case of government-subsidized research, the research is anticipated to create new jobs and products that would result in an increased tax revenue stream to the government. Such funding is outside the scope of this article; though, it should be noted that there have been calls for a return on investment for government-funded research that is exploited by technology companies. Fred Block, *Swimming Against the Current: The Rise of a Hidden Developmental State in the United States*, 36 POL. & SOC’Y 169 (2008).


173 Government guaranteed loans are granted by a number of different agencies, including but not limited to the FDIC, Ex-Im Bank, and the Small Business Administration.

more as “a deal-making middleman, a traditional role for investment bankers,” rather than as an investor, though the Federal Reserve authorized the Federal Reserve Bank of New York (FRBNY) to make $30 billion in loans available to J.P. Morgan in order to facilitate the transaction. FRBNY also acted to loan AIG funds during its liquidity crisis. Although the securities held by FRBNY are not strictly part of the government portfolio, loans from Federal Reserve Banks that were done in the context of government deal making and FRBNY acted as an agent of the Federal Reserve Board usually using funds that the government creates and adds to the money supply. Given the close relationship and its quasi-public status, the FRBNY transactions help inform how the government operates as a market actor during financial crisis and therefore will be discussed when relevant to the institutional analysis of government investment.

Both formal and informal institutions constrain the government in its investments. As for formal rules, an agency of the government needs a legislative mandate to make investments, such as the authorization under the EESA for Treasury to make TARP investments. Additionally, there are many informal institutional constraints that shape the way in which an LME makes and manages its investments. These informal constraints may constrain an entity’s actions without the need for legislation or an agency rule.

Government investment occurs with less frequency in a LME than in a CME; though investment occurs in LMEs in the presence of market failure. Given its liberal market economy, U.S. government investment in private assets has long been disfavored—at least within the political discourse. Since the early 1980s when the laissez-faire policies of Milton Friedman gained popularity, the Reagan administration started a trend towards deregulation, minimalist intervention in the market, and privatization. However, even prior to the Reagan era, government investment was discouraged. One of the best examples of the political divide over government investment is the decades-old debate over whether Treasury should invest the Social Security

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Trust Fund in a diversified portfolio that includes stocks rather than just government bonds.\textsuperscript{178} Conservatives were adamant that government not invest in private enterprise to fund social welfare programs.\textsuperscript{179}

This section groups the institutions surrounding U.S. government investment into two broad categories – (1) rules surrounding the investment decision, and (2) management of the investment – i.e. the role of the government in corporate governance. The first category relates to the investment decision – i.e. whether to purchase equity in a company – and the reasons behind the decision. The investment decision is broadly conceived here to include not only the initial decision to invest, but also the motivation behind investments, the terms of the investment and the exit strategy. The institutions within the first category are characterized by the belief that government should only invest in private enterprise for policy reasons and not for the purpose of wealth creation. This belief impacts financial investments by constraining the flexibility with which managers of government controlled financial investments can diversify assets.

The second category is equally broad and relates to the subsequent management of the investment and the relationship between the company and the government shareholder. The government’s role as both a shareholder and its role as a regulator suggests inherent conflicts of interests for a LME. The rules within this category are characterized by an institutional norm where politically driven activism in corporate governance is tolerated even if that activism runs counter to the principles that a prudent private investor would follow. The rules in the second category can be thought of as complimentary with those in the first category in that “the presence (or efficiency) of one increases the returns (or efficiency of the other).”\textsuperscript{180} The political interference in corporate governance can be justified if the intent of the investment was not wealth maximization but was some policy that grew out of the


\textsuperscript{180} Peter A. Hall & David Soskice, Varieties of Capitalism: The Institutional Foundations of Comparative Advantage 1, 17 (Oxford Univ. Press 2001).
political process. The existence of these norms does not suggest that they lead to an overall efficiency in the political economy. This article merely attempts to describe in this section the norms which surround government investment – i.e. that investment in a liberal market economy generally occurs for policy reasons and that political influence in managing the investment is tolerated if not encouraged.

A. Institutional norms governing the investment decision.

Despite the political rhetoric against it, U.S. government investment in private enterprise occurred frequently even before the sub-prime crisis. Unlike most private investors, the government generally invests for policy reasons rather than for the purpose of wealth-creation. This motivation can result in some inefficiency in the investment decision as well as consequences for the market as a whole. In general, the government’s approach to investment is far different from that of a prudent private investor. For purposes of this article, this section stresses those differences by emphasizing the way in which government action differs from that of the prudent investors. Consequently, many of the following rules are stated in the negative – i.e. what is lacking – rather than the affirmative. The preference for policy driven investments generates a unique blend of characteristics and consequences that include the following: (1) valuation at market prices and terms is not required of an investment; (2) political influence in the investment decision is tolerated; (3) maximizing the economic return is not required; (4) preference for short holding periods, (5) preference in favor of public-private ventures and against nationalization; and (6) government willingness to bail out firms considered “too big to fail” leads to moral hazards. This section will discuss each of these results and then offer some conclusions.

1. Valuation at market prices and terms is not required of an investment.

The rules by which the government invests do not encourage a market-based valuation of the securities. In other words, the government sometime overpays for the value that it

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181 Block contends that a “hidden development state” funding technology research and development existed since the 1980s and that the state’s political rhetoric committing to the free market merely hid that form of state guided capitalism from the public. Fred Block, *Swimming Against the Current: The Rise of a Hidden Developmental State in the United States*, 36 POL. & SOC’Y 169 (2008).
purchases. In addition, the government does not always insist on
terms that a prudent investor would insist given the circumstances
of the investment. During the financial crisis, Treasury was widely
criticized for its valuation methodology in pricing some of the
securities it purchased. Some of the mistakes made were inevitable
given that agencies were reacting to a crisis under time
constraints.\textsuperscript{182} However, some private investors making similar
investments during the same time came away with much better
deals. The over-valuation of investments by the government may
be a result of a lack of expertise, lack of incentive or the result of a
reasoned process to abstain from optimal pricing for policy
reasons. This section will first describe the U.S. government
investment programs during the 2008-2009 subprime financial
crisis and then analyze the valuation criteria used by Treasury
when making the investments.

The financial crisis spawned a number of government
programs and a confusing set of acronyms. Between October 2008
through 2009, the purpose, funding and terms of any given
investment under the EESA was fluid. Both the Bush and Obama
administrations were reactive – tailoring and funding investments
according to the art of the possible rather than by a strict sense of
ordered criteria. Under the EESA, Treasury was initially
authorized to purchase subprime mortgages and asset-backed
securities under a program titled Troubled Asset Relief Program
(TARP). However, Treasury soon determined the assets sales
could not proceed with enough speed to stem the financial crisis,
and it used its authorization under TARP to create other programs.
By July 2009, Treasury had started twelve different programs
targeting different sectors of the economy or particular firms – e.g.
financial institutions, automobile industry, AIG, and home owners
to name a few.\textsuperscript{183} Funding of some programs also came from the
Federal Reserve under the Term Asset-Backed Securities Loan
Facility (TALF). Leveraging the grace often accorded a new
president in his first 100 days in office, President Obama cajoled
Congress to pass the American Recovery and Reinvestment Act of
2009 (ARRA). The ARRA was a classic Keynesian economic
stimulus plan that principally authorized spending $787 billion on
infrastructure and other government projects in order to restart

\textsuperscript{182} Steven M. Davidoff & David Zaring, \textit{Regulation by Deal: The Government’s
\textsuperscript{183} For a list of programs, see OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR
THE TROUBLED ASSET RELIEF PROGRAM, SIGTARP: JULY 21, 2009 QUARTERLY
REPORT 4, Table 1 (2009).
growth in the GDP, but the legislation also modified the terms under which the previously approved TARP investments would operate.

The TARP investments were justified, in part, as an investment in which the taxpayer might make a profit. Treasury Secretary Henry Paulson reassured Congress during hearings prior to the passage of the EESA that the TARP money would be “an investment, not an expenditure….” Secretary Paulson went on to say that “there is no reason to expect this program will cost taxpayers anything.” Treasury acted quickly and during October and November 2008 invested $254.2 billion in over hundreds of transactions. In December 2008, Secretary Paulson reiterated that the valuations on the initial preferred stock purchases were made at par. However, not everyone agreed that prices paid were at market value. The Congressional Oversight Panel (COP) set up to monitor deployment of the TARP for Congress concluded, “Treasury paid substantially more for the assets it purchased under the TARP than their then-current market value.” Additionally, Treasury did not include contractual restrictions that a private investor would have likely negotiated given the investment environment in October 2008.

Incongruously, some of Treasury’s investments were made at a valuation well below the fair value of the assets. The legal and accounting definition of fair value is the price at which a willing buyer and seller would agree on in the sale of an asset in an active market. COP analyzed the ten largest TARP investments to determine if Treasury paid fair value at the time of the investment. Although preferred stock is technically equity in a company, the shares typically have characteristics that are similar to bonds. The preferred shares pay a cumulative dividend of 5% per annum for five years and 9% after the fifth year. Under the original EESA

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185 Id.
187 Id. at 2.
189 The cumulative feature allows the board of a QFI to choose to not declare a dividend in a particular year, however the amount that would have been paid
provisions, banks could redeem the shares at par value within three years but only by raising other funds in the capital markets – i.e. through another preferred share offering or through common stock. However, ARRA eased the rules to allow banks to redeem shares prior to the three year waiting period and from any source – public or private.191 The redemption provisions were modified in large part to banks lobbying because of political interference in the corporate governance – principally the salary provisions anticipated in ARRA.192 To the extent that a bank does not redeem its shares, the government can sell the preferred stock on the open market if it chooses to do so.

The preferred shares include a “warrant sweetener,” which gave the government a right to purchase common stock worth up to 15% of the preferred share investment at a price that is the 20-trading day average of the institution’s share price at the time of the preferred share investment. The warrant sweetener is a typical term in some preferred share investments, especially those where the investor is taking some risk. If the common stock price goes up, the investor can exercise the warrants to purchase the common stock and then immediately sell the common stock in order to pocket the difference between the common stock purchase price as set forth in the warrants (the “strike price”) and the trading price on the day the warrants are exercised.193 Given the amounts invested here, such purchase and immediate sale could possibly affect share prices since the float would radically increase. The government could also sell warrants on the open market, which would value not only the difference between the strike price and the market value but also the time value of the warrants.194

“accumulates” as an amount owed to the preferred shareholders. No other dividends can be paid out, such as those to common shareholders, unless the QFI first pays out any dividends owed to preferred shareholders first.

194 Many formulas exist to value options and warrants. For a discussion of some issues surrounding these valuation method, see Benjamin A. Templin, Expensing Isn't the Only Option: Alternatives to the FASB's Stock Option Expensing Proposal, 30 J. CORP. L. 357, 385-6 (2005).
Given the complexity of preferred shares, the COP used three well-accepted valuation methods – (1) Yield-Based Discounted Cash Flow Approach, (2) Credit Default Swaps-Based Discounted Cash Flow Approach, and (3) Contingent Claims Analysis. Each model was applied and then comparisons were made in order to verify the calculations. The warrants were valued separately using a Monte-Carlo pricing model that is widely used in similar deals. The models discounted the valuations between 5% to 20% to take into account the illiquid nature of Treasury’s investment given the size of the investment. COP found that, on average, the ten largest investments by Treasury – amounting to $184.2 billion – received assets that were worth only $66 for every $100 invested at the time of the sale. Some of the investments – those that involved less risk – were more fairly valued than the “at-risk” investments. In the case of U.S. Bancorp and Wells Fargo & Co., which the market deemed to be less risky in October 2008, the study showed that Treasury received assets that were 87% to 99% of the costs. However for the high risk investment in AIG, Treasury received only 37% to 45% of the face value of the securities bought. COP concluded that the reason for the wide variation in valuation was that Treasury offered the same terms (5% dividend rate rising to 9% after the fifth year) to every financial institution. For banks and institutions that were likely to default, “the 5% dividend rate on the preferred shares was substantially below their market cost of capital, whereas for the healthier firms, it offered a smaller advantage over market rates.” Thus, Treasury purchased stable assets at slightly above

195 The first two methods estimate future cash flows from the securities and then applies an appropriate discount rate. The Credit Default Swaps-Based Discounted Cash Flow Approach better adjusts for a risk premium but is more applicable to common shares than preferred, thus the study used this valuation method as a check against the other two systems. The third methodology “relies on a probabilistic model of how the firm’s asset value, and therefore, its ability to pay claimants, evolves over time.” CONGRESSIONAL OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: VALUING TREASURY’S ACQUISITIONS 33 (2009), http://cop.senate.gov/documents/cop-020609-report.pdf.

196 The analysts “applied a ‘reduced marketability discount factor’ to reflect the fact that the large size of Treasury positions made them potentially costly to liquidate and hence less valuable.” CONGRESSIONAL OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: VALUING TREASURY’S ACQUISITIONS 35 (2009), http://cop.senate.gov/documents/cop-020609-report.pdf.

197 Id. at 4.
198 Id. at 36.
199 Id. at 37.
200 Id. at 35-38.
par value and risky assets at well above par value. In other words, Treasury overpaid for all of the assets in the study.

Not surprisingly, private investors – notably Warren Buffet’s Berkshire Hathaway, Qatar Holdings and Abu Dhabi – made no such mistakes when investing their money in similar deals during the same time-period. Warren Buffet, the world’s most famous value investor, purchased $5 billion in Goldman Sachs preferred stock as an investment for his company, Berkshire Hathaway. Using the same valuation methods, COP found that Mr. Buffet purchased assets that were worth 108 to 112% of the face value of the stock. Like a true value investor, Mr. Buffet waited until there was a mispricing in the market and then bought a valuable asset at a bargain price. Abu Dhabi and Qatar Holding’s investment of £7 billion in Barclays plc was valued by COP at 122% to 125% of the price paid.

The difference in valuations can be easily explained. The private investors accounted for risk and priced the securities accordingly. Whereas Treasury treated all banks similarly – offering the same deal terms to both strong and weak banks. COP speculates that as a matter of policy, Treasury did not want to signal to the public that some banks may have been riskier than others by demanding harsher terms for riskier banks. Such a negotiation strategy could lead private investors to assume that Treasury knows of non-public information. In such a situation, the demand for harsher terms sends a negative signal to the market, which could cause a sell-off in the stock. If that was Treasury’s motivation, then it was certainly not effective. The S&P 500 index stocks dropped a staggering 41% from September 2, 2008 through November 20, 2008.

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201 Id. at 35.
204 Likewise, more favorable terms sends an unintended positive signal to the public; thus raising the share price of a financial institution beyond its fair value through speculative buying.
205 The S&P closed on Sept. 2, 2008 at 1277.44 and dropped 525.14 points to 752.44 by the close on Nov. 20, 2008. However, the market was liquid enough and with enough volume that market data was valid for the valuation formulas used in the Congressional Oversight Panel’s report. CONGRESSIONAL OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: VALUING TREASURY’S ACQUISITIONS 32 (2009), http://cop.senate.gov/documents/cop-020609-report.pdf.
Another material mistake on the part of Treasury in its initial TARP investments to banks under the Capital Purchase Program was its failure to contractually bind the banks in how funds were to be used. Treasury’s primary purpose in making the investment was to jumpstart the credit markets that had frozen up in October 2008. However, the sales agreement for the preferred stock did not include provisions for how the money was used nor did it provide for reporting. The plan backfired. Instead of increasing the capital flow to businesses and consumers, it was “widely reported that banks have been ‘hoarding’ the money, acquiring other banks, and paying off debt.” Later on in the crisis, however, Treasury investments in the domestic auto industry were made only after prolonged and substantive negotiations and the investment contracts included more conditions than earlier TARP investments.

In addition to the mispricing of some investments and the lack of restrictions on use, Treasury gave up rights that would normally accrue to an investor. For example, Treasury agreed to waive its voting rights as to any common shares that it purchases under the warrants. In all likelihood this policy was implemented by the Republican administration because of a reluctance to have government interfere in corporate governance. Although the Republican administration tried to avoid interference in corporate governance, it failed to act as prudent investors by contractually binding the companies in how it would deploy the funds. Additionally, Treasury gave up any voting rights that would accrue as to common stock purchased through the exercise of warrants.

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209 Voting rights as to common stock purchased by exercise of the warrants would pass to any purchaser of Treasury’s common stock so the value of the common stock would not diminish. CONGRESSIONAL OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: VALUING TREASURY’S ACQUISITIONS 49 (2009), http://cop.senate.gov/documents/cop-020609-report.pdf. Moreover, the government could choose to just sell with warrants, which would have a tradable
2. **Political influence in the investment decision is tolerated.**

Despite rhetoric that political influences were largely absent from the investments made during the financial crisis, there were numerous instances where decisions to invest were made because of political preferences rather than economic exigency. One problem with policy-based investment is that decisions are driven by the political process; thus such investments are open to manipulation in the political bargaining process. Political influence does not necessarily suggest that unsound economic decisions may result; however, the presence of political bargaining in resource allocation raises issues of whether the greater public good is served.\(^{210}\) When politics controls decision-making on the allocation of resources, there is a chance that politicians with greater political bargaining power will influence the decision so as to favor their constituencies to a greater degree than the public as a whole.\(^{211}\) Political influence can be pervasive in government agencies. In some agencies, nearly all decisions require approval of political actors without regard to the public good.\(^{212}\) The issue of political influence over government investment decisions was prevalent well before the financial crisis. Commentators have long chastised politicians for manipulating public pension fund money to achieve political goals, as opposed to maximizing the wealth of such funds.\(^{213}\)

The influence of politics on government investment decisions may lead to adverse consequences for market-driven economies. If the state, rather than market forces, determines winners and losers, some firms gain a competitive edge not based on efficiency and prudent management but on political influence and bargaining.\(^{214}\) Such political interference can have value if the exercise price was below the market price.

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\(^{210}\) Richard W. Painter, Bailouts: An Essay on Conflicts of Interest and Ethics when Government Pays the Tab, 41 McGeorge L. Rev. 131, 135-136 (2009). Painter maintains that while Congress members are expected to advocate for and serve their constituencies, government officials in the executive branch which run programs such as the bailouts should be guided by a “fiduciary principle” to serve the greater public good. *Id.*

\(^{211}\) *Id.*


\(^{214}\) William J. Baumol, Robert Litan & Carl J. Schramm, *Good Capitalism, Bad Capitalism, and the Economics of Growth and*
consequences for the political economy as a whole since private investors may become reluctant to participate in some ventures if they know the state is going to interfere. This section will first examine three instances of politically-driven investments during the financial crisis, including: (1) investments made in financial institutions under TARP/CPP, (2) the AIG bailout, and (3) the Automotive Industry Financing Program. Instances of politically-driven investments before the financial crisis will then be considered.

Under the TARP/CPP, the government acted to save some investment banks, thrifts and commercial banks by brokering sales, but it let other banks fail leading commentators to question whether there was a reasonable basis for the government’s decision-making. The federal government intervened on behalf of Bear Stearns by acting as a broker in the firm’s sale to J.P. Morgan. However, when faced with the collapse of Lehman Brothers, Treasury Secretary Paulson let one of the five largest investment banks in the U.S. declare bankruptcy. Secretary Paulson claimed the Federal Reserve did not have legal authority to make loans to Lehman; however, the assertion does not appear credible given that the government used an emergency provision of the Federal Reserve Act to fund Bear Stearns. The controversial decision to let Lehman fail was more likely due to “political reality, personal preference” and a desire by Secretary Paulson to make a statement at that point in the crisis that not all banks would receive investments. While the brokered sale of Bear Stearns was justified in order to prevent systemic risk to the financial system, the same reasoning was not used when evaluating Lehman. Bear Stearns was determined to be “too big to fail,” but officials concluded that Lehman Brothers was not despite the fact that Lehman’s eventual bankruptcy was the largest in Chapter 11

PROSPERITY (Yale Univ. Press 2007).
218 Id. at 477-479 (2009).
219 Id. at 492-493.
in U.S. history.  

After the EESA was passed in October 2008, Treasury made the decision to invest only in “healthy banks” while letting unhealthy banks face a market solution—i.e. seeking out a buyer, private investors or eventually being closed by the Office of Thrift Supervision. Treasury maintains that political influence is absent from the investment decision and that it bases its decision on the recommendations of regulators. However, the determination of whether a bank is “healthy” enough may also be influenced by the amount of pressure Congress members have brought onto agencies to favor home state banks. While Treasury has not funded every instance where a Congress member sought to change an initial rejection of TARP funds, Treasury has been receptive to reviewing applications supported by Congress members, especially after the Ohio congressional delegation threatened hearings. Shortly thereafter, Congress members from Ohio, Alabama and Massachusetts actively supported certain applications, and regional banks in their home states that otherwise had weak capital structures were given TARP funding. After these incidents and in response to calls for greater transparency, Treasury adopted voluntary procedures whereby to counter lobbyist influences, such as certifications to Congress “that each TARP investment decision is based solely on objective investment criteria.”

The government support of a failing institution can create a competitive edge for the company. After the AIG rescue, the massive insurance company had the resources necessary to offer discounts of over 30% on some of its products; thereby garnering business from competitors who had not received government financing. State insurance agencies and the Government

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221 Id. at 120-121.
227 Liam Pleven & Sudeep Reedy, AIG’s Rivals Blame Bailout for Titling
Accountability Office (GAO) announced investigation into whether AIG violated any anti-competitive practices in its discount pricing. Executives at competing insurance companies complained bitterly to Federal Reserve Chairman Ben Bernanke asking that discounting be halted.228

The Automotive Industry Financing Program (AIFP)229 – popularly known as the “auto industry bailout” – also illustrates the fine line between decisions driven by views on economic policy for the nation as a whole and those that favor a political constituency. In a controversial series of loans, the government provided GM and Chrysler with $23.4 billion in order to avoid bankruptcy only to later require that both companies go through a structured bankruptcy – a process that left the original lenders with little to show for their investment. As Chrysler and GM teetered toward bankruptcy in fall 2008, Democratic politicians mobilized to offer a bailout arguing that it was necessary in order to preserve jobs and assure consumers of the viability of the companies who had warranted their purchases. Coming on the heels of what was largely perceived as a Republican driven Wall Street bailout, the money destined to the car companies was seen by many as support for the unions – a key Democratic constituency.

Financing for the automobile industry occurred in a series of steps, starting with the creation of the AIFP as a TARP program. An attempt was made in the House to authorize $15 billion in funding separate from the EESA, but the Senate rejected it.230 TARP funds were originally intended to be used for financing financial institutions; however, the EESA also grants authority to the Treasury Secretary to specify program requirements for the use of TARP funds.231 Given the lack of other funding sources, President Bush used his executive power to that the car companies fit within the broad definition of “financial institutions” as defined

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231 12 U.S.C.A. § 5211
in the EESA and approved the allocation of $17.4 billion in short-
term loans. While there has been debate over whether the EESA
actually authorized Treasury to use TARP funds for the automobile
industry loans, COP concluded that given the ambiguity within
the EESA as well as confusion about Congressional intent, Treasury
“has faced no effective challenge to use TARP funds for this
purpose.” When faced with an ambiguity or when Congressional
intent is unclear in a statute, courts grant agencies a great deal of
deferenCe, so that any permissible interpretation of a statute is
generally upheld.

Additional funds were authorized in early 2010 though the
loans included a condition that both companies devise plans for
long-term viability. By March 31, 2009, the Obama administration
determined the submitted plans were not viable, and then
negotiated with management, labor unions, franchisees and
bondholders to create a preplanned bankruptcy for both GM and
Chrysler. As part of the negotiated settlement, the government
agreed to provide additional financing so that both companies to
see them through the restructuring. In addition to providing
funds to Chrysler and GM, the government also provided loans and
equity investments in the two companies’ financing arms, GMAC
and Chrysler Financial, thereby bringing the total of loans and
equity investments made under AIFP to approximately $80
billion.

The debate over whether Treasury should have pursued a
pre-planned bankruptcy earlier has broken down along party
lines. Democrats were of the opinion that a bankruptcy of GM

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232 CONGRESSIONAL OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT: THE
USE OF TARP FUNDS IN THE SUPPORT AND REORGANIZATION OF THE DOMESTIC
AUTOMOTIVE INDUSTRY 73 (2009), http://cop.senate.gov/documents/cop-
090909-report.pdf.

233 Id. at 4.


235 U.S. DEPT. OF TREASURY, FACT SHEET ON THE NEW PATH TO VIABILITY FOR

236 U.S. DEPT. OF TREASURY, FACT SHEET ON THE NEW PATH TO VIABILITY FOR

237 U.S. DEPT. OF TREASURY, Troubled Asset Relief Program – Monthly 105(a)
Report, Appendix 1, 5-6 (May 2010).

238 CONGRESSIONAL OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT: THE
USE OF TARP FUNDS IN THE SUPPORT AND REORGANIZATION OF THE DOMESTIC
AUTOMOTIVE INDUSTRY 102 (2009), http://cop.senate.gov/documents/cop-
and Chrysler would pose a systemic risk that could harm other sectors of the economy. Republicans argued that the government intervention was a politically motivated move to maximize the interests of the labor unions at the expense of the bondholders. In the conservative view, the car companies should have entered into a structured bankruptcy before the initial government loans were made. A Chapter 11 bankruptcy does not necessarily cause huge layoffs. An earlier reorganization may have done more in reassuring consumers than propping up inefficient companies with tax dollars. Moreover, the market failure of the car companies without government intervention would have opened opportunities for more efficient entrepreneurs to start new companies. In addition, there are broader implications for a market-based political economy when there is government intervention. The effect of propping up inefficient firms that are headed for bankruptcy will “’falsify’ the market’s signals” thereby misleading investors and penalizing efficient firms.

Finally, the Obama administration’s strategy was largely criticized because it interfered with the contractual rights of the bondholders by favoring unions in the post-bankruptcy ownership. The pre-planned bankruptcy plan advocated by the Obama Administration created a post-bankruptcy ownership structure that favored the union-driven employment retirement funds rather than bondholders. Normally in a bankruptcy, secured bondholders stand first in line followed by unsecured creditors. However, Old GM and Old Chrysler bondholders were left with pennies on the dollar. As the companies emerged from bankruptcy, the Government owned 9.9% of New Chrysler and held a loan for $7.1 billion. The largest New Chrysler shareholder (67.69%) to

090909-report.pdf
239 Id.
240 Id.
243 Declan McCullagh, Chrysler Bankruptcy Exposes Dirty Politics, CBSNews.com, (May 7, 2009)
245 U.S. Dept. of Treasury, Troubled Asset Relief Program – Monthly 105(a) Report, Appendix 1, 6 (May 2010).
emerge out of bankruptcy was a retirement trust fund managed by the politically powerful United Auto Workers Union. The government stake in the New GM was 60.8% while an employee benefits group held 17.5%, and the pre-bankruptcy unsecured bondholders were reduced to 10%.

Not all of the bondholders accepted the Obama plan willingly. Chrysler bondholders challenged the Bankruptcy Court decision in Federal District Court, but lost in an expedited appeal to the Second Circuit Court of Appeals. The appeal to the U.S. Supreme Court was denied certiorari. In litigation by a GM bondholder, the District Court upheld the Bankruptcy Court’s decision and found that the due process rights of the bondholders were not violated. While the courts were not sympathetic to the bondholder’s legal rights, some conservative commentators have argued that the Obama administration’s political maneuvering violated the spirit of the U.S. Constitution given the implicit moral principles supporting contract and property rights found within the document. From a political economy perspective, Government interference with contractual and property rights fundamentally opposes one of the four primary institutional norms of a successful entrepreneurial economy. If entrepreneurs cannot rely on the support of the government to enforce contractual rights, then they will be less willing to take risks in starting new companies.

Was the development of the AIFP and the pre-planned bankruptcy political payback for the unions who supported Democrats through large campaign contributions? It is entirely possible that the Obama administration’s plan was policy driven


247 The Canadian government owned the final 11.7% in the post-bankruptcy reorganization. U.S. Dept. of Treasury, Troubled Asset Relief Program – Monthly 105(a) Report, Appendix 1, 7 (May 2010).

248 In re Chrysler LLC, 576 F.3d 108 (2d Cir. 2009).


250 In re Motors Liquidation Co. 2010 WL 1730802 (S.D.N.Y. 2010).


rather than a political payback; however, the bondholders likewise had legitimate policy arguments favoring a different ownership structure.\(^\text{253}\) The government led effort that reduced bondholder rights is expected to make the private equity firms more cautious about lending money to politically powerful companies.\(^\text{254}\) Future lenders to such firms will be wary of whether their investment will be protected during a potential bankruptcy. The cost of capital for such companies will rise in such circumstances\(^\text{255}\) making them less competitive with foreign car companies.\(^\text{256}\)

3. **Maximizing economic return is not required**

When the state invests for policy reasons, the investment may lead to below market returns. This can be the result of mistakes made in the initial valuation or it could be that the government chooses its investment by criteria other than wealth maximization, such as for social goals or as part of the political bargaining process. When the state is the investor, different political interests will compete for investment money, much as they currently do through lobbying efforts for earmarks. Opposing groups vie for different social, regional, ethical or moral goals in the investment decision. Sometimes, a particular social goal aligns with the principle of wealth maximization. Other times, however, a prudent investor seeks an investment with a goal other than wealth maximization. This section will first examine the returns – both real and estimated – of financial crisis investments and then examine anecdotal evidence on returns in general made on government investments.

Treasury and administration officials have made much of the fact that many of the TARP investments have been repaid and

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the total cost of the program was less than anticipated.\textsuperscript{257} By May 2010, banks and other entities paid back more than half of the $384 billion in TARP funds that had been invested.\textsuperscript{258} Additionally as of May 2010, the income received from all TARP investments (measured by warrant sales and dividend and interest payments) stood at $24.4 billion.\textsuperscript{259} For the 34 entities that had completely repaid the government by the end of December 2009, the absolute return on investment for the government was 8.8%.\textsuperscript{260} As expected, not all of the investments are successful. As of February 2010, 104 recipients of CPP funds failed to make timely dividend payments amounting to $188.98 million.\textsuperscript{261} Due to continuing losses, AIG has consistently failed to pay dividends it owed the government amounting to missed payments of $4.2 billion as of March 31, 2010.\textsuperscript{262}

While many individual investments showed a positive return, the headlines did not highlight two additional data points—(1) investments made under EESA and HERA will likely show negative returns and (2) private investors would have likely yielded a much higher return. Given that many investments have not yet matured, any estimate of a gain or loss here is preliminary. The losses predicted under the TARP program have been a matter of speculation and sometimes widely differing opinions. The Congressional Budget Office (CBO) optimistically estimated in February 2010 that the CPP portion of TARP (the equity investments in banks) would result in a $2 billion gain, but the Office of Management and Budget (OMB) predicted a loss of $1 billion.\textsuperscript{263} Everyone seems agreed that when all TARP programs are included, there is likely to be a loss. As of the end of March 31, 2009 Treasury predicted that the it will lose $105.4 billion on its TARP investments.\textsuperscript{264} While the picture is still unclear, it is

\textsuperscript{259} U.S. Department of the Treasury, \textit{Troubled Assets Relief Program (TARP) Monthly 105(a) Report – May 2010}, 7 (June 10, 2010).
\textsuperscript{261} OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, SIGTARP: APRIL 10, 2010 QUARTERLY REPORT TO THE CONGRESS 76 (2010).
\textsuperscript{262} \textit{Id.} at 91.
\textsuperscript{263} \textit{Id.} at 74.
\textsuperscript{264} U.S. Dept. of Treasury, \textit{Troubled Asset Relief Program – Monthly 105(a)
enough to say that financial losses are tolerated, though current predictions are far less than the original estimates given that much of the stock held by Treasury has increased in value.\textsuperscript{265} As for individual investments, it appears that investments made with a greater degree of political influence also have a greater degree of expected loss. The politically driven investments in GM and Chrysler are expected to trigger significant losses. The losses from the automotive industry investments are estimated to range from $31 billion (OMB prediction) to $34 billion (CBO estimate).\textsuperscript{266} Treasury has already recorded loss on its pre-bankruptcy loan to Chrysler when it recently accepted a payment of $1.9 billion for a loan that originally had a face value of $4 billion.\textsuperscript{267} Likewise, investments in organizations considered too big to fail, appear to have a greater degree of an expectation of loss. OMB predicts the loss on the AIG bailout at $50 billion as of February 2010 although CBO pegs the total cost at $36 billion.\textsuperscript{268} Despite these dire estimates, the CEO and Treasury are optimistic that AIG will eventually pay back the entire investment.\textsuperscript{269} The Fannie Mae and Freddie Mac investments are thought to have the largest potential for loss. In June 2010, the realized loss was $145 billion with estimates that it could reach $400 billion or even $1 trillion if the housing market worsens.\textsuperscript{270}

Private investors who invested during the same period as the government showed a significant difference in their returns. Ten months after Mr. Buffet took a stake in Goldman Sachs, his $5 billion investment was estimated to be worth $9.1 billion – an annualized return of 111%. In sharp contrast, Treasury realized only a 23% annualized return on the same investment.\textsuperscript{271} In another comparative analysis taking into account all TARP

\textit{Report,} Appendix 1, 2 (May 2010).
\textsuperscript{265} U.S. Dept. of Treasury, \textit{Troubled Asset Relief Program – Monthly 105(a) Report,} Appendix 1, 4 (May 2010).
\textsuperscript{266} OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, SIGTARP: APRIL 10, 2010 QUARTERLY REPORT TO THE CONGRESS 114 (2010).
\textsuperscript{267} Id. at 13.
\textsuperscript{268} Id. at 5.
\textsuperscript{270} Michelle Lodge, \textit{Fannie-Freddie Bailout Could Cost Taxpayers $1 Trillion,} CNBC, June 29, 2010, \texttt{http://www.cnbc.com/id/37982580}.
\textsuperscript{271} Zachery Kouwe, \textit{Buffett’s Goldman Stake Pays Richly}, N.Y. TIMES, July 24, 2009, at B5.
investments that were repaid in 2009, economists demonstrated that private investors, who might have had the same opportunity as the government to purchase these selected investments in October 2008, would have realized a profit three times the size of the government, assuming the private investors negotiated a market price for the shares.272

Of course, the measure of the success of the government’s investment is not necessarily that the overall TARP program was profitable or that the government maximized the wealth of the investment. Rather the measure of success is whether the investments achieved the goals of preventing a collapse in the financial system. Treasury credits the TARP and related investments with preventing a complete collapse of the credit markets in the short-term, given the rebound in the financial markets one year after the collapse.273 Concerns over the long-term health of the economy persist.274

The economic success of policy-oriented investments has traditionally been difficult to assess. Given that the government’s role is not geared toward wealth-creation, it is natural that most government investments would be made for purposes other than wealth maximization. In a study of state government venture capital fund investments, Peter K. Eisinger found that most investments were geared towards creating jobs in a state rather than for the purpose of wealth creation.275 However, there can be serious consequences in terms of the success of the government’s goals when such political bargaining rather than pure policy goals drive the process. For government pension funds, policy-based investing has the potential to erode shareholder economic value and “adversely affect fund performance.”276 For example, investing in geographical regions that are economically depressed277 would

277 State legislatures put pressure on public pension plans to invest in local
be a policy-based investment that may or may not result in the maximum return available to a fund. An investment in an ailing industry may preserve jobs within a politician’s region for a short time, but will not ultimately be profitable if the industry itself is in decline. The danger is that the entire investment by the government may be lost. Pursuing a policy-based investment agenda sometimes results in better returns. For a long time, alternative energy projects were not thought to have much profit potential. However, when the price of oil skyrocketed in the mid-2000’s and consciousness was raised about global warming, green technology and alternative energy companies became desirable investments.

Although losses are expected under the TARP investments, some government investment programs have turned a profit. Two federal government corporations – the Overseas Private Investment Corporation (OPIC) and the Export-Import Bank of the United States (Ex-Im Bank) – illustrate the challenges and potential of an investment entity within the federal government. Policy, rather than profit, dictates the investment methodology for both organizations. OPIC invests in development projects in emerging markets that would not otherwise receive funding given the political risk. Since its inception in 1971, OPIC has been profitable every year. In 2009, OPIC had net income of $242.5 million, up from $166.5 million in 2008.

The Export-Import Bank of the United States (Ex-Im Bank) has had more mixed results. Similar to OPIC, Ex-Im Bank
addresses markets where political or other risks prevent alternative private financing. The government bank extends credit and insurance to businesses hoping to export U.S. goods to these areas, though historically, the bank has had conflicting demands from the state and the market. While formed to meet the needs of private companies, the bank has felt political pressure from “policymakers in the White House, as well as Treasury, State, and War (later Defense).” Ex-Im Bank also competes with other foreign export credit agencies in that each advances the business interests of its own nation. Although Ex-Im Bank has a series of losses during the 1970s and 1980s, it now claims that it has “returned to the U.S. Treasury $5.2 billion more than it received in appropriations for program and administrative costs.”

Even to the extent that the government makes a conscious choice to pursue social or economic goals over financial gain in its investments, the government does not always achieve its stated goals. In other words, while the government might not seek wealth maximization to measure its return on investment (ROI), it should seek some way to measure the social gain as a form of ROI. Under the CPP program within TARP, one goal was to increase lending to small businesses during a period of market failure. However, that policy goal was not achieved since lending declined for banks that received over 81% of TARP funds under the CPP.

4. Preference for short holding periods

To the extent that the government intervenes during a financial crisis by purchasing securities, the holding period is typically limited, which is consistent with the political economy of an LME. In making the TARP investments, Treasury reflected the government’s predisposition for short-term holding periods.

283 Id.
284 Id.
288 Id. at 26.
289 Press Release, U.S. Dept. of the Treasury, Treasury Department Releases
Senators sought to make the informal rule favoring short holding periods into a formal law through a proposed bill that would have mandated a maximum 18-month holding period for any investment where the government owns more than 20% of an entity. Under the bill, the government would have to put all such assets in a trust and the trustee would be required to liquidate any investment before the 18-month holding period passed unless the trustee determined that the maximizing the value of the investment required additional time.

One consequence to this approach is that the long-term potential of some investments will never be realized. The warrants issued pursuant to the TARP CPP preferred stock purchases illustrate the point. The taxpayers again did not receive the full potential of the warrants when companies repurchased the securities earlier than expected. Part of the lost potential was due to mispricing and part due to the missed opportunity of holding onto the warrants for greater appreciation. Using well-accepted valuation techniques, COP found in its July 2009 report that Treasury received only 66% of the market value when banks repurchased warrants. By the time COP issued its February 2010 report, Treasury had improved its methodology but was still receiving only 92% of the value in warrant repurchase. The value of a warrant is tied to the stock price as well as numerous other factors including the expiration date and volatility of the stock. Despite the complexity of pricing models and potential risks, if the government had held onto the warrants for a longer period of time, it could have resulted in a greater recovery of taxpayer dollars. Provided that a particular bank’s stock price goes up, then the valuations of the warrants would rise as well. While there is also the possibility that some warrants may expire as


291 Id. at 89-89


worthless, the redemption feature did not allow Treasury to make a prudent investment decision as to which warrants to retain in order to realize further gains.

This institution favoring short-term holding periods has been U.S. policy well before the TARP investments. The Resolution Trust Corporation (RTC) is a prime example. RTC was created to sell off the assets of failed savings and loans during the 1980s and 90s. In the late 1980s and early 1990s, the US government was faced with being the receiver of assets of failed savings and loans. The response was to create the Resolution Trust Corporation (RTC), which had the primary purpose of selling off the assets. RTC’s directive was to get rid of the assets quickly rather than have the government hold and manage the property. In the rush to divest itself of the holdings, allegations arose over excessive fees charged to the RTC by consultants and sales that were made for less than the book value. The primary goal of the RTC was to divest assets quickly with secondary goals of promoting jobs and opening opportunities for businesses owned by women and minorities. The ultimate cost to the taxpayer in selling assets in this manner was $150 billion.

The RTC directive reflected the economic policies of the Reagan and Bush administrations in reducing government involvement in the market. Government competition with private actors is considered a form of public regulation. Governments typically are at a distinct advantage by not incurring the same costs (e.g. the government pays no income tax) as private firms and by having a regulatory advantage when competing. Despite the likelihood of higher returns through long-term investment, free market political considerations prevent the government from becoming an investor in private enterprise because of fears that such investment could result in a state-directed economy. Interestingly, the RTC was held out a model entity that could

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296 Id.
298 Id. at 35-36.
manage the sale of toxic assets. Although such an organization was never established, the model of a federal government corporation could be useful to insulate investments from political pressure. To the degree that political interference in corporate governance can be minimized, the institutional constraint on short holding periods might be removed thus allowing for the potential of greater returns on taxpayer investments.

5. Preference in favor of Public-Private Ventures and against Nationalization

Before the U.S. takes an ownership position in a private enterprise, the government usually attempts to act as a dealmaker and broker a market solution among private actors. When the government does take an equity position, then an institutional preference exists against full ownership of firm (nationalization of the firm) even for short periods of time.

Consistent with its LME, the U.S. typically tries to find a private solution to rescue troubled financial firms before investing public funds. When Long-Term Capital Management faltered in 1998, the Federal Reserve arranged for private entities to save the firm. During the initial months of the current financial crisis, Treasury likewise attempted to broker deals, such as the Bear-Stearns sale to J.P. Morgan. While the government provided federal loans of $28.2 billion to facilitate the sale, “much of the risk was borne by private parties.” As the crisis unfolded and it became apparent that AIG was nearing bankruptcy, Treasury and the Federal Reserve took on the entire risk of the rescue rather than using its leverage to force a rescue among many lenders. The government has been widely criticized for fostering moral hazards by not enlisting private lenders in the AIG rescue. Treasury and Federal Reserve bankers justified their actions by maintaining that private lenders should not be coerced into making loans and that the rapid deterioration of the markets required an immediate

response.\textsuperscript{304}

However, the government stopped short of full nationalization in any of its rescue attempts. Unlike some state-directed capitalist economies, the U.S. generally avoids state-owned enterprises. While the government owns some federal government corporations providing services to the public, such as Amtrak or the U.S. Post Office, liberal market economies disdain full ownership in the absence of market failure.\textsuperscript{305} However, even in the absence of a market solution during the financial crisis, the government did not completely nationalize bailed out firms. In the case of Fannie Mae, Freddie Mae and AIG, the government took a maximum equity stake of 79.9\% letting existing shareholders maintain an interest.

The reasons behind the 79.9\% cap on investment are partly practical and partly political. On the practical side, the government did not want its ownership in these companies to suddenly be deemed government entities for accounting purposes.\textsuperscript{306} If the government owned 100\% of the company, it would be compelled to put the firm’s liabilities onto the government’s balance sheets,\textsuperscript{307} thus potentially increasing the government deficit. In addition, full ownership of the firms would mean that the companies would have to change their accounting practices to conform with the specialized accounting rules that pertain only to agencies.\textsuperscript{308} The designation of a private corporation as wholly controlled by the government could also lead to a determination that it is “an agency or instrumentality of the United States for the purpose of individual rights guaranteed against the Government by the Constitution.”\textsuperscript{309}


\textsuperscript{305} The government nationalized Amtrak because it was widely believed that an affordable national passenger rail system was in the public interest but the market did not support the economics of such a system. \textit{Lebron v. Nat’l R.R. Passenger Corp.} 513 U.S. 374, 383-384 (1995).


\textsuperscript{307} \textit{Id.}

\textsuperscript{308} Id. Davidoff and Zaring also suggest two other practical reasons for the limit – (1) the 79.9\% threshold would allow firms to still deduct interest on government loans under IRS rules in the event that the companies actually had a profit and (2) under the Employee Retirement Income Security Act (ERISA), the threshold meant the government would not be jointly and severally for the firms’ commitments. \textit{Id.} See 26 U.S.C. § 163 for tax code provision on interest.

Such a designation would mean that newly acquired corporations would have to with constitutional and possibly other legal restrictions under which agencies operate.\textsuperscript{310}

Davidoff and Zaring describe Treasury’s approach to deal-making as a “venture capitalist model” rather than a “private equity model.”\textsuperscript{311} In the venture capital model, the government “leave[s] management of the firm in place…but offer[s] money and expertise to the venture.”\textsuperscript{312} Whereas, private equity investors “tend to take control of the firm with an eye to restructuring it and selling it off later at a profit.”\textsuperscript{313} While such an approach allowed the government to maintain that it had not nationalized the banks, the government’s objectives in making the investments – i.e. to jumpstart the credit markets – was not necessarily achieved.\textsuperscript{314} Politically, nationalization may have been difficult to achieve in Congress. Complete control of a corporation by the government might require Congressional approval under the Government Corporation Control Act of 1945,\textsuperscript{315} and resistance to the bailouts was already fierce in Congress.

Another example of an attempted public-private partnership is Treasury’s Legacy Securities Public-Private Investment Program (PPIP). PPIP uses TARP funds to create a market in “toxic assets” – the securities backed by sketchy, often subprime, real estate loans whose dropping value led to the credit crisis. Given the uncertain value of the loans and mortgage-backed securities, trading in the secondary market ceased in fall 2008. The lack of a secondary market for the loans and securities has led to a “negative economic cycle” where declining asset prices led to further uncertainty, which led to fire sales of assets, which leads to further uncertainty and so on.\textsuperscript{316} Under PPIP, Treasury attempted to create investment partnerships with private firms to share the risk and

\begin{flushright}
312 \textit{Id.} at 539.
313 \textit{Id.}
\end{flushright}
purchase these toxic assets from banks at a discount.\textsuperscript{317} As of early 2010, the program was not considered successful in restarting the market for mortgage-backed securities since the banks holding the toxic assets are unwilling to sell at the price the investors are willing to pay.\textsuperscript{318}

6. \textbf{Government willingness to bail out firms considered “too big to fail” leads to moral hazards.}

   Much has been written about the creation of moral hazards when the government either implicitly or explicitly offers a guarantee to bail out firms that are deemed to be “too big to fail.”\textsuperscript{319} The government creates a moral hazard when it gives an implicit or explicit guarantee on losses. Private entities are generally assumed to make riskier decisions that may lead to higher rewards if they know that the government will bail them out in the event of losses. Government guarantees are thought to give incentives to market actors to take on riskier bets; thus leading to a cycle of guarantee, market crash and government bailout. The cycle of guarantees and bailouts creates distortions in a liberal market economy – in essence putting the government in the role of guarantor rather than requiring private actors to take responsibility. Moral hazards are thought to be one of the leading causes of market crashes in general\textsuperscript{320} and of the 2007-2009 financial crisis specifically.\textsuperscript{321}

   Within the political discourse, agencies and politicians shun moral hazards,\textsuperscript{322} however, in practice, the “too big to fail” rationale has been repeatedly used to bail out firms on the brink of bankruptcy. Government supports firms that are thought to be “too big to fail” under the assumption that bankruptcy for such firms

\begin{footnotesize}
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\item \textsuperscript{317} U.S. Dept. of Treasury, \textit{Troubled Asset Relief Program – Monthly 105(a) Report}, Appendix 1, 10-11 (May 2010).
\item \textsuperscript{318} CONGRESSIONAL OVERSIGHT PANEL, \textit{FEBRUARY OVERSIGHT REPORT: VALUING TREASURY’S ACQUISITIONS} 128-129 (2009), \url{http://cop.senate.gov/documents/cop-020609-report.pdf}.
\item \textsuperscript{319} BENTON E. GUP, \textit{TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS}, 143-4 (Praeger Publishers 2004).
\item \textsuperscript{320} See Frank Partnoy, \textit{Why Markets Crash and What Law Can Do About It}, 61 U. PITT. L. REV. 741, 757-759 (2000). Partnoy gives three reasons for why a market might crash – (1) cognitive error, (2) moral hazard and (3) information asymmetry. \textit{Id}.
\item \textsuperscript{321} Karl S. Okamoto, \textit{After the Bailout: Regulating Systemic Moral Hazard}, 57 UCLA L. Rev. 183 (2009).
\end{itemize}
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poses a systemic risk to the broader economy.\textsuperscript{323} Government bailouts were justified during the financial crisis by a “too big too fail” rationalization that started with the government brokered sale of Bear Stearns\textsuperscript{324} and continued through the take-over of Fannie Mae and Freddie Mac, and AIG. In one notable exception during the financial crisis, the government did not rescue Lehman Brothers because of the moral hazard issue,\textsuperscript{325} though commentators have since judged Lehman as an entity that was too big to fail given the subsequent breakdown in the financial system.\textsuperscript{326} While government intervention under the “too big to fail” rationalization was thought to stem economic crisis, the bailouts and subsequent investments during the financial crisis perpetuate the cycle of implicit and explicit guarantees that lead to moral hazards.

The moral hazard problem and insolvency of Fannie Mae and Freddie Mac is well documented. In fact, predictions of the insolvency were made for years before the government takeover.\textsuperscript{327} Both Fannie Mae and Freddie Mac were created as government sponsored enterprises (GSEs). GSEs are distinguished from federal government corporations (FGCs). The government typically retains full ownership of FGCs, but GSEs have both private and public ownership. Partial ownership by the government led to criticism that there was an implicit government guarantee of debt issued by the entities thus leading to risk-taking by managers – a prediction that came true in 2008. In September 2008, the Federal Housing Finance Agency put Fannie Mae and Freddie Mac into conservatorship after months of deteriorating credit markets and a determination by government auditors that that accounting records of the two entities “significantly overstated their capital.”\textsuperscript{328}

\begin{thebibliography}{99}
\bibitem{325} Yomarie Silva, \textit{The “Too Big to Fail” Doctrine and the Credit Crisis}, 28 \textit{REV. BANKING & FIN. L.} 115, 123-4 (2008).
\bibitem{327} For a discussion of the controversy that has surrounded Fannie Mae and Freddie Mac, see Bradley K. Krehely, \textit{Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac}, 6 \textit{N.C. BANKING INST.} 519 (2002).
\bibitem{328} Steven M. Davidoff & David Zaring, \textit{Regulation by Deal: The Government’s
However, at the time of the Fannie Mae and Freddie Mac takeover, the government was presented with an opportunity to address the moral hazard issue. If it completely wiped out the interest of shareholders and bondholders then future managers and shareholders would be less likely to take on the risks that led to the moral hazard.329 Davidoff and Zaring maintain that if the government had been serious about preventing moral hazard, then it would have wiped out the equity and bondholders entirely.330 However, the government took only a 79.7% interest leaving a sizeable stake for existing shareholders. Moreover, Treasury also announced that it would guarantee $5.4 trillion in Fannie Mae and Freddie Mac mortgage-backed securities and debt.331 In late 2008, the Federal Reserve also began a program to purchase as much as $600 billion in mortgage backed securities and other debt on the secondary market that was originally issued by Fannie Mae, Freddie Mac, Ginnie Mae and Federal Home Loan banks.332 That was later expanded to a total of $1.25 trillion on March 18, 2009.333 The response by the Federal Reserve was likely driven by back-channel political maneuvering. What has not been as widely reported is the fact that the US took over the two corporations as a result of pressure from the Chinese central bank and other countries’ sovereign wealth funds, which own much of the Fannie Mae and Freddie Mac securities.334

While the government bailout of Freddie Mac and Fannie Mae was predictable, the AIG liquidity unfolded much more quickly. Given that the AIG was a private firm, rather than a GSE, the bailout response led COP to conclude that the Federal Reserve and Treasury have “fundamentally changed the rules of America’s

329 Id. at 489-490.
330 Id. at 489-490.
Through a series of loans and equity investments, the Federal Reserve Bank of New York and Treasury has provided AIG with $182 billion in assistance and taken a 79.9% ownership interest. The government has been soundly criticized for not seeking out private lenders to support the bailout effort or forcing AIG’s creditors to assume some of the costs associated with the bailout. In a stunning rebuke, COP accused Treasury of “undermining the basic tenets of capitalism” when it gave AIG “a full government rescue with no shared sacrifice among the creditors.” The bailout in essence created a market expectation that government will bail out other firms deemed “too big fail” thus creating a moral hazard issue that has undermined the credibility of the U.S. financial markets and shifting the burden of risk to taxpayers.

The Obama Administration is not blind to the moral hazard issue. The monitoring of banks that accepted TARP funds and the initiatives on executive pay are also said to be geared to counteract moral hazard. Additionally, government officials insist that financial regulatory reform will create a set of rules that will monitor risk and prevent moral hazard.

B. Institutional norms regarding shareholder rights and corporate governance.

After the government makes an investment, issues arise over potential conflicts of interest between the government’s role and institutional norms regarding shareholder rights and corporate governance.

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340 Treasury Secretary Timothy F. Geithner maintained that, "The dominant public policy imperative motivating reform is to address the moral hazard risk created by what we did, what we had to do in the crisis to save the economy." David Cho, Banks 'Too Big to Fail' Have Grown Even Bigger WASHINGTON POST (August 28, 2009) available at http://www.washingtonpost.com/wp-dyn/content/article/2009/08/27/AR2009082704193.html.
as a regulator and its financial interest in a particular. At the heart of the controversy is a tension between the government’s mandate to operate in the public interest and the desire of most shareholders to maximize the value of a firm. Some of the resistance to government investment in a liberal market economy comes from the fear that the involvement of the government shareholder in corporate governance runs the risk of advancing policies in the public interest that will make the firm less competitive.\textsuperscript{341}

Of course, not all shareholders are interested in maximizing the value of a firm. The stakeholder theory of the firm holds that corporations should operate in the long term interest of the various stakeholders, such as employees and the surrounding community, and not just maximize short-term financial gain. Advocates of policy-driven management of state investments rely on a stakeholder (or constituent) theory of the firm in which management considers not only shareholder interests but also interests of labor and the community at large when making firm level decisions.\textsuperscript{342} Stakeholder theories are more consistent with CMEs than LMEs; so while firms may still thrive under a stakeholder theory, there are likely negative consequences to entrepreneurism and innovation if a stakeholder theory of the firm ultimately prevails. Additionally, when the state is a majority shareholder, as in the case of GM and AIG, an issue also arises over whether the state owes minority shareholders a fiduciary duty to maximize the wealth of the corporation.\textsuperscript{343}

Given all of these concerns, there has been much pressure on the U.S. government to forgo its shareholder vote when it owns equity in a private enterprise. Under TARP and other programs, Treasury cut back on its shareholder voting rights considerably, but still exerted considerable influence over some firms. In practice, politicians extracted concessions from companies not through the use a shareholder proxy vote, but through regulation, legislation and intimidation. Conservative commentators’ worst fears of government meddling in the market were realized as Washington replaced executives and boards, made executive compensation a political issue and advanced policy goals fuel by requiring GM and

\textsuperscript{341} Laurence S. Seidman, \textit{Funding Social Security}, 81 TAX NOTES 241, 244 (1998)
Chrysler to pursue a strategy to build fuel-efficient cars.\(^{344}\)

1. **Shareholder Votes, Trusts and Corporate Governance**

   Not surprisingly, the government is more active in corporate governance when it owns a larger stake in a company or if the company is faltering. Treasury has stated that it “will not interfere with or exert control over day-to-day company operations” in companies in which it owns an interest.\(^{345}\) However the degree of agency involvement has varied considerably according to industry. COP noted that the automotive sector was subject to much more hands-on involvement than the financial industry under TARP, although there are some exceptions.\(^{346}\) Major investments in the finance industry, such as AIG, were subject to “significant control.”\(^{347}\)

   Interestingly, Treasury has no shareholder voting rights in AIG yet the agency exerted a great deal of control through other means. The 79.8% ownership interest in AIG is held by a trust set up by the Federal Reserve Bank of New York (FRBNY) with Treasury as the beneficiary. Treasury has no formal legal control over the trust, though Treasury has to be consulted before any shareholder vote or disposition of the shares.\(^{348}\) One principal reason for the trust structure was to avoid the conflict of interests between the government as a regulator and as an owner and to protect against political influence.\(^{349}\) Critics of the AIG trust suggest three modifications to the current structure: (1) trustees should manage for the benefit of the U.S. taxpayer rather than Treasury, (2) that the trustee be under a duty to manage the trust so

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\(^{347}\) *Id.* at 87.


as to “maximize the value for the trust beneficiaries,” and (3) trustee be prohibited from personally enriching out of “investment opportunities that might belong to AIG,” out that the “trustees are required to “manage the trust in the best interest of Treasury, rather than the U.S. taxpayers specifically.” Interestingly, other large holdings, such as the government’s stake in GM, Chrysler and Citigroup, were not put into trusts. There was a move in Congress to require the government to create trusts for any TARP investment where the government owned more than 20% of a company, but the bill has not advanced beyond the committee stage.351

While the AIG trust provides the legal construct of a buffer from the political process, in practice, political actors have asserted a great deal of control over corporate governance. Treasury has performed as a seasoned activist investor – playing a significant role in corporate governance. For example, Treasury, in cooperation with the Federal Reserve and FRBNY, have been involved in the recruitment of new members for the board of directors and senior management and “have taken on an active role with respect to planning and strategy.” Treasury does have more express legal rights in AIG’s corporate governance because of the preferred shares sold through TARP.

Under TARP, Treasury has voting rights in some of its investments but not others. Treasury’s preferred stock purchases under TARP were made without acquiring any voting rights, though certain rights do accrue to Treasury. If a financial institution misses six dividend payments then Treasury can appoint two directors to the entity’s board of directors. Also, Treasury holds a veto right on mergers, exchanges and the issuance of shares senior to the preferred stock. Treasury exercised it rights to appoint two directors to the AIG board in April 2010 after the company missed six dividend payments.

Treasury hold voting stock in GM, Chrysler, Ally Financial

350 Id. at 90.
354 U.S. Dept. of Treasury, Troubled Asset Relief Program – Monthly 105(a) Report, Appendix 1, Appendix 1 21(May 2010).
and Citigroup, but has indicated that it will only exercise its voting rights on important governance issues, such as (1) board of director votes, (2) mergers, exchanges, sale of substantial assets and dissolution (3) issuance of securities requiring a shareholder vote, and (4) amendments to the bylaws and charter. Treasury bound itself contractually to these terms for public companies and through either shareholder agreements or voluntarily for private companies. Treasury is also contractually bound to not vote any shares of common stock that come into Treasury’s portfolio from the exercise of warrants issued as part of the TARP/CPP preferred stock purchases. Treasury waived these future common stock voting rights in response to concerns over government interference in corporate governance.

Should the government have waived or otherwise restricted its ability to exercise a shareholder vote? Commentators concerned over the issue of political interference have suggested that the government shareholder forgo exercising its voting rights. Yet, shareholder activism is an important tool in preventing management waste. Shareholders serve an important oversight function, and some number of active investors are needed in order to fulfill that function. Recently, shareholder activism has been on the rise. Activist investors, such as hedge funds and pension plans, have mobilized to exert even greater control, often to the chagrin of management, by initiating proxies on business direction initiatives – issues that are traditionally reserved for boards and managers. Few scholars dispute that a shareholder has a right to

355 U.S. Dept. of Treasury, Troubled Asset Relief Program – Monthly 105(a) Report, Appendix 1, Appendix 1 20-21 (May 2010)
358 Although Congress allowed the Federal Retirement Thrift Investment Board to invest in index-based funds in 1986, it restricted the entity from exercising any voting rights. Laurence S. Seidman, Funding Social Security, 81 TAX NOTES 241, 244 (1998)
361 Marcel Kahan & Edward Rock, Hedge Fund Activism: The Case For Non-Intervention, 33 ADMIN. & REG. L. NEWS 6 (2008). Public pension funds, such as the $200 billion California Public Employees’ Retirement System (CalPers) fund, are also leaders in shareholder activism. CalPers has initiated several
use the proxy process, though controversy exists as to whether those rights should be expanded or limited. 362

While the government severely restricted its shareholder rights, this does not seem to have affected its ability to exercise significant influence on corporate governance issues. This article argues that the state should not be restricted in exercising its shareholder voting rights on the theory that the exercise of those rights will relieve tension in the political area. As will be seen below, the level of political interference in corporate governance rose with some TARP investments despite the fact that the government lacked a shareholder vote. This paper suggests that if the state exercised its shareholder vote as a means of controlling the firm this might lessen the motivation to use legislative and regulatory means to advance the state’s interests. The challenge is to create a set of institutions and an organization that governs state exercise of shareholder voting rights that will maximize long-term firm value while maintaining objective regulatory and legislative oversight. A set of such institutions is discussed in more detail in Section III of this article.

2. Political influence in corporate governance

Organizational structure and decision-making in Washington is geared to fashioning public policy and not to running a business or managing a portfolio. Consequently, it’s not surprising that politicians and government workers advance politically motivated policy interests, as opposed to maximizing shareholder value, when managing ownership in a private enterprise. Politicians gain credibility with voters when advancing policies that target highly paid executives at financial firms or investments by public entities that are politically unpopular.

The interference of politicians in the decision-making of proxy contests on social and political issues, such as environmental disclosures and limiting executive pay. Gina Chon, Calpers Aims Director List at Increasing Board Sway, WALL ST. J., June 18, 2010, http://online.wsj.com/article/SB10001424052748703513604575310944269110772.html?mod=WSJ_Careers_Management90.

public pensions provides examples of political meddling. In 2007, several state legislatures tried to force their state pension plans to divest holdings in companies operating in Iran because of Iran’s support of insurgents in Iraq. Through a coalition, the state pension plans sent a response that they considered the issue to be a matter of corporate governance rather than foreign policy. The coalition urged companies operating in Iran to weigh whether the risks outweighed the rewards. However, political interference is greater when the investment is made as a result of a bailout rather than a public pension fund investment. Since the legislative branch authorizes specific funds in a bailout, such as the EESA, politicians have a more direct oversight role.

During the financial crisis, the issue of executive salaries and retention bonuses highlights the tension that arises when the political and legislative process attempts to modify contract terms retroactively. No one disputes that executive salaries and bonuses, especially those of Wall Street bankers, are widely considered to be excessive. Even prior to the financial crisis, much had been written about excessive executive salaries and bonuses and the need to tie pay to performance. The ultimate solution is largely going to be driven by changes in government regulations and many different solutions have been proposed. For purposes of this article, the question is whether the government’s in its role as a shareholder in private enterprise interfered with contract rights and corporate governance. An important distinction exists between the government as regulator and the government as shareholder. When the government uses its regulatory power to coercively interfere in corporate governance or change contract terms, it harms the underlying institutions of entrepreneurial capitalism, which require

366 Reform proposals are outside the scope of this article. For a normative evaluation and framework for proposed solutions, see Lucian A. Bebchuk & Holger Spamann, Regulating Bankers’ Pay, 98 GEORGETOWN L. REV. 247 (2010), David I. Walker, The Challenge of Improving the Long-Term Focus of Executive Pay, 51 BOSTON COLLEGE L. REV. 435 (2010), and Michael B. Dorff, Confident Uncertainty, Excessive Compensation and the Obama Plan, 85 INDIANA L. J. 491 (2010).
The issue of executive salaries became highly politicized when it became public that executives at companies receiving government funds would receive billions in bonuses despite the financial downturn.\(^{368}\) Naturally, the issue of executive compensation is appropriate for both the political arena and as a legitimate shareholder concern. As a political and regulatory matter, government can and should investigate and legislate on the issue of executive compensation as it applies to industries as a whole. In addition, the government can and should assert its rights as a shareholder and use any legal means available through contract negotiation or corporate governance to curb excessive salaries.

However, there are significant consequences when the government uses its regulatory and legislative powers in a coercive manner to target executives at companies in which the government holds an interest. Constitutional questions arise regarding bills of attainder and \textit{ex post facto} laws. To the extent that the government seeks legal modification of existing compensation contracts, the public process has included coercive threats of litigation and public shaming of individuals – possibly violating privacy rights and engaging essentially private persons within the political arena.\(^{369}\) This section will first review the rights in general of shareholders, and then examine how the government responded to the executive compensation issue and the degree to which it used its leverage as a regulator/legislator to change contractual terms.

Any investor – whether it is the government or private persons – can contractually set limits on executive compensation when negotiating the investment contract. Indeed, many investment contracts – especially for risky endeavors – set limits on compensation or require approval of the investors before granting bonuses or raises. To the extent that shareholders are not protected through the investment contract, they can assert their rights under corporate law. Under corporate law, shareholders can attempt to curtail excessive executive pay either through the proxy process or as a litigant,\(^{370}\) though both methods are generally


\(^{370}\) Renee M. Jones, \textit{Law, Norms, and the Breakdown of the Board: Promoting
thought to be less than effective given the separation between ownership and control.\textsuperscript{371} Despite the legal constraints, institutional investors have increasingly sought to use their proxy rights to limit executive compensation.\textsuperscript{372} Alternatively, some shareholders have used shareholder derivative lawsuits to limit compensation packages claiming that the approval process used by a board of directors breached a fiduciary duty or otherwise constituted an \textit{ultra vires} act. Given the deference afforded boards of directors through the business judgment rule, such efforts have also met with limited success.\textsuperscript{373}

Controls over executive compensation were built into the initial TARP investment contracts; however voter outrage sparked political action in Congress when it was revealed that AIG planned $165 million in bonuses.\textsuperscript{374} Initially, the TARP funds provided some limited restrictions on executive and employee salaries and bonuses by prohibiting compensation that encouraged unnecessary risk-taking, banning excessive golden parachutes and lowering the amount of salary that could deducted for tax purposes on the company’s tax returns.\textsuperscript{375} These soft restrictions provide a disincentive for a company to give large salaries and bonuses but do not outright prohibit the payment of large bonuses or salaries except in cases of misrepresentation. The restriction provides that the CEO, CFO and the next three most highly compensated executive officers are not compensated in such a way that would encourage “excessive risks that threaten the value” of the QFI. Golden parachutes of three times an executive’s base salary were prohibited, compensation over $500,000 could not be deducted by the QFI for tax purposes and bonuses and incentive compensation would be “clawed back” in the event that statements of earnings, gains or other criteria “are later proven to be materially

\textsuperscript{373} \textit{In re Walt Disney Co}. Derivative Litig., 907 A.2d 693, 746-747 (Del. Ch. 2005).
\textsuperscript{374} Office of the Special Inspector General for the Troubled Asset Relief Program, SIGTARP: Initial Report to the Congress, 54 (February 6, 2009).
After AIG announced $165 million in bonuses, the subsequent political uproar led the House to pass legislation that would tax some bonuses granted to employees working firms receiving significant government financing under TARP and other programs.\(^{\text{377}}\) The proposed tax would have effectively canceled out much of the bonuses by applying a levy of 90% on money paid out to employees who worked at companies receiving $5 billion or more in government financing and whose household income was over $250,000.\(^{\text{378}}\) Commentators suggested that the tax could be unconstitutional under a theory of prohibitions on bills of attainders or an expanded *ex post facto* clause.\(^{\text{379}}\) The Senate tabled its measure, and the proposal never gained any additional support.\(^{\text{380}}\)

Another option open to the government would have been to compel AIG to breach the bonus contracts with its employees or seek rescission through a court action. Efficient breach of a contract is condoned in a market economy so long as the innocent party is made whole through damages. The White House considered breaching the AIG bonus contracts, but concluded that legal fees would be greater than the cost of the bonuses.\(^{\text{381}}\) The government could have also sought to rescind the contracts under a variety of theories including employee breach for nonperformance, fraudulent conveyance, nondisclosure, and impracticability, although it is not certain that any of these theories would have held up in court.\(^{\text{382}}\) A suit could also have been brought under the

\(^{\text{376}}\) Office of the Special Inspector General for the Troubled Asset Relief Program, SIGTARP: Initial Report to the Congress, 54 (February 6, 2009).


\(^{\text{378}}\) To Impose an Additional Tax on Bonuses Received from Certain TARP Recipients, H.R. 1586, 111th Cong. § 1(a)(2) (2009).


\(^{\text{381}}\) Jonathon Weisman, Naftali Bendavid & Deborah Solomon, *Treasury Will Make Grab to Recoup Bonus Funds*, WALL ST. J. (March 18, 2009).

restitutionary theory of unjust enrichment, though it was also considered a long shot. The House Judiciary Committee went so far as to introduce a bill titled the “End Greed Act” that authorized the Justice Department to bring lawsuits against executives who had received bonuses from some companies, but the measure was defeated.

Rather than legislate or pay damages, various politicians used the media and its investigatory powers to shame the recipients of the AIG into giving back the bonuses. The attorneys general for New York and Connecticut each announced investigations that would “name and shame” recipients of the bonuses. While it was politically expedient to rally against executive compensation, some of the AIG bonuses were actually consistent with the market salaries for talented finance professionals. Given that it was in the government’s interest to retain the best people available to make AIG profitable, the granting of some bonuses could actually be arguably prudent. AIG’s president justified the bonuses by noting that the FDIC and aides to Treasury Secretary Geithner were involved in the decision-making, and the highest paid bonuses had gone to people who had saved AIG hundreds of millions of dollars by unwinding complex derivatives. The public and moral outrage over the bonuses convinced many at AIG to give back at least a portion of the bonuses, with 15 employees out of the 20 highest compensated agreeing to return the money.

386 Jake DeSantis, Dear A.I.G., I Quit!, NEW YORK TIMES (March 25, 2009).
389 Greg Hitt, Drive to Tax AIG Bonuses Slows, WALL ST. J., (March 25, 2009) available at http://online.wsj.com/article/SB123794222776332903.html. After a year, however, little of the money that had been pledged was actually returned. Knowledge@Wharton, Kenneth Feinberg and Executive Compensation: ‘My Number-one Priority: Repay the Taxpayer’ available at http://knowledge.wharton.upenn.edu/article.cfm?articleid=2448.
Conservative commentators chastised politicians for using their public office as leverage in renegotiating compensation packages. Some dedicated employees who were actively part of the solution quit in disgust after politicians and AIG executives brought pressure to give back bonuses to which they were contractually entitled.

After realizing that the EESA provisions on executive compensation were inadequate, Congress amended the EESA when it passed the ARRA. The new provisions placed caps and other restrictions for TARP recipients entering into employment contracts after February 11, 2009. The salaries of some executives were capped at $500,000 and the changes required that companies issue restricted stock for any additional compensation. One question that arises is whether the corporate recipients of TARP funds prior to the ARRA should have been bound by these new provisions. The TARP investment contracts entered into with Treasury specified that recipients be bound by the initial version of the EESA. Since those prior contracts did not anticipate rigid compensation standards banks that received TARP investments prior to February 11, 2009 could argue that the new restrictions would not apply to any post-February 11, 2009 employment contracts as well as prior contracts. The government in effect changed the TARP investment agreements through legislation rather than negotiation.

For past TARP investments, Treasury had an interesting provision that allowed the government to unilaterally modify the contracts for the initial round of TARP investments. In an interesting twist that is likely to inhibit private enterprise from accepting government investment in the future, Treasury contractually provided for future political interference. One little discussed term in the purchase agreements gave Treasury a “unilateral right to amend any provision of the purchase agreement to the extent required to comply with any changes after the signing of this agreement.”

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391 Jake DeSantis, Dear A.I.G., I Quit!, NEW YORK TIMES (March 25, 2009).
392 Jake DeSantis, Dear A.I.G., I Quit!, NEW YORK TIMES (March 25, 2009).
date in federal statutes.” The Oversight Panel suggested that such a clause could be used to provide for reporting requirements. However, its use here allows Congress to unilaterally change a provision of the EESA, which could materially alter the original contract. Naturally, any contract would be modified if it provided for performance that was made illegal by subsequent legislation. However, the provision here allows Congress to modify EESA to give the government additional rights under prior contracts. Under a strict view of contract law, a unilateral right to modify a contract could arguably make a contract unconscionable or illusory. Since the right to modify rests with the political arm rather than objective managers, the action can be used coercively to extract additional terms, which were not bargained for.

One express provision of the ARRA amendments to the EESA made clear that the new restrictions did not apply to employment contracts entered into prior to February 11, 2009. However, the ARRA required that Treasury review all bonus payments made prior to the passage of the ARRA and to negotiate with companies and employees to return payments made that the Secretary deemed to be “contrary to the public interest” or otherwise inconsistent with TARP. By authority granted to it under the ARRA, Treasury promulgated regulations to establish the Office of the Special Master for TARP Executive Compensation – known colloquially as the “Pay Czar.”

However, by politicizing the issue and using its leverage to renegotiate existing contracts as well as changing terms of the TARP investment contracts, the state acted in a way that is inconsistent with the political economy of entrepreneurial capitalism. One consequence of the politicization of the compensation issue was that firms sought to pay back TARP funds earlier than originally planned, thereby leading to questions of whether the banks were still adequately capitalized. The broader political economy issue surrounding the government’s reaction to compensation was that the sanctity of contract rights – one of the fundamental institutions of entrepreneurial capitalism – had

397 31 C.F.R. § 30.16(1a)(2) (2009).
become open to political risk – i.e. the risk that the government would interfere in property rights in the interest of “redistributionist ‘justice.’”

3. **Conflicts of interest create tension when the government is both regulator and shareholder**

Critics of government investment maintain there is an inherent conflict of interest when the government is both a shareholder and a regulator. Government’s role as a regulator can have a enormous effect on the value of a firm. Decisions by the Federal Reserve on the money supply can have an enormous effect on Wall Street firms. “Given the government’s ownership interest in financial institutions, it would be natural to suspect conflicts arise if the individuals with responsibility for interest rate decisions are the same ones charged with returning the taxpayer’s money from TARP investments. This is not to suggest that any nefarious decisions were made – only that the appearance of conflicts undermines credibility. Potential conflicts also arise over the award of government contracts. Might the government as a controlling shareholder exert influence over a corporation to award a sweetheart deal with a state agency, or conversely might the government draft contract bids in a way that the outcome favors its portfolio companies?”

Additional conflict of interest issues come up when the government owns shares in competing companies, such as GM and Chrysler. While many investors hold a portfolio of companies in which there are bound to be some competitors, the role of Treasury as a controlling shareholder could give accusations of conflicts and possible breaches of a fiduciary duty. With a different twist, the government can also launch broader policy initiatives and use taxpayer dollars to drive customers to its portfolio companies. The Cash for Clunkers program, although nominally aimed to improve fuel efficiency in cars, helped jumpstart sales for Chrysler and GM.

400 *Id.*
404 CONGRESSIONAL OVERSIGHT PANEL, *SEPtember Oversight Report: The*
The ethics rules governing conflicts of interest in government bailouts are considered inadequate.\textsuperscript{405} Conflicts also arose during the crisis given that many of the regulators were formerly Wall Street professionals.\textsuperscript{406} The close relationship between the regulators and the executives at financial institutions receiving TARP investments led to the appearance that the banks received a better deal than the automobile industry.\textsuperscript{407} Concerns over ethical conflicts of interest in government investments has not been limited to TARP and the other programs. Critics of the Ex-Im Bank charge that political influence drives the lending decision process.\textsuperscript{408} Before the Enron scandal surfaced, Ex-Im Bank loaned or guaranteed loans of $650 million to the corrupt power trader. Enron and its executives had contributed generously to both political parties. In fact, an Enron executive sat on the board of Ex-Im Bank. It was later discovered that some of the loans were used to fund bogus sales of energy. Over $500 million of the loans were unpaid when Enron faced liquidation.\textsuperscript{409}

Conclusions

The issues that arise in government investment have led commentators to oppose government ownership of private enterprise for four interrelated reasons: (1) that the government bureaucracy does not have the market expertise necessary to efficiently purchase and manage assets; thus leading to waste,\textsuperscript{410}

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\textsuperscript{409} Id.
\end{flushleft}
(2) that investments will be made for social or political purposes rather than for economic gain,411 (3) an inherent conflict of interest arises when the government acts as both a regulator and an investor,412 and (4) fear of political interference in corporate governance.413 The next section discusses the norms that lead to the last two fears.

III. Regulating Public Ownership of Private Enterprise

Can state investment and ownership of private enterprise be reconciled with a neoliberal market economy and the American entrepreneurial culture? This section attempts to establish a set of rules of the game – both formal and informal – that will guide and constrain state decision-making regarding investments in private enterprise in order to address the problems identified. To differentiate these behaviors from states capitalism, this article uses the term “state entrepreneurship” to describe the underlying principles of the proposed rules.

State entrepreneurship,” “state entrepreneurship,” “state entrepreneurship” and the “entrepreneurial state” are terms that have been used by economists, academics and politicians to describe a developmental role for the state; yet the term has also been misused to describe investment activities that are politically-driven rather than classically entrepreneurial.414 State entrepreneurship has often been associated with coordinated market economies (CMEs) rather than liberal market economies (LMEs). Some may object to the use of the term state entrepreneurship as anything other than a form of state capitalism. However, a classic Schumpeterian definition of entrepreneurship necessarily includes
profit seeking, risk taking, innovation and market-based transactions. These characteristics are inconsistent with politically motivated investments and the institutions that characterize CMEs.

This article redefines state entrepreneurism as activities that support the flourishing of innovation and economic growth in a LME. State entrepreneurism, as a normative matter, provides that the government will maximize the return on all investments by abiding by the rules of the game of a market economy. In order to achieve that goal, investment and portfolio decisions must be insulated from direct influence by politicians. While the government maintains its regulatory oversight, the state investment function is separated from the political and bureaucratic arm in order to prevent rent-seeking behavior. In a state entrepreneurial model, investments are purchased at fair value without coercive threats, such as nationalization. Moreover, government does not use its legislative or regulatory power to extract concessions from private companies in a state entrepreneurial model. While government remains a regulator, the investment function is separated from the political and bureaucratic arm in order to prevent rent-seeking behavior. In this model, the state does not seek to control; rather, the state seeks to both feed and harness the power of an entrepreneurial capitalist society by investing in a diversified portfolio of stocks, bonds and other assets in which the state does not have complete ownership over any given private enterprise. Through investment, the state insures the free flow of capital – a key ingredient for private entrepreneurs to flourish.415

Why use the word entrepreneurism? As David Pozen reflected in his engaging rhetorical study, We are all Entrepreneurs Now, it is fashionable among academics and policy makers to label any innovation as “entrepreneurial.”416 “Social entrepreneurs,” “Norm entrepreneurs,” and “Moral entrepreneurs” foster innovative change within academic disciplines.417 Pozen explains that the buzzword proliferated because it easily identifies the concept of innovation and resourcefulness within a particular academic field.418 Moreover, the term captures positive

416 David Pozen, We Are All Entrepreneurs Now, 43 WAKE FOREST L. REV. 283 (2008).
417 Id.
418 Id. at 315.
connotations. The entrepreneur – certainly through the 1980s and 1990s if not before – had become an American hero and folk legend – especially as breakthrough technology companies proliferated from the garages and apartments of Silicon Valley engineers.\textsuperscript{419} Given its positive connotations, actors within a system are more likely to accept change – whether political, social or institutional – when it is characterized as “entrepreneurial.”\textsuperscript{420}

However, characterizing government investment as state entrepreneurship is not a mere rhetorical exercise to re-label or market an American brand of socialism in order to make U.S. citizens feel better. Rather, to characterize government investment as state entrepreneurship this article argues that the government must operate according to the same rules of the game as private investors in an entrepreneurial economy. Moreover, in order to represent advancement over prior policies, it must achieve its goals of fostering economic growth without creating moral hazards or rent seeking behavior.

Measuring the success of an investment, however, is more complicated when the government is involved than when the investor is a private money manager. In the latter case, the measure of success is merely wealth creation, although there are notable exceptions to that rule.\textsuperscript{421} The goals of government investment, however, are more broadly conceived to serve the public good, which may or may not include maximizing the cash flows from the investment. In order to elaborate upon state entrepreneurship within a liberal market economy, this article first creates a typology of government investments which describes the different sets of goals for any particular investment. The article then describes a overarching set of institutional norms that can apply to any given type of investment.

A. Typology of Government Investment.

Government investment can be broadly described by the following five characteristics: (1) infrastructure investments, (2) social investments, (3) political investments, (4) economic investments and (5) financial investments. While government investment occurs with more frequency in CMEs than LMEs, all

\textsuperscript{419} \textit{Id.} at 320.

\textsuperscript{420} \textit{Id.} at 319-20.

\textsuperscript{421} There are many mutual funds and other investment vehicles focused on social goals, such investing in companies that are environmentally conscious. See generally, Social Investing Forum, \textit{What is Socially Responsible Investing?}, available at \url{http://www.socialinvest.org/resources/sriguide/}.
five types of government investment typically exist in any given political economy. The degree of investment in any given category may be greater in one form of political economy than another. The principal differences in government investment between CMEs and LMEs can be found in the institutions that shape and constrain those investments. Government invests for many different reasons, and this typology tries to identify the principal reasons for state investment. By isolating the motivation of the government in making the investment, one can better determine the ROI and if the investment was successful.

**Infrastructure Investments:** The most common and well-accepted form of government investment is the infrastructure investment, such as building roads, schools and hospitals. Such investments have indirect, though still tangible, returns by increasing commerce through transportation and a healthier and better-educated workforce. The Erie Canal, the interstate highway system and the Panama Canal are all seen as investments that paid off both economically and socially.422

**Social Investments:** Social investments are closely linked to political investments but are distinguished in that the investments are made not in the interest of advancing a political relationship but in advancing the cause that likely has its roots in particular political ideology. Social investments are made to advance some public purpose such as housing for the poor or the development of fuel-efficient cars. The return on investment might be a reduction in social ills, such as homelessness or a reduction in pollution.

**Political Investments:** Political investments are those made as a bargaining mechanism between political actors in order to reach a compromise, advance a political relationship, or achieve a strategic objective. For example, an investment made in a third world nation with an unstable government would be political in that by improving the country’s economy the favored regime has a greater chance of achieving stability, which can ultimately be politically beneficial to U.S. international policy.

**Economic Investments:** Economic investments are made to improve GDP mostly through the creation of jobs. Public venture capital funds that make investments to help improve the economy in a region or a sector of the economy are considered developmental and are economic in the sense that such investments could lead to a rise in GDP by creating jobs and adding products or

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422 FELIX ROHATYN, BOLD ENDEAVORS: HOW OUR GOVERNMENT BUILT AMERICA, AND WHY IT MUST REBUILD NOW 3 (Simon & Schuster 2009).
services to the economy. Investments made to prevent systemic risk, such as the AIG investment made under the TARP program, is economic in the sense that but for the investment, the collapse of the company would cause greater harm to the economy than the cost of the investment.

Financial Investments: Financial investments refer to investments made to help fund social programs. In other words, the investment is a savings mechanism to finance the future cost of another government program. For example, the Social Security Trust Fund is a financial investment in which government bonds are being held to finance retirement benefits for the Baby Boom generation. A growing number of states now diversify portfolios to include not only bonds, but also stocks, real estate and other assets.

For some investments, it is difficult to isolate just one motivation or to classify the investment as being in only one category. Some investments have multiple motivations. The investment made by the government in GM and Chrysler through the Automotive Industry Financing Program could be construed as economic, political and, to a lesser extent, social. The investment was economic to the extent that it prevented systemic risk to the economy. Yet, the investment was also arguably politically driven given the influence of labor unions within the Democratic party. To the extent that the government mandated that the car companies produce fuel-efficient vehicles if they were to

424 Many commentators contend that the U.S. Treasury bonds held in the Social Security Trust Fund are merely accounting entries and not actual investment earning interest. See ALLEN W. SMITH, THE LOOTING OF SOCIAL SECURITY 43-44 (Carroll & Graf Publishers 2004). This article For a more complete discussion of the bonds, see Benjamin A. Templin, Full Funding: The Future of Social Security, 52 J. L. & POL. 395, 408-415 (2006).
427 The started objectives of Treasury’s investment in the automotive industry have varied and provide little clarity as to the primary reason behind the investment. CONGRESSIONAL OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT: THE USE OF TARP FUNDS IN THE SUPPORT AND REORGANIZATION OF THE DOMESTIC AUTOMOTIVE INDUSTRY 3-4 (2009), http://cop.senate.gov/documents/cop-090909-report.pdf.
428 Id. at 3.
get the funds, then the investment was arguably made for social purposes.\textsuperscript{429}

B. Institutional Norms for Government Investment that Support a Liberal Market Economy.

The challenge here is to describe a set of norms whereby the state is constrained to act according to the rules of prudent investor when it acts as a market participant and not use its leverage as a regulator to modify market incentives for innovation and growth. In order to create a set of norms, it is first useful to identify the characteristics of a successful market economy. Baumol, Litan & Schramm four characteristics of a successful entrepreneurial include: (1) market based institutions and organizations that make it efficient for an entrepreneur to create, finance and hire labor for the enterprise,\textsuperscript{430} (2) strong property and contract rights,\textsuperscript{431} (3) protections against coordinated market activities and rent-seeking behavior,\textsuperscript{432} and (4) policies that support free trade, innovation and the prevention of monopolies.\textsuperscript{433} With Baumol, Litan & Schramm’s four characteristics help inform how the state must act when it becomes a market participant. If the state destroys property or contractual rights when it enters the market, entrepreneurs will be less incentivized to create new businesses. As discussed above, the U.S. intervention in the GM and Chrysler bankruptcies affected the contractual rights of bondholders. Such action is likely to raise the cost of capital for these businesses. Likewise, the government actions of bailing out firms deemed “too big to fail” is a coordinated market activity which gives an edge to some firms by providing insurance that such firms do not have to fund.

Some commentators would argue that the only set of norms that would encourage an entrepreneurial economy would be a complete ban on government investment except in the case of market failure. A more practical approach is adopted here given

\textsuperscript{430} WILLIAM J. BAUMOL, ROBERT LITAN & CARL J. SCHRAMM, GOOD CAPITALISM, BAD CAPITALISM, AND THE ECONOMICS OF GROWTH AND PROSPERITY 7-8 (Yale Univ. Press 2007).
\textsuperscript{431} Id.
\textsuperscript{432} Id.
\textsuperscript{433} Id.
the emergence of government investment both domestically and internationally. With the characteristics of an entrepreneurial economy in mind and the assumption that government investment is inevitable, this article now turns to analyze how the government as an investor and market participant should behave in order to preserve an entrepreneurial economy while still engaging in long-term investments.

State entrepreneurism, as defined by this article, requires that the state follow six rules of the game in order to optimally preserve an entrepreneurial economy in the presence of long-term government investment. These principles are:

**Principle # 1: Market Driven.**
Investments by the state should be market-driven and have a discernable and potentially positive return on the investment.

**Principle # 2: Prudent Investor Standards.**
The government entity must invest according to the standards of a similarly situated non-governmental prudent investor by following well-accepted rules such as diversification of assets and purchasing assets at a fair value.

**Principle # 3: Maximize Return on Investment.**
Each investment should be managed so that it maximizes its return on investment. This requires identifying the goals of each investment according to its typology.

**Principle # 4: Political Insulation.**
Investment and portfolio management decisions must be insulated from political influence by establishing a federal government corporation that exists separate from the normal federal bureaucracy.

**Principle # 5: Non-Coercive Regulatory Action.**
The government must separate its regulatory function from its investment function and must not use its regulatory and/or law-making powers to
target companies or employees for reasons related to the investment.

**Principle # 6: Accountability and Transparency.**
In order to prevent rent-seeking behavior and to maximize ROI, the government arm making the investments must be held accountable. Transparency in the investment and management decisions is a key method to achieving such accountability.

These six institutional constraints are designed to be complementary in that the presence or efficiency of one increases the returns from or efficiency of the others.434 For example, political insulation helps lessen the possibility of coercive regulatory action. Following prudent investor standards will more likely maximize the return on any given investment. The application of a principle will differ depending on the type of investment made by the government. For example, the meaning of maximizing ROI will differ according to type of investment. If an investment is made for financial reasons then maximizing ROI suggests that the government pursue wealth maximization, whereas ROI for a political investment will be measured according to the degree that the investment furthers the political agenda for which the investment was made.

The rest of this article explores each of the six principles in more depth.

1. **Principle # 1: Market Driven**

*Investments by the state should be market-driven and have a discernable and potential positive return on the investment.*

Regardless of the type of investment (i.e. infrastructure, social, political, economic or financial), each state investment should be market driven in that it is constrained by market demand, which is broadly construed to include both real and potential market demand. Market demand is classically defined as the range of quantities demanded at various given prices. Thus, market-driven investments are those that are determined by market forces.

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To the extent that there is no market demand for the investment, the government would refrain from making the investment. Government investment typically occurs where there is market failure to provide a desirable good, such as infrastructure investments. Given the more broadly defined types of investments to include financial investments — i.e. portfolio investments meant to help fund social programs — a constraint that the investment be market driven will help prevent waste of overpayment or investments in non-performing assets.

Additionally, each investment should only be made if there is a discernable and potential positive return on investment (ROI) to act as a constraint on government waste or political investments of the sort that are the result of cronyism. Administrative law as it relates to informal adjudications helps inform the standard by which the government will be judged in making investments. Whether a given investment might produce a potential positive return would be measured by the low threshold of a reasonability standard where the government could make an investment so long as the investment decision has a reasonable basis in fact and was supported by the record. Furthermore, no investment may be arbitrary or capacious. The lower standard would not preclude including some riskier investments in the broader portfolio since such a diversified portfolio of such investment often produce outsized returns. Thus, an investment in nanotechnology, an industry that may take over twenty years to see broader commercial application, would have a reasonable basis for a potential positive return.

How would the market driven standard operate given the different types of government investment? Principally, government investment is made when there is market failure; thus any investment made for economic development reasons or to prevent systemic risk would be market driven. Economic investments are market-driven when there is market failure. Government steps in to provide liquidity in a crisis or to provide funding for a project that is too big for the private sector to absorb. Thus, the TARP investments in banks and financial organizations are appropriately market driven investments made for economic reasons. However, bailouts of industries that have a declining market or the high probability of a negative ROI would not be made. For example, the buggy whip industry faced distinction because the automobile replaced the horse and carriage. In that instance, the state would not invest in a declining industry because no future market exists.
for buggy whips.\textsuperscript{435}

Financial investments would occur only if welfare programs need funding and investment constitutes a Pareto improvement. Social Security and Medicare are both facing a funding crisis, and investing the Trust Fund in a diversified portfolio of stocks, bonds and other assets has been shown to outperform the current bond-only portfolio in the long-term.\textsuperscript{436} Social investments would be made only if a return on investment could be shown so that by making the investment, the government somehow comes out ahead. For example, if it can be shown that government health care expenditures for the poor can be reduced by starting preventive care clinics, then the investment has a discernable ROI and the investment should be made. The investment, of course, needs to be monitored on an on-going basis to insure that the ROI is optimized. See Principle # 3, Wealth Maximization below. Examples of successful market-driven publish organizations already exist. The public university system in California and other states encourage their professors to conduct patentable research that is then commercially exploited.\textsuperscript{437} Some government expenditures are naturally “non-market resources that support the market.”\textsuperscript{438} Yet these expenditures are distinct from government investments.

2. **Principle # 2: Prudent Investor Standards.**

The government entity must invest according to the standards of a similarly situated non-governmental prudent investor by following principles such as diversification and purchasing assets at a fair value.

This principle evokes two concepts. First, the state must not exercise its coercive power – i.e. threats of nationalization – when purchasing assets. Second, the state entity should follow the principles of a prudent investor by diversifying and paying the fair

\textsuperscript{435} The buggy whip industry example is a classic economics illustration of supply and demand that should be familiar to any student of economics.


\textsuperscript{437} COLIN CROUCH, CAPITALIST DIVERSITY AND CHANGE: RECOMBINANT GOVERNANCE AND INSTITUTIONAL ENTREPRENEURS 141 (Oxford Univ. Press 2005). Crouch goes on to state that the simple hypothesis of market-driven university research is more complex when takes into account the public research that is conducted by these universities. Id.

\textsuperscript{438} Id.
market value price for assets.

State entrepreneurism distinguishes itself from state capitalism by not using coercive techniques, such as nationalization, in order to acquire assets. Purchases by the government should be on the open market valued as a reasonable private investor would value the purchase. This does not mean that the government should overpay. In fact, to be consistent with Principle #3, wealth maximization, the U.S. should drive a hard bargain in private purchases. As discussed previously, the government drove hard bargains on some issues with TARP investments but severely undervalued the initial investments under the Capital Purchase Program.

In drafting the enabling legislation, lessons can be learned from the successful Canadian Pension Plan Investment Board Act. The structure of this legislation specifies how investments are made and the goals of the fund in order to ensure that politics remain out of the decision making process. For example, the enabling legislation could require that the fund be broadly diversified.

3. Principle # 3: Maximizing Return on Investment

*Each investment should be managed so that it maximizes its return on investment. This requires identifying the goals of each investment according to its typology.*

For any given investment type – i.e. infrastructure, social, political, economic or financial – the government should seek to maximize the ROI. The measure of an investment’s ROI differs depending upon the type of investment.

For financial investments, the ROI is merely the degree to which the investment has increased monetarily. Thus, maximizing ROI for financial investments merely means wealth maximization. As a practical matter, one way to achieve wealth maximization would be to mandate a diversified portfolio of stocks, bonds and

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other assets to help reduce the risk of a downturn and insure that political influence does not skew holdings to one region or section. In addition, investments would be held for the long term in order to maximize the wealth.

In contrast, a political investment is made for the purpose of bargaining or compromise among political actors in order to advance a political agenda, thus maximizing the ROI would consist of making those investments that ultimately increase the effectiveness of the particular agenda.

4. Principle # 4: Political Insulation

Investment and portfolio management decisions must be insulated from political influence without sacrificing accountability.

In order to depoliticize the investment decision, government investments should be managed through a centralized state investment authority that exists outside of the federal agency structure. As already discussed, the inherent conflicts of interest between the regulatory function and the investment function require a separation between the investor/management arm of the state and the legislative/regulatory arm. At the same time that a federal SWF should remain independent of political influence, it must also be held accountable. Within the existing federal organization structure, there already exists a form of entity – the federal government corporation (FGC) – that has often been used to create political insulation and give government access to business methods and tools not normally accorded to agencies. Congress has created FGCs to help manage the nation’s finances since the eighteenth century and many government agencies that deal with financial matters are normally structured as FGCs. Adopting the FGC model as the organizational structure would separate the SWF from political influence and give professional investment advisors the latitude they need to make investment decisions.

\[\text{441} \text{ Such an entity will, in effect, join other foreign SWFs as a new class of financial intermediary.}\
\[\text{442} \text{ See Hong Li, China Investment Corporation: A Perspective on Accountability, 43 International Lawyer 1495 (2009).}\

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decisions that maximize wealth.

Other countries have effectively used such a structure. In 1997, Canada created a federal Crown corporation that was charged with creating wealth for the purpose of funding the country’s social insurance programs. While some politicians have tried to exert influence, the Canadian government corporation has remained politically neutral.445

FGCs are controversial. Scholars have raised questions about the legitimacy, accountability and transparency of American FGCs. From a constitutional point of view, it is uncertain under the state action doctrine, whether an FGC would be considered a state actor and therefore required to comport with U.S. constitutional requirements and federal law governing agencies. 446 Other constitutional questions that are raised include the impact of the non-delegation doctrine, and the Appointments Clause.447

FGCs came under close scrutiny in the debate over the privatization of government functions. Much has been written about government outsourcing of traditional government functions such as the operation of prisons, schools, and the delivery of welfare benefits.448 In the debate over the public-private divide, scholars have focused attention primarily on the privatization of public functions and the constitutional implications of having a private entity deliver public services, such as private prisons.449

This has led to a wide body of scholarship, which speculates that the public-private distinction is archaic, and that some entities should be deemed quasi-public. The public-private entity distinction creates the opportunity to discuss not only private actors that take on a public role as quasi public institutions but also public actors which play a role in the private markets -- i.e. quasi private institutions. The characterization of a U.S. SWF as a FGC which follows the principles of state entrepreneurship suggests an entity that conceptually has the power, tools and autonomy of a private hedge fund yet is still held accountable as a public entity to

447 Id.
its sole shareholder – the U.S. government. Needless to say, such an entity must be made accountable and controllable so that rogue managers do not engage in waste, rent-seeking behavior or pursuing a political agenda.

As to the constitutional question of whether a federal investment authority structured as an FGC is a state actor, Congress can avoid costly court battles by just conceding in the enabling legislation that a federal SWF is a federal agency for constitutional purposes. Scholars concerned over FGCs and the state action doctrine are primarily focusing on the transfer of the state’s powers to investigate, regulate and create rules to a private actor. A federal investment authority will not be charged with any of those functions. Indeed, the whole point is to separate those functions away from the investment authority so that investment and management decisions are not coercive. It is possible that political influence may affect a federal investment authority through the appointment process for directors; however, the enabling legislation could mandate that there be minimum requirements so that only qualified financial professionals would be appointed.

Constitutional provisions provide the greatest protection against meddling by politicians. A constitutional amendment seems extreme but is not unprecedented on the state level. Both California and Oklahoma provide protection to their state employee pension funds against political meddling by mandating that the fiduciary duty of its fund managers is to its beneficiaries. Of course, many amendments are proposed but few are passed. Defining the purpose of the SWF as a funding mechanism for entitlement programs, such as social security and Medicare, will create political will within the electorate to maintain the fund’s driving principle of wealth creation in order to provide for a retirement income.

450 Any appointment of directors by the President would require the advice and consent of the Senate in order to comport with the Appointments Clause of the Constitution. It is unlikely that the managers of a multi-trillion dollar government investment fund would be considered “inferior officers” under the Constitution. See U.S. Const. art. 2, § 2.


454 See Okla. Const. art. 23, § 12.
A federal investment authority that is structurally separate from agencies must, of course, be held accountable. FGCs are subject to the same agency problems that plague corporate governance for private companies. With private corporations, accountability for the actions of managers is achieved through board of directors’ oversight, shareholder voting rights, derivative lawsuits, market takeovers, and government regulation. For an FGC, many of these tools, such as market takeovers, are not relevant. If the goal is to insulate the fund politically, then giving the Executive or Congress the same rights as a board of directors or shareholders would not achieve that goal. Instead, the political process must be used to choose an independent board with strict fiduciary duties and obligations that could be enforced through the courts if necessary.

5. **Principle # 5: Non-Coercive Regulatory Action**

The government must separate its regulatory function from its investment function and does not use its regulatory and/or law-making powers to target companies or employees for reasons related to the investment.

To the extent that Congress desires to advance social or political goals, then it can do so through legislation that seeks to advance those goals. Such legislation may identify political or social investment. However, in the management of any given investment, the regulatory agencies must not be influenced by the political establishment to attempt to influence the corporate entities. To the extent that the government wishes to influence the corporate entity in which an investment is made, it should use the mechanisms accorded to shareholders. This does not mean that the government forsakes its role as a regulator or advocate of policy change. Instead, the government wears two hats – that of the regulator and that of the investor. While conflicts of interest might abound, norms within corporate law give us a model whereby the government can resolve the dissonance of conflicting roles.

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456 Id. at 585–86.
457 Id. at 591.
458 Id. at 577.
459 Id. at 627.
6. Principle # 6: Accountability and Transparency

In order to prevent rent-seeking behavior and to maximize ROI, the government arm making the investments must be held accountable. Transparency in the investment and management decisions is a key method to achieving such accountability.

One of the most consistent criticism made during the TARP investments was that Treasury needed to be held accountable and the decision process had to be more transparent. There are, naturally, many mechanisms for oversight available and the TARP program is an excellent illustration where several arms of the government converged to oversee the process.

Built within the EESA are several mechanisms meant to establish transparency and accountability for TARP. While many government and non-government groups monitor the program, watch dogs have been critical about Treasury’s investment criteria and management of assets, calling for even greater transparency and accountability.\textsuperscript{460} Monitoring the TARP investments became the function of five different groups including: (1) Financial Stability Oversight Board (FSOB),\textsuperscript{461} a group consisting of executive branch officers; (2) U.S. Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP);\textsuperscript{462} (3) the Congressional Oversight Panel (COP),\textsuperscript{463} (4) the Congressional Budget Office \textsuperscript{464} and (5) Government Accountability Office (GAO).\textsuperscript{465}

Additionally, the courts would serve as a possible means for oversight of government investment. Given that investments


were made by Treasury, the judicial deference\textsuperscript{466} given to agencies by the courts may result in a lack of rigorous judicial review. In some circumstances, judicial deference is justified since courts often lack the expertise that particular agencies have to decide whether an action is in the public interest.\textsuperscript{467} The Federal Reserve is given great deference in making loans at favorable rates to stressed banks unless the action is deemed to be arbitrary or capricious.\textsuperscript{468} The Federal Reserve justified the guarantees made in the Bear Stearns sale to JPMorgan because the agency determined that to let Bear Stearns proceed to bankruptcy would pose a systemic risk to the entire banking system.\textsuperscript{469}

While there are significant reporting responsibilities, the oversight role for Congress should be oversight of the government organization that manages the investments and not oversight of the firm in which the investment is held.

\section*{Conclusion}

This article sought to normatively assess the performance of the government as a shareholding entity and to create a prescriptive model by which government could co-exist in a market economy as an investor and still foster entrepreneurship. Adapting government investment to free market capitalism advances a number of useful policy goals including fostering innovation, economic development and creating a funding mechanism for social programs. The emergence of foreign SWFs suggests an evolution of the role of government as an active participant in markets and also serve as a model by which the U.S. might form an independent investment authority to manage its investments.

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\item[467] \textit{Id}.
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