Treasury Inc. : How The Bailout Redefines Corporate Theory & Practice

J.W. Verret
Treasury Inc.: How the Bailout Reshapes Corporate Theory & Practice

By J.W. Verret

Abstract:

Corporate law theory and practice considers shareholder relations with companies and the implications of ownership separated from control. Yet through the TARP bailout and the government’s resultant shareholding, ownership and control at many companies has merged, leaving corporate theory and practice for the financial and automotive sectors in chaos. The government’s $700 billion bailout is a unique historical event; not merely because of its size, but because of a resulting ripple through corporate scholarship and practice.

This article builds on the author's four testimonies before Congress during the financial crisis and implementation of the TARP bailout and his consultation for the Inspector General for TARP. It updates the six central theories of corporate law to reveal that none function adequately when considered with a controlling government shareholder that enjoys sovereign immunity from corporate and securities law. From agency theory and nexus-of-contracts thought to the shareholder/director primacy debate, even to notions of progressive corporate law, existing theory breaks down when a government shareholder is present. The article also develops an economic model of incentives facing political decision-makers in exercise of their shareholder power. After considering corporate theory, the article offers predictions for how Treasury's stock ownership reshapes the practice of corporate law. In short, TARP will result in a tectonic shift for current understanding about insider trading, securities class actions, share voting, and state corporate law fiduciary duties. The article closes with three recommendations. First, that Treasury take frozen options, an invention explained in the text, rather than equity. Second, that Congress pass legislation establishing a fiduciary duty for Treasury to maximize the value of its investment, a suggestion that has resulted in Sens. Warner and Corker introducing implementing legislation based on the author’s suggestion. Third, that Treasury adopt a sales plan for closing out its TARP holdings.

Table of Contents:

I. Introduction
II. History of Company Ownership by the Federal Government

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1 Assistant Professor of Law, George Mason University School of Law, & Senior Scholar, Mercatus Center Financial Markets Working Group. This work is informed by the author’s four appearances before Congress to testify before the House Committee on Oversight, the House Committee on Financial Services, and the Senate Committee on Banking, Housing and Urban Development during the Spring and Summer of 2009. It is also informed by the author’s work as a consultant for the Treasury Dept.’s Special Inspector General for the TARP bailout. I appreciate helpful comments from Richard Epstein, John Macey, Roberta Romano, and other participants at the NYU Law School Conference on Securities Regulation Workshop; Henry Butler, Richard Booth, and other participants at the Northwestern University Law School Searle Center Conference on issues in Corporate Governance; and Bruce Johnsen, Bruce Kobayashi, Lloyd Cohen, Eric Claeys, Todd Zywicki, and other participants at the Levy Center Workshop.
III. The Troubled Asset Relief Program
IV. The Federal Government as Control Shareholder
V. Shareholder Control Meets Sovereign Immunity
VI. Interest Group Politics of Government Ownership
VII. Implications for Corporate Law Theory
VIII. Implications for Corporate and Securities Practice
IX. Proposed Solutions

"The good and efficient working of a Board of Bank Directors depends on its internal harmony.... In France the difficulty...has been met characteristically. The Bank of France keeps the money of the State, and the State appoints its Governor. The French have generally a logical reason to give for all they do, though perhaps the results of their actions are not always so good as the reasons for them. The [director] has not always, I am told, been a very competent person"

Walter Bagehot, first Editor-in-Chief of The Economist in "Lombard Street", 1873

I. Introduction

The theory and practice of corporate and securities law in the United States is a carefully constructed tapestry, woven through the time span of the American experience. Over that time, the expectations of investors, managers, and regulators have enjoyed a dance of slow experimentation toward a steady and predictable evolution. The thesis of this article is that when the Treasury Department and the Federal Reserve, through the TARP bailout, took equity positions in over 600 of the nations banks, as well as AIG, Fannie Mae, Freddie Mac, GM, Chrysler, and GMAC, they introduced an entirely alien variable to this finely woven tapestry.

There are two foundations underlying this observation. First, the Treasury Department and the Federal Reserve are generally controlling shareholders, even in spite of relatively low minority interest in particular companies. Second, they are controlling shareholders that also enjoy sovereign immunity from the federal securities laws and state corporation law. The presence of a control shareholder in publicly traded corporations is relatively infrequent. The presence of a control shareholder in publicly traded companies that also enjoys sovereign immunity from corporate and securities law is entirely novel. As a result of this perfect storm, a thorough investigation of the implications of the government's ownership via TARP reveals a number of uniquely unforeseen consequences to the theory and practice of corporate and securities law.

To emphasize the unique nature of Treasury's ownership through TARP, this article will begin by briefly considering the history of the United States government's entanglement in private business. Though the federal government has frequently chartered businesses that were wholly owned by the United States, particularly during WWII, and occasionally exercised power over publicly traded businesses through special provisions in their charter, such as the case of Fannie Mae and Freddie Mac, the United States government has never taken a
controlling interest in a publicly traded company chartered under state law. As such, the government's ownership in businesses through TARP is a circumstance without precedent.

The emphasis of this article is the revolutionary problems for corporate law theory and practice posed by the presence of a controlling shareholder that also enjoys sovereign immunity. Therefore, before rethinking those theoretical and practical elements, this article will wade into these unexplored depths to consider the two threshold questions in the analysis. First, is the government really a controlling shareholder? And second, do the Treasury and Federal Reserve actually enjoy sovereign immunity from corporate and securities law?

One answer this article approaches will be that the government is likely a control shareholder for the largest TARP recipients in which it holds an interest, including Citigroup, AIG, GM, Fannie Mae, Freddie Mac, and with some significant measure of certainty the 9 remaining banks from among the top 19 banks to originally receive TARP funding. This article also offers the suggestion that the government might, with a steadily decreasing degree of certainty based on degree of government ownership, also be considered a control shareholder for many of the other 600 banks accepting TARP funding.

This article then considers the application of sovereign immunity to the Treasury and Federal Reserve's exercise of ownership in TARP companies under the bailout. After considering a number of novel theories under which a clever plaintiff's lawyer might try to challenge the federal government's sovereign immunity, it ultimately arrives at the conclusion that the federal government's belt-and-suspenders approach protecting it from liability in this arena, including the liability waivers of the Emergency Economic Stability Act, waivers included in the Securities Exchange Act, and challenges in using other avenues, eventually foreclose meaningful challenge to the federal government's sovereign immunity in its exercise of ownership power over its TARP shares.

Then we get to the first bit of real meat in the article, with the first prong of the thesis: The theoretical underpinnings of American corporate law are completely unprepared for the presence of a control shareholder with sovereign immunity. This is a fairly unique outcome. Corporate law theory is home to essentially six distinct and at times vigorously opposed schools of thought that do battle in the arena of corporate theory. First, this article looks to the foundations of corporate law in agency theory and nexus-of-contracts theory. In both, it considers the effects of a control shareholder with sovereign immunity. Then, it considers the Cain and Abel-like warring children of the agency and nexus-of-contracts marriage: shareholder primacy and director primacy. Shareholder primacy is a difficult fit, as it contemplates a non-conflicted shareholder electorate that minimizes the special interest director problem, a wash-board which TARP ownership obviously complicates. Director primacy is an easy critic of TARP ownership, as it is inherently hostile to the accretion of shareholder power, and yet is difficult to understand in light of elected directors who may be beholden to government shareholders.

The team production model theory of corporate law is also considered in this article, with the result that the model's reliance on the board of directors as a
mediating hierarch, balancing the interests of varying stakeholders, is complicated by the political pressures placed on the government shareholder hierarch in this situation. The progressive corporate law model of corporate law is also considered in light of this dynamic, with the result that the accountability of government regulators and the disclosure rules underlying progressive corporate law are threatened by the presence of government ownership.

In the final analysis, this article considers each of the central theories of corporate law in turn, and in depth, with updated analysis that considers the presence of an immune control shareholder, and arrives at the conclusion that none of these central corporate law theories supports, or even properly describes, the propriety or effect of a controlling shareholder that enjoys sovereign immunity and at once regulates the businesses in which it holds an interest.

Next, this article considers interest group theory and economic evidence of government ownership in private business, particularly banks, to build a unique theory of how government shareholders can be expected to act in using their unique powers in corporate law. In addition to compiling existing evidence regarding the political and economic effects of government ownership in private business, particularly banks, this article offers the beginning of a new economic model to describe the decision-making process of a government bureaucrat charged with exercising control over a private business.

Nearing the close of the inquiry, this article then enters the second prong of its thesis by offering some analysis for practitioners of corporate and securities law with a warning about the effect of Treasury as a shareholder. In short order, it warns that i) Treasury has free reign to engage in insider trading of its shares, ii) Treasury is the only control shareholder that evades fiduciary duties to other shareholders under corporate law, iii) Treasury may end up serving as a lead plaintiff in private securities class action litigation against the very companies it is trying to support through TARP, iv) unregistered securities of any TARP recipient held by another TARP recipient may be considered affiliated sales, which means they would be voidable at the option of any shareholder that purchases them v) the ability of boards of directors to approve conflicted transactions, which hinges on their independence under state corporate law, may be endangered, and vi) the government will obtain the right to nominate candidates for the Board of publicly traded companies, and vote for other shareholder's nominees, under the SEC's recent shareholder proxy access rule.

In a final flourish, this article offers a touch of hope to the concerned corporate law traditionalist in the form of three unique reform suggestions. First, it recommends that the government eschew its voting common equity, and even its non-voting preferred shares, in favor of frozen options. Those options would be designed such that the government would never be permitted to exercise them, and accordingly never be permitted to exercise the voting or other rights that accompany either common or preferred shares, but the government would be permitted to sell them into the market and allow other non-governmental shareholders to exercise them and exercise all the rights that accompany the form of shares into which those temporarily frozen (only in government hands) options morph. This should serve as a significant buffer to the analysis that the federal government holds a control position in TARP companies which is so central to
this article's analysis concerning the resultant complications in corporate theory and practice.

Second, in conjunction with, or even in spite of an absence of, the frozen shares recommendation of this article, this article recommends that the Treasury and the Federal Reserve set up trusts to hold its ownership that create an explicit obligation of those entities to maximize long term shareholder wealth in the invested TARP companies. This would be accompanied by a waiver of the federal government's sovereign immunity with respect to state corporate law, as well as a waiver of its immunity under section 3(c) of the Exchange Act and attendant immunity provisions of the Emergency Economic Stability Act.

Third, also in conjunction with (or in spite of a lack of) the preceding recommendations, this article suggests that the federal government as a shareholder should execute a 10b-5 trading plan similar to the type filed by executives to protect against liability for insider trading. This plan should be binding on the Treasury by law, with appropriate ranges of trade amounts to leave a reasonable measure of discretion for Treasury bureaucrats on each trading date, to minimize the threat of insider trading by the Department and cement a near term exit date by the government from its positions in private businesses.

This issue is far more than a theoretical exercise. The theory and practice of corporate and securities law governs the exercise of power in the securities markets. The average American, either directly through their holdings in mutual funds, or derivatively as beneficiaries of public or private pension funds, enjoys the lion's share of profits and losses in that market. Careful attention must be observed to any overriding force, such as the government's ownership via the bailout, that disrupts the order and evolution of that market. The federal government’s position as the dominant shareholder in the financial services and automotive sectors requires careful consideration of its shareholder rights. Governments are a very unique brand of shareholder. Without careful consideration and advance planning for how those shareholder rights and responsibilities will be managed, the unintended consequences to capital markets could be dramatic.

II. History of Company Ownership by the Federal Government

Government ownership of corporations is not without precedent in the United States. Amtrack, for instance, is a government owned company. 2 The first

2 Lebron v. National presents See Lebron v. National R.R. Passenger Corp. 513 U.S. 374, 386, 115 S.Ct. 961, 968 (U.S.N.Y.,1995), (summarizing the status of Amtrak and the history of government owned corporations in the United States.). Amtrak is incorporated under the District of Columbia Business Corporation Act D.C.Code Ann. § 29-301 et seq. (1981 and Supp.1994), but is subject to the provisions of that Act only insofar as the Rail Passenger Service Act which created it does not provide to the contrary. Section 541 It does provide to the contrary with respect to many matters of structure and power, including the manner of selecting the company's board of directors. The RPSA provides for a board of nine members, six of whom are appointed directly by the President of the United States, and the Secretary of Transportation, or his designee, sits ex officio.§ 543(a)(1)(A) The President appoints three more directors with the advice and consent of
government created business in the U.S. was the Bank of the United States, created by Congressional action in 1791 which authorized the United States to own 20 percent of the corporation's stock. ³ The Federal Government continued to charter private corporations for the next century, such as the Northern Pacific Railroad Company, but only once participated in such a venture itself: the Union Pacific Railroad, chartered in 1862 with the specification that two of its directors would be appointed by the President of the United States.⁴

In 1902, to facilitate construction of the Panama Canal, Congress authorized the President to purchase the assets of the New Panama Canal Company of France, including that company's stock holdings in the Panama Railroad Company, a private corporation chartered in 1849 by the State of New York.⁵ The United States became the sole shareholder of the Panama Railroad, and continued to operate it under its original charter, with the Secretary of War, as the holder of the stock, electing the Railroad's 13 directors.⁶

The first large-scale use of Government-controlled corporations came with the First World War.⁷ But it was during the Great Depression that Government corporations really came into the limelight, guided by the goal of stabilizing the economy and to making distress loans to farms, homeowners, banks, and other enterprises.⁸ To offer one eerie echo of the past, the Reconstruction Finance Corporation (RFC) was created to make loans to banks, insurance companies,

³ See Lebron v. National at 386. That Bank expired pursuant to the terms of its authorizing Act 20 years later. A second Bank of the United States, the bank of McCulloch v. Maryland, was later created by a bill providing that the United States would own 20 percent of its stock, and the President would appoint, by and with the advice and consent of the Senate, 5 of the Bank's 25 directors, the rest to be elected annually by shareholders other than the United States. See Lebron at 387. That banks charter also expired in 1836.


⁷ Lebron at 388. In 1917 and 1918, Congress created, among others, the United States Grain Corporation, the United States Emergency Fleet Corporation, the United States Spruce Production Corporation, and the War Finance Corporation, none of which were publicly traded and all of which were also dissolved after the war.

railroads, land banks, and agricultural credit organizations, including loans secured by the assets of failed banks, sharing a nearly identical driving goal to that of the TARP program. 9

The RFC then sought to execute its authority by forming a number of corporations, at times under state law and at times under federal charter. 10 Once WWII ended, government involvement in corporations had become widespread, and concerns about their accountability led to calls for the government to reign in government corporations. 11 Congress then passed the Government Corporation Control Act (GCCA). 12 One of the more important provisions of the GCCA for our purposes was that it ordered the dissolution or liquidation of all government corporations created under state law, except for those that Congress should act to reincorporate; and prohibited creation of new Government corporations without specific congressional authorization. 13

In the 1960's new corporate entities were formed. Many of them were merely government agencies located within the existing Government structure. 14

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9 See Lebron at 388. (Noting that a few corporations, such as the Tennessee Valley Authority (TVA), brought the Government into the commercial sale of goods and services. See Act of May 18, 1933, ch. 32, 48 Stat. 58, as amended, 16 U.S.C. § 831 et seq. (1988 ed. and Supp. V).

10 See Lebron at 388-389. In 1940, Congress empowered the RFC to create corporations without the need to obtain specific authorization from Congress each time. See Act of June 25, 1940, § 5, 54 Stat. 573-574. For example, the RFC created the Defense Plant Corporation, the Defense Supplies Corporation, the Metals Reserve Company the Petroleum Reserves Corporation, the Rubber Development Corporation, and the War Damage Corporation, among others. See GAO Corporation Manual 32, 38, 169, 182, 219, 279. Other corporations were formed, sometimes under state law, without even the general congressional authorization granted the RFC. For example, the Defense Homes Corporation was organized under Maryland law by the Secretary of the Treasury, using emergency funds allocated to the President, id., at 28; and the Tennessee Valley Associated Cooperatives, Inc., was chartered under Tennessee law by the TVA, id., at 244 (“There has been found no Federal statute specifically authorizing the Board of Directors of the Tennessee Valley Authority to organize a corporation”). By 1945, the General Accounting Office's Reference Manual of Government Corporations listed 58 Government corporations, with total assets (in 1945 dollars) of $29.6. See id., at iii, v-vi.

11 See Lebron at 389-390.


13 Lebron at 390. Justice Scalia also notes that “in the years immediately following World War II, many Government corporations were dissolved, and to our knowledge only one, the Saint Lawrence Seaway Development Corporation, was created. See Leazes 25, 27.”

Beginning in 1962, however, the Government turned to sponsoring corporations that were not designated as arms of the federal government under the GCCA. The first of these, the Communications Satellite Corporation (Comsat), was incorporated under the District of Columbia Business Corporation Act.\(^\text{15}\) Comsat was capitalized entirely with private funds.\(^\text{16}\) In contrast to the corporations that had in the past been deemed part of the Government, Comsat's board was to be controlled by its private shareholders and 3 of its 15 directors were appointed by the President.\(^\text{17}\)

The Comsat model was explicitly created with the purpose of permitting a private company to raise private capital, but also enjoy preferential treatment from the government at the same time.\(^\text{18}\) The government soon followed in creating other corporations, nearly all of which were under the direct control of the federal government and none of which were publicly traded.\(^\text{19}\)

The final noteworthy example of government owned corporations are Fannie Mae and Freddie Mac. Both were government chartered but shareholder owned and publicly traded companies.\(^\text{20}\) In one part of their business, they would aggregate mortgages into pools and sell interests in the pools, mortgage backed securities (MBSs).\(^\text{21}\) They would guarantee the credit risk on those mortgages, or the risk that the mortgage holders would default, for roughly 2 trillion worth of such mortgages.\(^\text{22}\) As of 2008, they guaranteed roughly 3.7 trillion in liabilities. This growth was substantial, particularly compared to 2.9 trillion in all outstanding corporate bonds and 4.4 trillion in outstanding Treasury debt trading at the time.

\(^\text{15}\) See Lebron at 391, citing D.C.Code Ann. § 29-301 et seq. (1981 and Supp.1994), see 47 U.S.C. § 731 et seq., Comsat was created with the express purpose of entering the private sector, but doing so with Government-conferred advantages, see Moe, supra, at 22.


\(^\text{17}\) 47 USC § 733(a).

\(^\text{18}\) See Lebron at 391, citing Moe, CRS Report, at 22, 24.

\(^\text{19}\) See Lebron at 391, “But some of these new “private” corporations, though said by their charters not to be agencies or instrumentalities of the Government, see, e.g., 47 U.S.C. § 396(b) (Corporation for Public Broadcasting (CPB)); 42 U.S.C. § 2996d(e)(1) (Legal Services Corporation (LSC)), and though not subjected to the restrictions of the GCCA, were (unlike Comsat) managed by boards of directors on which Government appointees had not just a few votes but voting control. See Public Broadcasting Act of 1967, § 201, 81 Stat. 369 (CPB’s entire board appointed by President); Legal Services Corporation Act of 1974, § 2, 88 Stat. 379 (same for LSC).”

\(^\text{20}\) See Peter J. Wallison, Regulating Fannie Mae and Freddie Mac: Now It Gets Serious), available at www.aei.org, at page 1.

\(^\text{21}\) See Peter J. Wallison, Regulating Fannie Mae and Freddie Mac: Now It Gets Serious), available at www.aei.org, at page 1.

\(^\text{22}\) They would also hold some of the MBSs in their own portfolios, thus holding both the credit risk and the interest rate risk associated with the mortgages, and attempt to hedge those risks through other transactions. This accounted for another 1.5 trillion.
Fannie Mae and Freddie Mac present an interesting case study for how government owned firms are managed, and how they are perceived by the market. The Treasury did not own an equity interest in Fannie and Freddie until it recently placed them under conservatorship after the prospect of their insolvency.\textsuperscript{23} The President did however have the ability, written into Fannie and Freddie’s charter, to place directors on the Board, which through voting is also one of the central powers also granted to stockholders. The federal government also implicitly guaranteed the debts of Fannie and Freddie, which makes the comparison all the more useful as Treasury’s capital injections and equity holdings in TARP banks have also been accompanied by debt guarantee, coupled with the fact that governments universally tend to continue to guarantee debts of companies in which they hold an equity interest.

From its creation until the government sold its shares in Comsat to Lockheed Martin, Comsat was a publicly traded corporation. In effect, it is probably the one example from modern history that comes close to the unique aspects of Treasury’s TARP holdings, namely government controlling ownership in a publicly traded, state incorporated company. Yet the full implications of this fact never truly developed due the government’s short tenure as owner. The federal government also did not own any common shares in the other close analogue to TARP, Fannie Mae and Freddie Mac.\textsuperscript{24}

Despite a rich of history of government involvement in creating business and privatizing government functions as business, there is no precedent for the unique confluence of factors for those businesses that have taken TARP funding in exchange for giving the government an ownership, and often controlling, stake. We find no example from among this rich history in which the government owned a controlling stake in a publicly traded business incorporated under state law. That unique fact is the wellspring for the thesis of the paper, that the architecture of corporate and securities law is unprepared for the theoretical and mechanical challenges that accompany government ownership in private businesses.

One may also argue that temporary government ownership to facilitate bank liquidation, as for instance the authority frequently used by the FDIC, should also be considered government ownership of private business. Bank nationalization can come in two distinct forms. It can be short term, dedicated solely to the orderly wind up of a bank’s assets, as in a the FDIC’s process for winding up failed banks that are FDIC insured or the creation of the Resolution Trust Corporation to deal with the S&L crisis of the early 90s. The second is a long term period of government ownership designed to alter the lending policies of a

\textsuperscript{23} Congress oversaw a regulator created to only oversee the two GSEs. Fannie and Freddie were originally chartered by Congress as federal agencies, but were later privatized by a sale of equity in their operations to private shareholders in order to ensure that their purchases and sales of mortgages could be removed from the federal budget. Peter Wallison, Private Profits, Public Risks, Wall Street Journal, March 24, 2008. Members of Congress expected Fannie and Freddie to subsidize low income borrowers. Peter Wallison, Private Profits, Public Risks, Wall Street Journal, March 24, 2008.

\textsuperscript{24} One distinction, of course, is that Comsat, Fannie Mae, and Freddie Mac were all originally created by the government, where most of the TARP firms were not.
bank. It remains to be seen whether the second form of nationalization accurately characterizes the government’s holdings in the financial sector under TARP.

III. The Troubled Asset Relief Program

In response to a dramatic credit freeze that put unprecedented pressure on financial institutions in late 2008, the U.S. government initiated a $700 billion bailout of the financial industry that mainly consisted of Treasury’s purchasing equity in troubled banks under the Troubled Assets Relief Program (“TARP”). In order to execute its mandate under the Emergency Economic Stabilization Act to ensure the health of the nation’s banking system, the Treasury Department purchased controlling interests in hundreds of the nation’s largest banks, GM and Chrysler, as well as the insurance conglomerate American International Group (“AIG”) and GMAC, the financing arm of General Motors.

As part of that bailout, Treasury took preferred shares, and subsequently initiated a plan to convert those non-voting preferred shares into shares convertible into voting common equity in banks participating in TARP. Treasury’s initial experiment in holding common equity took place at Citigroup, in which it took a controlling 34% voting stake.

The original plan for the TARP program was for the government to use the 700 billion authorized under the EESA to buy and sell troubled assets. That plan was quickly shelved, and the Treasury Department immediately began a number of different programs. I will omit description some of the programs falling under TARP, and focus only on those directly linked to the government’s accepting equity positions in return for its injections of TARP Capital.

Under the Capital Purchase Program (“CPP”), Treasury made investments in 649 banks of $203 billion, of which 8 institutions received $134 billion. $70 billion of that has since been paid back. Through the Targeted Investment Program (“TIP”), the government invested an additional $40 billion in Citigroup and Bank of America. The CPP is the central link to Treasury’s equity investment in the financial sector. Of the $203 billion it spent, $25 billion each went to Bank of America, Citigroup, JP Morgan, and Wells Fargo. Another $10 billion each went to Goldman Sachs and Morgan Stanley. When combined with the TIP program, the federal government’s investment in Bank of America and Citigroup becomes $45 billion each. Initially recipients under the CPP were not permitted to buy back their shares for three years, but that was modified by the American Recovery and Reinvestment Act of 2009 to permit banks to buy back their CPP shares in consultation with their banking regulator.

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25 SIG TARP Report at 3.
28 SIG TARP Report at 37.
29 SIG TARP Report at 37.
30 SIG TARP Report at 37.
31 SIG TARP Report at 48.
Under the initial terms of the Capital Purchase Program (“CPP”), banks receiving capital injections gave the government preferred shares with a 5% dividend for five years which then increased to 9% after five years and warrants to purchase additional common shares. Participants in the CPP may redeem the preferred shares at face value after 3 years. In addition, the Treasury may sell them at any time. Valuing the government’s TARP share holdings is tricky, owing to the nature of the credit market freeze-up that is slowing breaking and problems in marking MBS and CDO assets to market. However, for our purposes considering them at cost will give some idea of the scale of share holdings.

The second major industry supported under the TARP program is the automotive industry, in particular Chrysler, GM, Chrysler Financial, and GMAC. GM has been the beneficiary of 49.5 billion under TARP, Chrysler 14.9 billion, GMAC 13.4 billion, and Chrysler Financial 1.5 billion. Currently all of the shares in the reconstituted GM, after its emergence from bankruptcy, are owned by the U.S. Government (60%), the Canadian government (12%), former bondholders (10%), and the GM health care trust (18%). The reconstituted GM is not publicly held, and as the major theories of corporate law discussed in this article apply to widely held companies and not privately held ones that GM would not be a good example for that analysis. In the event that GM is publicly listed while the U.S. Government remains a shareholder, that would change. Further, the private bondholders and the health care shareholders will still expect fiduciary duties from the government as control shareholder, and in some jurisdictions those fiduciary duties are stronger for privately held companies than for publicly held.

The Treasury Department’s statement on the GM Restructuring says that it intends to manage its investment in Citigroup in a “hands off, commercial manner.” Treasury published a white paper regarding its ownership in GM in which it offered four key principles for how it would try to minimize political influence in GM’s operations, and yet there is no mechanism by which those principles can be enforced by a third party, nor are there any penalties for their violation.

On March 30, 2009, the President’s Auto Task Force determined that Chrysler’s restructuring plan was not likely to permit it to emerge from bankruptcy, and

32 SIG TARP Report at 94.
34 Massachusetts case.
35 Obama Administration Restructuring Initiative at 2.
36 SIG TARP Report at 111. Listing the following core principles in the Treasury’s White Paper, including to i) seek to dispose of its ownership interest as soon as practicable, ii) reserve the right to set upfront constraints to protect taxpayers, promote financial stability, and encourage growth, iii) protect the taxpayer’s investment by managing its ownership stake in a hands-off, commercial manner, iv) vote on core governance issues, including the selection of a company’s board of directors and major corporate events or transactions.
pressed Chrysler to arrange a merger deal with Fiat. The U.S. Government also took an 8% stake in Chrysler in exchange for its loan, but Fiat took a 20% stake and the UAW Health Care Trust took a 55% stake.

The Treasury Department obtained a 35% ownership stake in GMAC from GM. GMAC is a provider of automobile financing, spun off from GM. The government has announced its intention to use GMAC to promote the financing, and therefore the purchases, of automobiles from companies taking TARP funding.

The government also invested another $70 billion in AIG through the Systemically Significant Failing Institutions Program. Under the Making Home Affordable Program, Treasury offered to use nearly $50 billion in TARP funding, in conjunction with at least $200 billion from the Federal Reserve, to support Fannie Mae and Freddie Mac, both of which are now wholly owned by the federal government under conservatorship. Citigroup also received generous support by way of a $5 billion TARP investment to support an asset guarantee program supporting $301 billion in Citigroup’s troubled assets. Various other TARP loan programs provide for asset guarantees and auto warranty guarantees for other companies, many of which took part in the programs described thus far.

Secretary Geithner announced a sweeping change to the TARP program on February 25, 2008. He announced that all banks with over 100 billion in assets would be subject to stress testing. He also announced that the capital purchase program (CPP) would be replaced with a Capital Assistance Program (CAP), which would involve Treasury taking preferred shares convertible into common equity rather than the type of preferred shares used under CPP. The Capital Assistance Program (“CAP”) was instituted to support the 19 largest financial institutions taking TARP money by serving as a backstop source of liquidity for those banks after they undergo a stress test designed to determine their long term liquidity needs. To date, no institutions have yet taken capital under the CAP program. One of the requirements of the CAP program is that participating banks give the government convertible preferred shares, that have the option of conversion into voting common equity.

The CPP preferred shares carried a 9% dividend, and would be convertible at the issuing bank’s option subject to regulatory approval. He would also permit banks with preferred shares issued under CPP to exchange them for CAP preferred shares.

37 SIG TARP Report at 107.
38 Kate LineBaugh, WSJ, Five Chrysler Directors are Named, See http://online.wsj.com/article/SB124682177419396773.html. Since control is by its very nature an exclusive concept, it would be a difficult argument to say that the government is a control shareholder of Chrysler with Fiat and the UAW holding such large stakes.
39 SIG TARP Report at 110.
40 SIG TARP Report at 112.
41 SIG TARP Report at 36.
42 SIG TARP Report at 36.
43 http://www.ustreasures.gov/press/releases/tg40.htm
44 SIG TARP Report at 53.
45 SIG TARP Report at 53.
convertible preferreds, and renamed TARP to the “Financial Stability Program.”

On Friday, February 27 Citigroup and Treasury reached an accord whereby some of Treasury’s preferred shares in Citi were converted into common equity. Immediately the price of shares in Citi fell 39% to reflect the dilution of other common equity holders, and share prices in other banks fell in anticipation of similar conversions at other banks. This allows Citi to avoid dividends required under those preferred shares. Treasury also announced that other banks who wish to convert their preferred shares will be able to do so at a 10% discount.

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46 In many ways Secretary Geithner’s plan to stabilize banks through issuance of preferred stock convertible into common equity can be traced back to a proposal by Friedman Billings Ramsey (“FBR”) advocating the practice in November 2008. Paul J. Miller et. al., U.S. Financial System Still Needs at Least 1.0 Trillion to 1.2 Trillion, Friedman Billings Ramsey Research, November 19, 2008, available at http://online.wsj.com/public/resources/media/Financial_Strategy-20081119.pdf, at 1. FBR advocated that “if the government would convert TARP capital issuances into pure, tangible common capital (akin to the 23 billion class C investment in AIG), it would go a long way toward encouraging subsequent private investment.” Paul J. Miller et. al., U.S. Financial System Still Needs at Least 1.0 Trillion to 1.2 Trillion, Friedman Billings Ramsey Research, November 19, 2008, available at http://online.wsj.com/public/resources/media/Financial_Strategy-20081119.pdf, at 1. That analysis also led the march to focus on tangible common equity rather than tier one capital as the true indicator of bank financial health. Both are used to examine a bank’s health, the ratio of equity to assets (loans outstanding) of a bank compares the residual interest of common stockholders to the pool of loans in which they have an interest. If either ratio is too low, it means the bank is overleveraged. Treasury’s TARP preferred shares were included in the tier one capital ratio, but not the tangible common equity ratio. At the time, FBR urged that TCE at the largest eight financial institutions was 3.4% of assets, implying 29x leverage, and that $1 trillion in new common equity would be necessary to bring tangible common equity back into normal alignment. Paul J. Miller et. al., U.S. Financial System Still Needs at Least 1.0 Trillion to 1.2 Trillion, Friedman Billings Ramsey Research, November 19, 2008, available at http://online.wsj.com/public/resources/media/Financial_Strategy-20081119.pdf, at 2. FBR urged that tier one capital, which included TARP preferred stock, was not a good measure of leverage because the preferred stock had a liquidation preference. Paul J. Miller et. al., U.S. Financial System Still Needs at Least 1.0 Trillion to 1.2 Trillion, Friedman Billings Ramsey Research, November 19, 2008, available at http://online.wsj.com/public/resources/media/Financial_Strategy-20081119.pdf, at 1. 9 FBR also argued that injections of capital connected to preferred stock was something that banks would not use to lend, because that lending would put pressure on its TCE ratio (because preferred shares do not help the TCE ratio, but additional lending would make it look more leveraged.). Paul J. Miller et. al., U.S. Financial System Still Needs at Least 1.0 Trillion to 1.2 Trillion, Friedman Billings Ramsey Research, November 19, 2008, available at http://online.wsj.com/public/resources/media/Financial_Strategy-20081119.pdf, at 9. Treasury adopted essentially the same justification for the conversion in its statement announcing its conversion of Citigroup shares.


49 David Enrich and Deborah Solomon, Citi, U.S. Reach Accord On a Third Bailout, Wall Street Journal, Sat/Sun Feb. 28-March 1, at B3.
the Feb. 9 prevailing stock price.\textsuperscript{50} $20$ billion worth of Treasury’s Citigroup preferred shares were not included in the deal.\textsuperscript{51} When the Treasury Department exchanged its non-voting preferred shares for voting common equity in Citigroup on June 9, 2009, it executed an Exchange Agreement to govern the transaction.\textsuperscript{52} The opening clauses of that agreement evidence the government’s lack of interest in maximizing the value of its investment with an explicit statement of intent that its investment is motivated in part by its desire to stabilize the financial system generally.\textsuperscript{53}

Citigroup has agreed to restrictions on its lobbying activities during the term that the government continues to own an interest in it.\textsuperscript{54} Pursuant to its Exchange Agreement with the Federal Government, Citigroup also remains bound by the “Employ American Workers Act.”\textsuperscript{55} Citigroup also remains bound by the Home Affordable Modification Program by the terms of its Exchange Agreement.\textsuperscript{56} Under the terms of the Exchange Agreement, the government agrees to sell off its interest in Citigroup by June of 2019 at a rate of 20% of its holdings yearly.\textsuperscript{57} This may permit it to remain a control shareholder for longer than that

\textsuperscript{50} David Enrich and Deborah Solomon, Citi, U.S. Reach Accord On a Third Bailout, Wall Street Journal, Sat/Sun Feb. 28-March 1, at B3.
\textsuperscript{51} David Enrich and Deborah Solomon, Citi, U.S. Reach Accord On a Third Bailout, Wall Street Journal, Sat/Sun Feb. 28-March 1, at B3.
\textsuperscript{53} Exchange Agreement at 2. This desire is clear by Treasury’s very act of converting its shares when the conversion makes no economic sense for Treasury as a shareholder. One reason for the conversion then is that it will artificially increase the bank’s common equity, which will give it a good tangible common equity number when the Treasury begins its promised stress testing regime for unhealthy banks. The Federal Reserve has indicated that it will focus on tangible common equity in performing stress tests on banks, in contrast to its previous focus on tier 1 capital. David Enrich and Monica Langley, U.S. Eyes Large Stake in Citi, Wall Street Journal, Feb 23, 2009, at A2. This is however an entirely artificial construct. Tangible common equity serves as a good proxy for a banks health when it reflects the market’s interest in becoming the residual beneficiary of fees from the bank’s loan portfolio, but here it merely reflects the federal government’s willingness to bail out a bank without concern for future price appreciation in its shares. But the distinction is entirely arbitrary when the holder in either case is more concerned with other objectives than maximizing the value of its shares. This also presumes that the market is as obsessed with tangible common equity as Treasury and FBR suggest. But Treasury is completely rewriting the rule-book with its new stress testing regime. This means it can alter the ratios it emphasizes, or create an entirely new one, and its focus on that new ratio can draw the market’s focus to it as well. One way to alleviate the consequences of holding common equity, while helping the banks tangible common equity number at the same time, would be the frozen options proposal explored in Section IX of this article. Treasury, the Federal Reserve, and the FDIC could make changes to the definition of tangible common equity in the regulations and in its new stress-testing regime to highlight those options as a significant element of common equity in that calculation.
\textsuperscript{54} Exchange Agreement at 47.
\textsuperscript{55} Exchange Agreement at 51.
\textsuperscript{56} Exchange Agreement at 51.
\textsuperscript{57} Exchange Agreement at 52.
10 year period in light of the large size of its current 34% holdings, potentially 16 to 18 years depending on the amount of other outstanding shares in Citigroup at that time.

The Treasury retains nearly all of its voting rights under the Exchange Agreement. That agreement initially states that Treasury will vote its shares in proportion to all other shareholders votes, but exempts “Designated Matters” from that policy.\(^{58}\) Those designated matters include nearly all matters on which a shareholder might be interested in voting, including the election and removal of directors, the approval of any business combinations, the approval of a sale of substantially all assets of the Company, approval of a dissolution of the company, approval of new securities, and approval of amendments to the charter or bylaws.\(^{59}\) The exchange of securities under the exchange agreement was subject to shareholder approval, and yet the government’s interim securities prior to the approval were so coercive as to effectively guarantee that the exchange agreement would be approved by the shareholders.\(^{60}\)

At a total of $50 billion, next to AIG, Citigroup is the second largest recipient of TARP money. And unlike AIG, where the government has an 80% stake, the government has a sub-majority control block at 34% in Citigroup. As such, Citigroup will become to most useful real world example for the theoretical and legal analysis presented in this article. Particularly, the next section will conduct extensive analysis of the level of control that the federal government has exercised over Citigroup.

**IV. The Federal Government as Control Shareholder**

Control is an elusive concept, but it forms an important part of corporate and securities law. It triggers fiduciary duties for control shareholders under state corporate law, as well as a number of applications under the federal securities laws. Some provisions enhance the burden or liability facing controlling shareholders or persons, still others will specifically prohibit actions that create certain control relationships.\(^{61}\) To name a few of the consequences of being deemed in control of a company under the Securities Act of 1933 (“the “33 Act” or the “Securities Act”) and the Securities Exchange Act of 1934 (the “34 Act” or the “Exchange Act”), a controlling person is limited in their ability to sell securities in the controlled company under Section 2(a)(11) of the Securities Act unless the securities have been registered and the sale follows various required methods. Also, issuers must identify their controlling persons in various filings as required by Securities Act Rule 405.

One of the more costly results of being deemed a control person under the securities laws is exposure to joint and several liability with offending issuers for violations of the securities laws.\(^{62}\) Section 15 of the Securities Act mandates

\(^{58}\) Exchange Agreement at 53.

\(^{59}\) Exchange Agreement at 53.

\(^{60}\) SIG TARP Report at 68.

\(^{61}\) Sommer at 559.

\(^{62}\) Sommer at 560-561.
joint and several liability for control persons of issuers liable under Section 11 and Section 12, and Section 20(a) of the Exchange Act mandates joint and several liability for control persons of issuers held liable under the Exchange Act, including 10b-5. This is a stark departure from the individual liability protections of the corporate form.

In some areas, the securities laws take a direct approach and prescribe a certain percentage of ownership as constituting control, such as the Investment Company Act of 1940's presumption that a 25% ownership position in a company constitutes control. Some of the provisions of the securities laws also take a bright line approach to regulation of transactions that are based on concerns about controlling shareholders. The proxy rules require filing a 13D upon taking ownership in 10% of the voting securities of an issuer. Section 16 insider trading liability also accrues for 10% shareholders.

Through Rule 405 under the Exchange Act the Commission has further offered that “The term control (including the terms controlling, controlled by, and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”

But for the most part, the Securities Act of 1933 and the Securities Exchange Act of 1934 do not provide an explicit definition of just what circumstances lead to control. This has led the much uncertainty and a variety of case law, staff interpretations, and no action letters exploring the factors that the SEC will use in determining control under those two statutes.

Berle and Means, the original students of the separation of ownership and control, state that “control lies in the hands of the individual or group who have the actual power to select the board of directors (or its majority). … Occasionally a measure of control is exercised not through the selection of directors, but through dictation to the management, as where a bank determines the policy of a corporation seriously indebted to it. In most cases, however, if one can determine who does actually have the power to select the directors, one has located the group of individuals who for practical purposes may be regarded as the “control.”” Thus Berle and Means also recognize the control, though occasionally an issue of contractual rights, is typically more a question of shareholder power.

Former SEC Commissioner Sommers, in a groundbreaking article on the topic, offers a question that is the central thesis of this paper. “How little stock may a person own or have the power the vote and still be considered a controlling person? This depends on many circumstances. Principal among these are the distribution of the other shares and the other relationships the shareholder has with the corporation and with other shareholders.” Sommers goes on to note

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63 Investment Company Act of 1940, Section 2(a)(9).
64 Proxy Rules
65 Section 16 of the Exchange Act
66 The Modern Corporation and Private Property(1932).
67 Sommer at 568
that “Obviously, the more widely stock dispersed voting stock is generally, the amount necessary to control is smaller.”

A substantial line of authority supports the proposition that either the power to control or actual exercise of control is sufficient. In Walston and Co, the SEC held that the power to control, as evidence by a creditor’s right to 90% of profits, status as the source of most of Walston’s business, and option to acquire stock, constituted control despite the fact that the creditor did not participate in the actual management of the business and held no actual stock. In effect, the power to control is sufficient to make one a controlling person, despite the fact that the power is never actually exercised.

This is analogous to the situation facing many TARP banks. The U.S. government is a substantial creditor of the companies in addition to owning positions in them, and also holds the ability to substantially affect the bank’s underlying business through its discretion in setting capital requirements and limiting bank operations. Under this view, the fact that Treasury or the Federal Reserve did not engage in active management of TARP Banks, and the fact that Treasury’s ownership in most TARP participants is non-voting, would therefore be irrelevant to this determination.

S.E.C. v Franklin Atlas Corp also supports the notion the percentage of stock ownership is not alone determinative. In that case, managers with the ability to control an enterprise was determined to be a control person, even though he actually owned no stock and the company had a controlling shareholder who owned a majority of the stock. This does not mean that shareholdings is irrelevant to the determination, on the contrary it is generally the most frequently utilized measure.

For the purposes of state corporation law, shareholders deemed to be in control of the corporation owe fiduciary duties of care and loyalty to minority shareholders. In Delaware, “a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation.” Rather than using a bright line test of control, the Delaware courts will examine the factors surrounding a shareholders relationship with the board to determine whether that shareholder is exercising actual control.

68 Sommer at 569.
69 Sommer at 564, citing 7 S.E.C. 937(1940).
70 See Section supra on TARP background
72 Roberta S. Karmel, Should a Duty to the Corporation be Imposed on Institutional Shareholders? 60 BUS. LAW 1, fn.8 (November 2004).
74 For example, in In re Cysive, a person holding 35%, and an option to purchase another 0.5% to 1.0%, of the stock was deemed to be a controller because he was also Chairman and Chief Executive Officer, and his brother and brother-in-law, who were both employed by the company, held another 0.5% of the stock. See In re Cysive, Inc. Shareholders Litigation, 836 A.2d 531, *552 (Del. Ch. 2003). By contrast, the Delaware Court of Chancery has also held that a 46% stockholder was not a controlling stockholder where the 46% stockholder was limited to electing two members
Cysive case strongly supports a finding that Treasury is a control shareholder in Citigroup after conversion of its preferred stock into nearly 36% of Citigroup’s common equity. Determinations of control for other TARP participants would be case dependant, but the strong contractual rights Treasury secured under the initial round of TARP would also support an inference of control. The government’s ownership positions in many other TARP companies are smaller than that at Citigroup, and some of them are held in the form of non-voting preferred stock. And yet the government’s exercise of power over those firms, in addition to the contractual rights it has under TARP, are revealing.\(^75\)

Thus we see that as defined under both corporate and securities law, the position and powers of a shareholder are one useful method to determine the presence of control. It is not, however, the only method. The actual exercise of authority is also useful.

Treasury and the Federal Reserve have exercised considerable authority thus far. A prime example of that exercise is revealed by the government’s ongoing relationship with Citigroup. During its last annual meeting, the federal government pressured Citigroup to find six new independent board directors acceptable to the U.S. government.\(^76\)

In using its control over Citigroup to cause it to end dividend payments to preferred stockholders, Treasury implicitly pressured the other preferred shareholders to convert their shares into common equity.\(^77\) Those preferred shareholders who exercised the conversion got to do so at a preferential stock price, $3.50 a share.\(^78\) The government’s regulatory oversight, and its oversight as a holder of a control stake in Citigroup, is coordinated through four agencies: Treasury, the Office of Comptroller of the Currency, the Federal Reserve and the FDIC.\(^79\)

In an attempt to minimize fears of nationalization, Chairman Bernanke indicated that the federal government would seriously avoid taking majority stakes in banks.\(^80\) But this ignores analysis of real control. The Treasury Department has recognized that minority interests in companies can effectuate control in its own regulations. In the rules promulgated to implement the Foreign Investment and

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\(^{75}\) For example, nearly all TARP recipients must vet their compensation packages through the TARP Compensation Czar at the Treasury Department, see text accompanying note 258 infra.

\(^{76}\) Joann S. Lublin, Citi Board Revamp Faces Hurdles, Wall Street Journal, at B3.

\(^{77}\) Peter Eavis, Paying the Price to Rebuild Citi, February 28, 2009, Wall Street Journal, at B12.

\(^{78}\) Peter Eavis, Paying the Price to Rebuild Citi, February 28, 2009, Wall Street Journal, at B12.

\(^{79}\) Damien Paletta, John Hilsenrath and David Enrich, U.S. Weighs further steps for Citi, March 10 2009, Wall Street Journal, at C1.

National Security Act of 2007, whereby the Committee on Foreign Investment in the United States reviews foreign governments that invest in U.S. companies, Treasury takes an expansive view of control.\textsuperscript{81} It indicates that a 10% interest is a strong presumption of control, but is willing to consider smaller stakes as controlling. Under the CFIUS definition, Treasury’s CAP Citigroup shares are firmly defined as a controlling interest in those securities at 36% interest. They would also be considered a controlling interest under the SEC’s definition, as well as meeting the definition of control shareholders under state corporate law.\textsuperscript{82} The Treasury Department has converted its preferred shares in Citigroup into common equity, giving it a position of up to 36% of Citi’s outstanding voting equity. This means that as defined under Delaware corporate law, the securities laws, and even the CFIUS process for reviewing foreign investments in U.S. Companies, the U.S. Treasury is a control shareholder in Citigroup. Further, the remaining unconverted preferred shares in other banks, issued to the Treasury by TARP participants, give the government substantial leverage over corporate policy decisions at those banks.

Treasury’s exercise of its new power over Citigroup has already begun, and it reveals some of the ways in which its interests and the long-term profitability of the bank may come into conflict. Citigroup has begun to cave to political pressure to engage in corporate policy decisions that, though unprofitable for the bank, are politically useful to its government regulators. It announced a plan to lower mortgage payments by an average $500 per month for those homeowners who have recently lost their jobs and are more than 60 days behind on their

\textsuperscript{81} See 31 CFR Part 800, Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons; Final Rule. “Specifically, ‘control’ is defined as the ‘power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of the total outstanding voting interest in an entity, board representation, proxy voting, a special share, contractual arrangements, formal or informal arrangements to act in concert, or other means, to determine, direct, or decide important matters affecting an entity; in particular, but without limitation, to determine, direct, take, reach, or cause decisions regarding the [matters listed in §800.204(a)], or any other similarly important matters affecting an entity.’” See §800.204(a). Two points should be emphasized concerning this definition First, it eschews bright lines. Consistent with the existing regulations, control is not defined in terms of a specified percentage of shares or number of board seats. Although share holding and board seats are relevant to a control analysis, neither factor on its own is necessarily determinative. Instead, all relevant factors are considered together in light of their potential impact on a foreign person’s ability to determine, direct, or decide important matters affecting an entity. Second, echoing the congressional views expressed in the conference report accompanying the original legislation in 1988, the focus of the statute and therefore of these regulations is control.person controlled by or acting on behalf of a foreign government.”

\textsuperscript{82} See infra, Section

...
Borrowers who have lost their jobs may be particularly poor bets for workouts, as they lack stable cash flows to pay even reduced mortgages. Citigroup also expressed support for a Congressional plan to allow judges to modify mortgages, legislation it opposed prior to receiving preferential treatment from the Treasury and which the rest of the banking industry opposed. The federal government has pressured Citigroup to divest of operating units overseas. Further, one account suggests that the jumble of conflicting orders and oversight from the agencies overseeing Citigroup and congressional interest has strained Citigroup’s ability to operate effectively.

Congressional pressure has often related to issues that represented a miniscule effect on treasury’s balance sheet or income, particularly executive compensation and perks, including use of the corporate airplanes. After taking control of IndyMac, the FDIC also adopted a policy of modifying mortgages without concern for corporate profitability.

Banks participating in TARP have cancelled employee reward programs and training events, that are immaterial compared to their budgets but that management believes otherwise serve a useful function, in order to minimize what they see as political misuse to those events to spur public outcry. Citigroup also explored cancelling its marketing sponsorship of Mets stadium for the same reason. Lucian Bebchuk, one of the leading advocates for regulation of excessive executive compensation regulation, has criticized executive compensation limits on TARP banks set by Congress.

Another concern with Treasury’s equity in Citi is that, with the U.S. government as control stakeholder in banks, other governments will alter their policies toward international branches or divisions of that bank in order to extract diplomatic concessions from the U.S. Government. Another unintended consequences of Treasury’s bailout has been that customers have gravitated to bailed out institutions, giving those institutions which participated in TARP a competitive advantage.

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advantage over competitors that were ironically safer prior to the bailout. This dynamic is likely to continue as long as Treasury holds stakes in banks, particularly in light of the observation that government owned banks receive regulatory preferences and are more likely to obtain government backing that non-government owned institutions.

Citigroup stands as the prime example for the government’s exercise of control over the institutions that have taken TARP money. It is likely that, the lower percentage ownership the government has in a TARP firm, the lower its control. As such, its potential to control likely quickly drops as one goes beyond the top 20 or 30 TARP banks. This section has omitted analysis of AIG, in which the government has an 85% stake, Fannie and Freddie, which the government completely owns, as well as GM, in which the government is also a majority owner. But the Citigroup example reveals how equity holdings can give government shareholders particular power, which when combined with regulatory authority can make a shareholder which would otherwise be non-controlling suddenly obtain control.

V. Shareholder Control Meets Sovereign Immunity

As explored in more depth in other areas of the article, controlling shareholders have significant liability to other shareholders, and under law. This article notes that the government as a shareholder may have a political interest in pursuing goals that directly harm the interest of other shareholders in the corporation. And yet, one of the novel circumstances of the government’s holding under TARP is that it has substantial sovereign immunity from liability as a controlling shareholder.

As a general matter, The United States is immune from suit unless it waives its sovereign immunity and consents to be sued. The government’s sovereign immunity also extends to its agencies. As a general observation, waiver of the sovereign immunity of the United States “cannot be implied but must be unequivocally expressed.” Determining the government’s sovereign immunity is a complicated exercise. First, we begin with a general presumption of immunity. Then we will need to determine if liability fits under one of the waivers to sovereign immunity passed by Congress. Finally, we will need to analyze the application of one of the express limits on liability found in either the EESA or the federal securities laws.

93 Doug Cameron, MF Global Cites TARP Fallout, Wall Street Journal, February 6, 2009, at C3. In the brokerage area, for instance, segregated client funds held by banks participating in TARP rose by 26% from August to November, while funds in institutions that didn’t participate in TARP fell 12%.
94 Though GM is not publicly traded, at some point the government will slowly sell off its shares, and as such at that time it is likely to become as cogent an example of government control as the other examples in this paper.
95 See the next section, on Interest Group Politics of Government Ownership, and accompanying notes.
97 Gilbert v. DaGrossa, 756 F.2d 1455, 1460 n. 6 (9th Cir.1985).
Pursuant to the Tucker Act, the Court of Federal Claims has jurisdiction to render judgment upon any claim against the United States founded either upon the Constitution, any act of Congress, any regulation of an executive department, or any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort. The Tucker Act confers no substantive right of recovery, such a right must be grounded in a contract, a statute, or a regulation. Further, claims under the Tucker Act are permitted solely for suits seeking an award of monetary damages.

The substantive right enforceable against the government by a claim for money damages necessary for Tucker Act jurisdiction must appear in another source of federal law that, in general, can fairly be interpreted as mandating compensation by the Federal Government for the damages sustained; to make such a showing, a plaintiff must only demonstrate that the substantive source of law is reasonably amenable to the reading that it mandates a right of recovery in damages. In order for a plaintiff to prevail on a Tucker Act claim that might exist under the list of claims generally found under state corporate law, it would need to be included in one of the enumerated categories listed, of which “state corporation law” is not included. The only avenue, if any, which would apply would be a violation of the Constitution. Takings clause litigation is a substantial body of Tucker Act jurisprudence. One theory which may potentially be squeezed under that umbrella would be a novel theory that the diminishment in share value resulting from the government control shareholder’s actions constituted a taking under the Constitution.

Two untested theory may be able to take advantage of the Tucker Act, but it would be a hard fought victory. The first would be a theory that the government’s actions in dimishing the value of other shareholders’ shares constituted a taking under the 5th Amendment. Taking clause cases are particularly difficult to win. In order to establish a regulatory taking under the fifth amendment, the Penn Central case uses a fact-based inquiry that considers (1) the economic impact of the action on the claimant, (2) the effects of the governmental action on the reasonable investment-backed expectations of the claimant, and (3) the character of the governmental action. The first prong would be complicated by the difficulty of measuring the effect of, for example, M&A deals encouraged by the control shareholder when no independent auction was completed. As such, there would be no economic damage to effectively measure. The second prong may be difficult for any plaintiffs who purchased their investment after TARP, or with the expectation that the government may

101 United States v. Jones, 131 U.S. 1, 9, 14-18 (1889) (enactment of the Tucker Act did not expand the powers of the Court of Claims beyond judgments for money an ability to grant injunctions or other equitable relief).
bailout the bank or automotive company and take a controlling equity position, as
the investment-backed expectations prong requires a showing that the plaintiff
acquired an interest “in reliance on a state of affairs that did not include the
challenged regulatory regime.”

The third prong may be difficult for a plaintiff
to meet in light of the government’s articulation that its ownership interest and
exercise of power is intended to minimize damage to financial markets.

The second avenue to attempt under the Tucker Act might try to use an implicit
waiver argument, considering the Supreme Court’s holding that “When the
United States enters into contract relations, its rights and duties therein are
governed generally by the law applicable to contracts between private
individuals,” and that once the United States waives its immunity and does
business with its citizens, it does so much as a party never cloaked with
immunity. One could argue that share ownership is merely a form of
contractual relation that happens to be governed by an extensive set of mandatory
and default rules that constitute the law applicable to those particular “contracts
between private individuals.” If that reasoning holds, then it would seem that the
EESA may constitute the sole limitation on suit against the government’s actions
in putting pressure on the corporation. Arguing that share ownership is a
contractual relation would be unlikely for Delaware corporations, however. The
Delaware Court of Chancery has been careful to maintain a clear distinction
between contract law and corporate law.

Even if plaintiffs were to seek recompense under the Tucker Act in the Court of
Federal Claims, they could not obtain the types of remedies that corporate law
plaintiffs typically seek. Injunctions of mergers are one of the more frequent
remedies that plaintiffs will obtain in the Court of Chancery, and a solely Tucker
Act claim would not be open to such a remedy. One of the reasons that

105 Loveladies Harbor, Inc. v. United States, 28 F.3d 1171, 1177 (Fed.Cir.1994)
106 Mobil Oil Exploration & Producing Southeast, Inc. v. United States, 530 U.S. 604,
607 (2000).
citing Clearfield Trust Co. v. United States, 318 U.S. 363, 369, 63 S.Ct. 573, 87 L.Ed.
838 (1943) (“The United States does business on business terms.”).
fiduciary duty claim to coexist in parallel with an implied contractual claim, would
undermine the primacy of contract law over fiduciary law in matters involving the
essentially contractual rights and obligations of [the] shareholders”); Jedwab v. MGM
relating to preferences or limitations that distinguish preferred stock from common,
the duty of the corporation and its directors is essentially contractual and the scope of the
duty is appropriately defined by reference to the specific words evidencing that contract;
where however the right asserted is not to a preference as against the common stock but
rather a right shared equally with the common, the existence of such right and the scope
of the correlative duty may be measured by equitable as well as legal standards.”)
110 One exception to this general rule is that Congress enacted the Remand Act of 1972
allowing the Court of Federal Claims to grant limited equitable relief. See Gregory C.
Sisk, The Tapestry Unravels: Statutory Waivers of Sovereign Immunity and money
limited equitable authority, however, is incidental and collateral to a Tucker Act claim for
Chancery will most often enjoin mergers or other corporate policy decisions rather than award damages after the fact is that determining damages in corporate deals, as for instance from an unfair merger, are particularly difficult to determine once a deal is complete.\textsuperscript{111} The practical result may be that if any Tucker Act claims were available, plaintiffs may lose for insufficient proof of damages.

A second central waiver of government sovereign immunity for our purposes is the Administrative Procedures Act. That Act permits suit against officers of the federal government.\textsuperscript{112} This Act is limited in that it only applies where (1) claims for relief in the nature of “money damages” are excluded from the APA under § 702; (2) final agency action is reviewable in court under the APA only when there is “no other adequate remedy” in a court; and (3) relief is precluded under the APA “if any other statute that grants consent to suit expressly or impliedly forbids the relief which is sought.”\textsuperscript{113} As will be discussed later in the section, the Emergency Economic Stability Act explicitly limits substantive application of the APA to TARP purchases.

The other blanket waiver of sovereign immunity that must be addressed in considering the federal government’s immunity as a TARP shareholder is the Federal Tort Claims act. This Act is distinct from the Tucker Act, subject to a unique line of precedent, and jurisdiction to hear tort claims against the federal government is exclusively granted to the United States District Courts under the Federal Tort Claims Act and thus cannot be considered under the Tucker Act.\textsuperscript{114} For the purposes explored in this article, there are no useful federal common law causes of action that provide an avenue for suit. In particular, there is little support for the existence of a federal common law fiduciary duty generally.\textsuperscript{115}

\textsuperscript{111} For instance, when a control shareholder forces a merger through a process that is determining to be unfair to the other shareholders in the company, and an auction or shopping period is the only way to determine what the shareholders would have gotten in a fair process, once the transaction is consummated no method for determining damages would be readily available. Conducting a hypothetical auction wouldn’t work, since no party would have skin in the game. One method available would be to conduct an outside appraisal to determine the inherent value of the business and the value of the business to other potential bidders. As that would require access to information from parties not privy to a suit, the lack of incentive to participate would limit appraisal as a method of calculation of the value shareholders may get from an alternative bidder in a board process that was not subject to control by an interested shareholder.

\textsuperscript{112} Administrative Procedure Act, 5 U.S.C. § 702 (2000) “An action in a court of the United States . . . stating a claim that an agency or an officer or employee thereof acted or failed to act in an official capacity or under color of legal authority shall not be dismissed nor relief therein be denied on the ground that it is against the United States or that the United States is an indispensable party. The United States may be named as a defendant in any such action, and a judgment or decree may be entered against the United States.”


\textsuperscript{115} See Roberta Karmel, The Securities and Exchange Commission Goes Abroad to Regulate Corporate Governance, 33 Stetson L. Rev. 849, 851 (.2004) “In Santa Fe
A reading of the Emergency Economic Stability Act “EESA”, which created and authorized TARP, reveals an even stronger protection from liability. The Treasury Secretary’s decisions pursuant to the EESA are generally subject to chapter 7 of title 5 USC, including review for decisions that are arbitrary, capricious, or a violation of law. It nevertheless also provides that “no action or claims may be brought against the Secretary by any person that divests its assets with respect to its participation in a program under this Act...other than as expressly provided in a written contract with the Secretary.” It further provides that “No injunction or other form of equitable relief shall be issued against the Secretary for actions pursuant to section 101, 102, 106, and 109, other than to remedy a violation of the Constitution.” Those sections give Treasury authority to purchase troubled assets. The Emergency Economic Stabilization Act vests in the Secretary of the Treasury the sole authority to exercise the rights in assets acquired under the TARP program. Troubled assets under the EESA was defined as “any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability.” There is also no sunset provision for Treasury’s ability to hold troubled assets.

Review for abuse of discretion, the threshold in APA cases, is a threshold that would likely preclude fiduciary duty review, whether by other bank shareholders or by taxpayers. According to Sunstein and Miles, the government wins somewhere between 55% to 65% of the time under arbitrary and capricious review. And yet, since arbitrary and capricious review is principally an issue of equitable relief, the injunction exclusion renders it mostly ineffective for the purposes of challenging Treasury’s actions as a shareholder in banks. Further, review of financial regulator’s decisions on how to provide guaranty assistance to banks is likely to obtain wide latitude under the arbitrary and capricious standard.

Industries, Inc. v. Green, the United States Supreme Court seized an opportunity to quash the development of a judge-made federal law of corporate fiduciary duty under Section 10(b) of the Exchange Act. The Supreme Court reversed and held that Section 10(b) cases require “deception, misrepresentation, or nondisclosure.” In so doing, the Court rejected the notion that the securities laws “federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.” Citing Santa Fe Indus. V. Green, 430 U.S. 462 (1977).

116 Emergency Economic Stabilization Act Section 119
117 Emergency Economic Stabilization Act Section 119
118 Emergency Economic Stabilization Act Section 119
119 Emergency Economic Stabilization Act Section 106(a)
120 Emergency Economic Stabilization Act
121 Emergency Act Section 106(e).
particularly where the decision goes to the heart of stability of the nation’s banking system.124

The EESA also doesn’t consider application of Section 3(c) of the Exchange Act125 exempting the federal government from coverage by the Exchange Act. As part of its belt and suspenders approach to protecting the Treasury Secretary from liability, it also exempts decisions concerning the disposition and management of TARP assets from injunction relief, even if plaintiffs were able to meet the arbitrary and capricious threshold.

There may be one useful distinction worth drawing on the application of the EESA. It may be that the liability waivers of the EESA would apply to government decisions on how to spend TARP funds, but would not extend to cover the act of pressuring corporations to institute policy changes as a result of the government’s ownership in TARP recipients. The legislative history of the EESA is necessarily limited, owing to the rapid timeframe in which it was passed, but some sources indicate that Congress never intended for TARP to be used to openly purchase shares in companies, much less use that share ownership to give it power over corporate policy decisions at the company level. As such, that argument, though useful in evading the exemption language of the EESA, would still be no help with trying to find a cause of action under the Tucker Act.

Though the EESA mentions the APA, it does not specifically address the Securities Act or the Securities Exchange Act. The federal government’s liability under the federal securities laws is unclear. There is an express rejection of liability for the federal government in the 1934 Securities Exchange Act.126 Thus the federal government’s immunity from the 34 Act is secure under the belt and suspenders protection of both the EESA and the 34 Act. The 33 Act would require a bit more involved discussion. The 33 Act has not such express opt out as is found in the 34 Act. Quite the opposite, “person” for the purposes of the 33 Act is specifically defined to include “an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or a government or political subdivision thereof”.127 Since “person” is a reference included throughout the 33 act to regulate conduct by participants in the securities markets and expose them to liability for failure to do so, it would seem that the intent behind the 33 Act was not to shield the government from liability.128

The inclusion of governments in the meaning of “person” in the 33 Act may be an avenue for liability under the 33 Act. This would be limited, however, to Section 12 violations. It would not include 10b-5 violations, nor would it encompass putting pressure on boards in ways that harmed the value of the enterprise unless such action was also accompanied by a material omission from a registration statement or prospects or failure to deliver a prospectus.

124 See Huntington Towers, Ltd. V. Franklin National Bank, 559 F.2d 863 (2nd Cir. 1978)
125 See note infra
126 See Section 3(c) of the Securities Exchange Act of 1934.
127 33 Act section 2(a)-2.
128 See, e.g., Section 5 of the Securities Act of 1933.
The 34 Act states that “No provision of this title shall apply to, or be deemed to include, any executive department or independent establishment of the United States, or any lending agency which is wholly owned, directly or indirectly, by the United States, or any officer, agent, or employee of any such department, establishment, or agency, acting in the course of his official duty as such, unless such provision makes specific reference to such department, establishment, or agency.” This provision is also relevant to the determination of control shareholder. If the Treasury, Fed, or an established trust is not considered a control shareholder for the purposes of the 34 Act, then it may not share joint and several liability under the securities laws.

The next issue would be whether individuals appointed to the Board of Directors share any governmental immunity. The Federal Reserve’s holdings in AIG, purchased mostly through TARP funds, were placed under the ownership of a trust. There is an open question as to whether the trust is actually independent from the government. The Treasury Secretary has indicated his intent to place common stock held in Citigroup into a similar trust sometime in the future. Thus the analysis of sovereign immunity would need to continue, for government ownership in which these entities are created, to a second degree to consider application to the trustees.

If the trust or its trustees are not considered to be an agent or officer of the United States, the analysis becomes much more complicated. The sovereign immunity of the United States from suit without its consent does not extend to its officers or agents, and an action against an official or agency of the United States is not necessarily a suit against the United States. Where defendant's conduct is such as to create a personal liability, the fact that the defendant is an officer of the United States does not forbid a court from taking jurisdiction of a suit against him or her.

Relief sought nominally against an officer is in fact against the sovereign if the decree would operate against the latter. Generally, a suit is considered one against the sovereign if the judgment sought would expend itself on the public treasury or domain, or interfere with the public administration, or if the effect of the judgment would be to restrain the government from acting, or compel it to act. It is not an easy matter to reconcile all the decisions of the court in this

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129 See author’s testimony before the House Committee on Oversight with the CEO of AIG and the AIG Trustees.
130 See generally Corpus Juris Secundus UNITEDSTS § 222.
131 Gautreaux v. Romney, 448 F.2d 731 (7th Cir. 1971); Pan Am. Petroleum Corp. v. Pierson, 284 F.2d 649 (10th Cir. 1960)
136 Dugan v. Rank, 372 U.S. 609, 83 S. Ct. 999, 10 L. Ed. 2d 15 (1963)
class of cases.¹³⁷ It is unclear whether a suit against the AIG trust would ultimately result in an expenditure by the government. The indemnification provisions of the AIG trust begin with a requirement that AIG indemnify them for any liability that they face as trustees, but the Federal Reserve agrees to indemnify any amounts AIG is unable to provide.¹³⁸ It does seem that a judgment against the AIG trustees would result in restraint on the government’s ability to fulfill its purposes, in light of how the AIG Trust Agreement includes various provisions that compel the Trustees to meet their fiduciary duty to the “Treasury” and consider the effect of their decisions on capital markets more broadly.

To the extent that the government places control of its TARP securities by establishing a trust, as it did with AIG, a shift occurs in the relationship between determining the existence of a control shareholder and the existence of immunity. The more that the AIG trust is determined to be a government actor, the more likely it will be in control of the company. However, to obtain the protection of sovereign immunity, the trust would want to show that it was a government entity.

There are very few limitations on trustee indemnification in the AIG Trust, and trustee fiduciary duty is defined in a vague way such that the Treasury’s interpretation on the reach of immunity would likely control.¹³⁹ Despite a lack of immunity from the laws referenced above, the documents creating the AIG Trust would limit the reach of liability even if sovereign immunity does not cover the AIG trustees. Legislation currently pending may change the nature of any future trusts set up by the federal reserve or treasury.¹⁴⁰

VI. Interest Group Politics of Government Ownership

This section will use interest group theory, as well as evidence from government ownership from around the globe, to offer some predictions for how governments will make decisions as controlling shareholders. This will inform our understanding of the presence of government as a controlling, immune shareholder for the following two sections concerning the effects of TARP on the theory and practice of corporate and securities law.

The consequences of a government agency holding voting equity in a private bank can also be costly. The implications of government ownership in private entities depend on the criteria used to analyze the situation. Constituent directors tend to gain power when governments have equity and debt leverage over private firms. Labor is the primary constituent of the corporation that seeks influence over the corporation, but local constituencies seeking to block cross border flows of capital and services, consumer rights activists, and environmental activists also seek a role. If increasing labor and other constituent participation in corporate

¹³⁹ See Terms of the AIG Trust Agreement at www.federalreserve.gov.
¹⁴⁰ See TARP Recipient Ownership Trust Act of 2009, introduced by Senator Corker.
decisions is the objective, then government leverage over boards of directors is a benefit.

If, however, maximizing the returns to the taxpayer from TARP shares is the objective, then the presence of constituent directors is a cost associated with the Treasury’s leverage and equity position in the financial and automotive sector. A significant element of tension between shareholder wealth maximization and constituent directors is inescapable. Bainbridge observes that shareholders as a group have far less power as political interest groups than do non-shareholder constituencies of the corporation. 141

Many global economies are characterized by extensive government ownership in firms. At times governments nationalize private industries, and at times they privatize nationalized industries, all of which offers an opportunity to consider the interest group forces that shape a government’s conduct as holder of a residual stake in firms. This section will also consider the consequences of government ownership of golden shares, which serve as a useful analogy for Treasury’s powerful ownership stake in TARP banks.

Governments as investment entities face pressure from local interest groups to use their shareholder rights to inhibit the free flow of capital into and out of the political jurisdiction associated with the investment entity. Comparisons to the different forms of government ownership in Europe, Asia and South America teach that government owned banks are frequently used to advance political agendas to the detriment of a bank's financial health. 142 Advancing a political

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142 A substantial prior literature evidences the risks of the second form of government nationalization of banks. LaPorta (2002) finds that government ownership of banks is negatively correlated with financial development and economic growth. Dinc 2005 uses comparisons across 36 countries to reveal that governments tend to lend more generously, compared to private banks, during election years. Existing economic literature on the effect of government ownership in banks has distilled into two central groups of thought. A political view holds that they are a way for politicians to pursue political objectives, such as maximizing employment or favoring certain interest groups, as a way to reward supporters. See Paola Sapienza, The Effects of Government Ownership on Bank Lending, Journal of Financial Economics, Volume 72, Issue 2, May 2004, at 1. One empirical examination of state owned banks in Italy found that, all else equal, state owned banks charge an average of 44 basis points less than privately held banks for the same borrower. Sapienza at 2. This study also found that companies in certain political regions benefited more heavily, depending on the party in power, with regions in which the national political party held more power likely to experience lower interest rates from the state owned banks than other areas. 142 It also found that state owned banks for some reason tended to favor lending to larger businesses than private banks. Other studies have shown that state owned banks held more heavily, by a factor of ten, to state and local governments. Sapienze has also found that government run banks in Italy lend at rates approximately 20 to 50 basis points lower than private banks. The case of India’s bank nationalization is instructive. See Shawn A. Cole, Financial Development, Bank Ownership, and Growth. Or, Does Quantity Imply Quality?, Harvard Business School Finance Working Paper No. 09-002. Available
agenda may actually be easier through controlling common equity stakes, an effective semi-nationalization, than outright nationalization. A government agency using shareholder power over private companies has two unique freedoms:
i) the ability to bypass the administrative law process, the separation of powers and judicial review that constrain regulatory discretion, and instead simply require the board to initiate corporate policy changes favored by the Treasury, and

ii) the ability to bypass the federal budget process and transparency to the voters that work to constrain transfers to political interest groups, and instead require the bank to make those transfers in the form of increased lending and artificial interest rate caps entirely off the federal budget.

http://ssrn.com/abstract=1158078, at 23. In 1980, India nationalized all private banks with a deposit base about Rs. 2 billion. Those banks were subject to direct control of the federal government, with the entire board of directors nominated by the ruling party. Those nominees typically were either from government positions, private industry, agricultural groups, or the general public. Between the nationalization of 1969 and 2000 there were twenty one private bank failures in India, Banarjee Cole and Duflo found that during this time the cost to the government of making depositors in those banks whole was less than the cost of recapitalizing the public sector banks, after adjusting for scale.

The identified goal of the Indian nationalization was to increase the scope of banking and lending in rural areas. This rural focus was intended to benefit lower income groups, and by association the agriculture industry. The effect of the Indian nationalization was that nationalized banks grew more slowly than private banks in the 1990s, and that they lent more to agricultural, rural areas, and to the government at the expense of lending to trade, transport, and the financial industry. Cole found that towns with nationalized branches experienced an annual growth rate of 2-3% higher than rural towns that without nationalized branches during 1980-1990, and the amount of credit in those towns increased by a factor of 1.5 to 2.5. He also found, however, that the effect of increased credit on rural towns was not a sustained impact, as the annual growth rate in towns with nationalized banks was 2-4% lower from 1990-2000, essentially wiping out the prior decades additional growth. This suggests that the additional liquidity was merely invested in bad loans. Nationalization also resulted in a significant reallocation of lending to agriculture as well as lower interest rates. Government ownership also reduced the quality of financial intermediation as evidenced by the fact that loans made by public sector banks were substantially more likely to default than loans issued by private sector banks, essentially resulting in a substantial drain on the public treasury when the national government eventually recapitalized them. Further, Indian bank nationalization failed to even attain its modest goal of increased employment or increased investment in the agricultural sector over the long term, despite the high cost of nationalization.

The consequences of moving the debt of private banks onto the public budget can be severe. For instance, when the U.K. moved the liabilities of two bailout-out banks in which it owns a control stake, Royal Bank of Scotland Group and Lloyds Banking Group, onto the public balance sheet it added $2.136 trillion to the public debt, more than doubling the U.K.’s public debt. Alistair McDonald and Laurence Norman, Bank Bailouts, Sinking Revenue Fray U.K.’s ledger, Wall Street Journal, February 20, 2009, A10.

Part of the relationship between Fannie and Freddie was a sort of interest group feedback loop that demonstrates this problem. Fannie and Freddie were permitted to lobby Congress with political donations. Peter Wallison, How Paulson Would Save Fannie Mae, Wall Street Journal, September 12, 2008. When the government was forced to take Fannie Mae and Freddie Mac into conservatorship, the government did not
Direct nationalization does not offer those benefits, but it does offer an even more concrete control for the government. Unions are the stakeholder most likely to seek influence in a government owned firm. One of the reasons why nationalized, or even partially nationalized firms are difficult to then re-privatize is that stakeholders obtain patronage networks from the firm through political influence, thus privatization requires a substantial political battle.

completely eliminate preferred and common stockholders, but limited its stake to 79.9%. See Steven M. Davidoff and David Zaring, Big Deal: The Government’s Response To The Financial Crisis (November 24, 2008), available at http://ssrn.com/abstract=1306342, at 24. Davidoff and Zaring offer four reasons which may have informed the decision to leave some equity outstanding: support Treasury’s position that it did not have to consolidate the GSEs onto the federal budget, keep the GSEs from having to adopt government accounting rules, permit the GSEs to deduct interest on their government loans from their taxes (which they would not be able to do if deemed government controlled), and keep the government from becoming liable for the GSEs retirement liabilities. See Steven M. Davidoff and David Zaring, Big Deal: The Government’s Response To The Financial Crisis (November 24, 2008), available at http://ssrn.com/abstract=1306342, at 25. David Moffett, Freddie’s most recent CEO, resigned after just six months, citing social mandates from the government that impeded his ability to turn around the company and make it profitable. James Hagerty and Joann Lublin, Freddie Chief Quits after six months, Wall Street Journal, March 3, 2009, A4. Prior to the revelations of accounting irregularities at the two GSE’s, its dedicated regulator performed the sort of inspections and audits typical of a financial regulator without uncovering any problems. Peter Wallison, Moral Hazard on Steroids: The OFHEO Report Shows that Regulation Cannot Protect U.S. Taxpayers (July 2006), available at www.aei.org, page 3. They were however completely taken by surprise when, for instance, the board of Freddie Mac dismissed its top two officers for accounting irregularities. Peter Wallison, The Evolution of a Policy Idea: How Restrictions on the Size of the GSEs’ Portfolios became the Central Issue in Reform of their Regulation, NFI Working paper 2006-PB-03, available at www.aei.org, at page 14.


Aaron Tornell, Privatizing the Privatized, in A. Krueger, ed., 2001, The Second Round of Reforms, The University of Chicago Press, also available as NBER Working Paper No. W7206 at http://ssrn.com/abstract=202743, at 5. One of the political explanations for privatization in late twentieth century Britian was that the conservative government was interested in allocating underpriced equity to the middle class through the privatization, which would then create a constituency that would support market oriented policies and thereby increase the Conservatives’ chance of re-election. See Bernardo Bortolotti and Mara Faccio, Government Control of Privatized Firms, Review of Financial Studies (2008), available at http://ssrn.com/abstract=536683, at 15. In effect, the privatization itself would give voters more of a stake in the profitability of the enterprise, thereby ensuring that they would support government policies supportive of the business management already allied with the Conservative government. In the U.S. this motive for privatization would not likely hold, because equity holdings are already widely distributed among the middle class. And so at the very least pointing to Europe as justification for the fact that governments can be forced to induce privatization of firms they have run may be troublesome. The only other inducement to privatization we have seen is that governments can be induced to divest of profitable firms if the public budget is in severe stress. See Bernardo Bortolotti and Mara Faccio, Government Control of
One interest group criticism of Treasury’s TARP holdings amounts to a suggestion that labor, management, and government will collectively conspire against the interests of taxpayers and shareholders, as well as the long term interests of a firm’s constituents.\footnote{Roe’s interest group theory for the development of financial regulation discouraging the intermediation of capital in the United States.}{149} We have already seen such a collaboration in Roe’s interest group theory for the development of financial regulation discouraging the intermediation of capital in the United States.\footnote{Privatized Firms, Review of Financial Studies (2008), available at http://ssrn.com/abstract=536683, at 18. This implies that only banks in which interest group rents do not capture all of the firm’s profits could be later privatized by the Treasury. But even when they do privatize, that privatization may be only partial. Governments face pressure to maintain powerful residual ownership in the privatized firms. The Russian privatization experience also supports that privatization is more likely when the government is suffering from severe budget deficits. Alexander Muravyev, Federal State Shareholdings in Russian Companies: Origin, Forms and Consequences For Enterprise Performance, Bank of Finland Institute for Economies in Transition, Discussion Paper No. 12 (October 20, 2002), available at http://ssrn.com/abstract=1015707, at 12. Russian firms with residual government ownership were also characterized by the presence of government officials in administrative and board positions. Alexander Muravyev, Federal State Shareholdings in Russian Companies: Origin, Forms and Consequences For Enterprise Performance, Bank of Finland Institute for Economies in Transition, Discussion Paper No. 12 (October 20, 2002), available at http://ssrn.com/abstract=1015707, at 14. Those representatives had little experience in the underlying business. Alexander Muravyev, Federal State Shareholdings in Russian Companies: Origin, Forms and Consequences For Enterprise Performance, Bank of Finland Institute for Economies in Transition, Discussion Paper No. 12 (October 20, 2002), available at http://ssrn.com/abstract=1015707, at 14.} Rational choice theory stands for the proposition that small and well organized groups will tend to gain benefits over larger and less homogenous groups in the political process. Ellen M. Pint, Nationalization and Privatization: A Rational-Choice Perspective on Efficiency, Journal of Public Policy, Volume 10, Issue 03 (July 1990), at 268. For example, one study indicates a negative correlation between labor productivity and residual government ownership in Russian privatized firms. This study found that a 10% increase in government ownership was associated with a 6.5% drop in labor productivity and a 1.2% drop in profitability. Alexander Muravyev, Federal State Shareholdings in Russian Companies: Origin, Forms and Consequences For Enterprise Performance, Bank of Finland Institute for Economies in Transition, Discussion Paper No. 12 (October 20, 2002), available at http://ssrn.com/abstract=1015707, at 25.\footnote{Roe’s theory for how labor and management interest groups helped to determine the shape of American finance in the 20th Century is instructive. The summary of Roe’s theory that follows is drawn from the author’s previous work. See J.W. Verret, 10 U. Pa. J. BUS. & EMP. L. 63, 65 ( Fall 2007). The political process Roe describes is as follows: The source of laws that restrict the power of intermediaries comes from both public opinion and interest group power. Where the broad public has even a weak preference that preference cannot be outweighed by that of a smaller, more interested group. Arthur T. Denzau & Michael C. Munger, Legislators and Interest Groups: How Unorganized Interests Get Represented, 80 Am. Pol. Sci. Rev. 89 (1986). The American public has always been suspicious of consolidated economic power. Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance *1994), at 48 The flow of funds, though, is essential to economic stability, thus a choice was inevitable: either intense regulation of one consolidated entity, or fragmentation with light regulation. Id. at 41. The American government chose the latter. See Roe generally. These two forces are magnified by federalism, which serves to enhance the effects of fragmentation and path dependency(For a detailed explanation of path dependency, see}
profitable nationalized firms create rents that can be re-distributed, by liberal and conservative governments alike, effectively making even profitable firms merely breakeven once the rents are distributed. The difference would be merely which constituency the rents would be distributed to. The government would seem then to only have an interest in privatizing unprofitable firms. But we have seen evidence that only profitable companies can be effectively privatized. Study of nationalization and privatization is useful in considering Treasury’s equity holdings, but the best analogy for the semi-nationalization created by the Treasury’s TARP holdings is the case of nationalized firms in which governments maintain significant and powerful residual holdings. Those residual holdings were particularly characterized by the power to block acquisitions.

Lucian Arye Bebchuk & Mark J. Roe, A Theory of Path Dependence in Corporate Ownership and Governance, 52 STAN. L. REV. 127 (2000)), which make institutions evolve in response to political choices. Institutions that might have served as powerful intermediaries, namely, mutual funds, pension funds, banks, and insurers, were all constrained by a series of political reactions and rulemaking that constrained their economic influence over firms through some version of the political model described in Roe’s thesis. See, e.g., David Langer, Protector Becomes the Threat to Pensions, Pensions & Investments, Sept. 14, 1992, at 15 (describing how United Steelworkers and the United Auto Workers were key lobbyists for ERISA). The political interest group theory is that managers and labor join together to oppose the rise of institutional investor power. Management does not want an intermediary that can monitor its extraction of rents in the form of excessive compensation, and labor is convinced that intermediaries will squeeze the employment rolls to maximize investor returns. Roe, supra note 1, at 42-45.

For instance, Britain’s nationalized railway and coal industries were directed to simply “break even,” and otherwise control prices to minimize consumer costs. Ellen M. Pint, Nationalization and Privatization: A Rational-Choice Perspective on Efficiency, Journal of Public Policy, Volume 10, Issue 03 (July 1990), at 275. An exception to this challenge would be nationalization as liquidation, which would effectively re-privatize the firm through a wind up procedure before interest groups have an opportunity to capture control over the firm through the government.

Ellen M. Pint, Nationalization and Privatization: A Rational-Choice Perspective on Efficiency, Journal of Public Policy, Volume 10, Issue 03 (July 1990), at 270. The national Coal Board that was created as part of Britain’s nationalization of the coal industry was charged with “making supplies of coal available in such quantities and at such prices as may seem best calculated to further the public interest.” Ellen M. Pint, Nationalization and Privatization: A Rational-Choice Perspective on Efficiency, Journal of Public Policy, Volume 10, Issue 03 (July 1990), at 274. The British Treasury also tended to distribute any profits from the industries they oversaw to labor, rather than minimize the costs to government nationalization by returning those profits to the Treasury. Ellen M. Pint, Nationalization and Privatization: A Rational-Choice Perspective on Efficiency, Journal of Public Policy, Volume 10, Issue 03 (July 1990), at 276. It was also found that once nationalization occurred, it became very difficult to re-privatize those firms unless they returned to profitability. Ellen M. Pint, Nationalization and Privatization: A Rational-Choice Perspective on Efficiency, Journal of Public Policy, Volume 10, Issue 03 (July 1990), at 279. This is because the only alternative is for the government to shut down the firm and fire the workers, which governments are loathe to do, and because after the interest groups have had their way with the firm, the firm becomes worthless without the government guarantee behind it.
Those governments’ residual holdings gave them the ability to also influence major corporate policy decisions.\textsuperscript{153}

It is also interesting to note that nearly two thirds of privatized firms in Europe during the great privatization wave of the 80s and 90s were characterized by this form of powerful residual government control.\textsuperscript{154} This indicates that once banks have come under government control for the purposes of running them as enterprises, even if they can be later re-privatized, the Treasury may also be expected to maintain for the federal government residual interests whose control exceeds their proportionate interest. The consequences of residual golden shares can threaten the profitability of the partially privatized firm.\textsuperscript{155} One study found that more fully privatized firms tended to be more profitable than those in which governments have powerful residual equity holdings, with Market to Book and

\textsuperscript{152} See Bernardo Bortolotti and Mara Faccio, Government Control of Privatized Firms, Review of Financial Studies (2008), available at http://ssrn.com/abstract=536683, at 1. See also Getting Tough on Golden Shares, Financial Times, June 6, 2003. During the privatization wave of the 1980s and 90s in Western Europe, governments sold off majority stakes in airlines, automotive and other manufacturers, banks, utilities, and a variety of other industries. Many of them kept shares that included provisions permitted the holder to block any merger or acquisition of the newly privatized company. Though these shares represented minority positions in those firms, the ability to veto mergers gave state investors a powerful voice in the company’s decision-making.

Many argue that those governments used their rights in golden shares to block legitimate offers to acquire those companies out of an interest in maintaining inefficiently high levels of employment or reducing cross-border flows of capital and services. For instance, France and Germany have been the subject of extensive litigation before the European Commission over their golden shares in, for instance, Airbus and Volkswagon. These golden shares typically possessed powers, among which were i) the right to appoint members to corporate boards ii) the right to consent to or veto acquisition of interests in the privatized companies iii) other rights to consent to ordinary management changes. See Bernardo Bortolotti and Mara Faccio, Government Control of Privatized Firms, Review of Financial Studies (2008), available at http://ssrn.com/abstract=536683, at 10. Those European governments with the right to appoint directors frequently appointed government officials to the board. See Bortolotti at 12.


\textsuperscript{155} One might ask why constituents of the corporation would lobby for policies which may threaten the long term profitability, and by extension long term viability, of the corporation from which they seek to extract rents. But even with its interest in general public welfare, rather than profit maximization, the opportunity costs of employees who were never employed in industry, that otherwise may have been under competitive pricing, or the opportunity costs of shareholder returns to private pensions that do not otherwise accrue as a result of the price controls, are not factored into the analysis. These hidden costs cannot make their way through the political process to exert pressure because actors who would otherwise lobby for these opportunities do not know who they are ahead of time. And so, as an interest group, they are unable to organize to protect their interest.
Return on equity ratios negatively correlated with a decreased level of privatization.\textsuperscript{156}

Another criticism for government owned firms is that the threat of bankruptcy or takeover, which would otherwise discipline management, is not present in government run firms.\textsuperscript{157} This criticism supplements the view that governments will re-orient the company’s objective from profit maximization to other goals like employment maximization.\textsuperscript{158} When the government’s interest is only partial many of these problems remain. One key insight is that governments tend to bailout firms in which they have an equity stake with greater frequency.\textsuperscript{159} When other shareholders lose confidence in management, they sell their stock, but when governments lose confidence in management they inject more capital into the firm. This means that the bankruptcy constraint is minimized. If the government maintains the ability to limit takeovers through voting in M&A situations, it will also exacerbate the managerial limitation.

Another study of Russian privatization indicated that firms in which the government kept residual equity ownership received preferential treatment in the application of government regulations over firms that were not government owned, magnifying the distortionary effects of government ownership.\textsuperscript{160} This is similar to the exemption from the federal securities laws that Fannie Mae and Freddie Mac were able to obtain for so long, as well as Wallison’s suspicion that they received preferential treatment in application of the antitrust laws.

Thus far this section has listed a variety of historical examples for how government’s re-orient the goals of private businesses away from profit maximization, but the question remains why that is the case. To get at that question, we must consider the incentives facing the government officials making decisions on how to exercise their authority as shareholders.\textsuperscript{161}


\textsuperscript{161} A public choice model for government bank lending versus private bank lending might be sketched as follows. Consider two variables, L=Aggregate Loans in Bank’s portfolio and P=the net present value of expected aggregate future payments on those loans. For a private bank, the decision metric is fairly simple, lend when L < P. An executive whose compensation is tied to the bank’s profitability would be informed by
To take the bank example, private bank executives will typically lend where the
net present value of profits from loans exceed the net present value of their cost.
Now consider that the decision process for a government shareholder is
complicated by a number of marginal variables that are not included for
executives, namely interest group rents from groups affected by company
policies who vote for members of Congress and Administrations. As you move along the spectrum of how much control government has over
banks, increasing shares of ownership result in a decrease in the cost of control.
To the extent that there are distortions in incentives by increasing share
ownership in banks, this is supported by previously explored evidence that
increases in a government’s percentage ownership in a bank correlates with
decreases in bank profitability.

Rents tend to come before costs for government officials, making those rents
magnify in importance. This is evidenced by a comparison of the average tenure
of financial regulators and Congressional banking committee Chairman to the
time it took government subsidies of lending to blow up in the cases of India,
Italy, and Fannie Mae explored in the article. The typical assistant secretary at
the Treasury Department or HUD serves for 2-3 years, but it took nearly 30 years
for Fannie and Freddie to explode. The fact that rents come before costs alters
that equation in directing corporate policy, and a shareholder interest in maximizing the
health of the bank would do the same. This model would be complicated by executive
compensation which was improperly linked to performance, but as government pay is in
no way linked to performance I will set aside that concern for the purposes of this
comparison.

Consider the following illustration: GB represents interest group rents, the benefits
interest groups obtain from the corporation, such as subsidized lending. GB2 represents
the political benefits to administering efficient government, through promotion an
administration’s re-election. GD1 represents the probability of being in office when a
government owned bank fails or significantly appreciates in value. GD2 represents the
share of political reward/blame that political actors gets for positive or negative effects on
the banks viability, taking into account the fact that political actors are able to share
blame among the political appointees in their Department, appointees in other financial
regulatory agencies, their predecessors, and members of Congress. GD3 represents the
share of rents to interest groups that are shared with political actors, such as political
donations or support or jobs after retirement from government. GC1 represents the net
present value of future expenditures under subsequent bailouts due to inefficient lending.
GC2 represents the cost of exercising equity control over banks. For government
controlled banks, the decision by an administrator overseeing the government’s
investment, and the decision metric used by other political actors who might be able to
use political leverage to influence that administrator’s decision, will be to lend when: L +
GC2 + [GC1 * GD2 * GD1] < P + [GB2 * GD2 * GD1] + [GB * GD3]. As the right
side of the equation gets larger from the two additional variables, then all else equal the
lower interest rate you’ll need (a component of P) to make the right side larger than the
left. This will result in subsidized lending through a lower interest rate on loans. This
model is also somewhat dynamic in the sense that subsidized interest rates is part of the
rent extracted by interest groups and shares with the TARP administrator and those
overseeing the TARP administrator, thus the decrease in interest rates will also itself
increase GB and GD1. This is evidenced by the cases of lending subsidies in Fannie Mae, Freddie Mac, Italy, Russia, India, and others explored in the article.

See note infra.
the NPV analysis, as the costs are time discounted but the rents are not, which would push the decision metric significantly toward excessive lending.

Another indirect cost of the government guarantee accompanying government ownership, is that the culture and infrastructure of the firm will be built around that guarantee. The institutional knowledge of the firm will be based around the existence of a government guarantee and in the service of the non-financial objectives that will typically come with government control and ownership. This will make later re-privatization difficult, as the market may not have an interest in buying into a firm whose instincts have been dulled by public sector backing and control, and who may not be able to survive on their own outside the nest.

VII. Implications for Corporate Law Theory

This section will examine the kaleidoscope of theories commentators have offered in their efforts to either to justify existing structures in corporate and securities law or to urge reform. Those theories will be examined in light of the presence of a controlling government shareholder that enjoys sovereign immunity. This section will show that of the five central theories used in corporate law, including classic agency and contractarian thought, shareholder primacy, director primacy, the team-production model, and progressive corporate law, none of them support the presence of the federal government as a control shareholder in a publicly traded company. Even more than that, these theories that serve to illuminate corporate law debates and rarely the opposing parties tend to break down entirely when considered with the presence of such a shareholder.

A. Agency Theory

Agency Theory is the bedrock of corporate law most frequently cited in its theoretical development, and is the first well developed building block in the debate. The standard Jensen Meckling story of agency costs has been used to

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164 Some argued that the best way to deal with the moral hazard problems of guaranteeing Fannie and Freddie debt was simply to increase regulation of the GSEs. Peter Wallison, Moral Hazard on Steroids: The OFHEO Report Shows that Regulation Cannot Protect U.S. Taxpayers (July 2006), available at www.aei.org, page 2. And yet, as Chairman Greenspan observed at the time, increased regulation of an implicitly government guaranteed enterprise only enhances the market’s perception that the government is all the more willing to guarantee their debt. Peter Wallison, Moral Hazard on Steroids: The OFHEO Report Shows that Regulation Cannot Protect U.S. Taxpayers (July 2006), available at www.aei.org, page 2.

165 As a particularly aggregious example of how Fannie and Freddie’s operational risks were ignored by private markets due to the government’s backing, Fannie and Freddie were forbidden from filing financial statements with the SEC starting in 2003 due to revelations of earnings manipulations and accounting fraud. And yet, during the years that investors had no access to filed financial statements, their demand for Fannie and Freddie debt continued unabated. Peter Wallison, Moral Hazard on Steroids: The OFHEO Report Shows that Regulation Cannot Protect U.S. Taxpayers (July 2006), available at www.aei.org, page 2.
explain the relationship between shareholders and the board of directors. Where
the providers of capital to an enterprise, the shareholder principals, and the users
of that capital, the managerial agents, are both utility maximizers, there is reason
to believe that the agent interest can conflict with their principals.\textsuperscript{166} Then in
order to maintain capital flows, manager agents will incur bonding costs to assure
principals, and principals will incur monitoring costs to minimize instances of
agent abuse of their authority over the principal’s capital.\textsuperscript{167}

One complication to this model for government shareholders is that the notions
of utility that are being maximized will substantially change. Thus the
government shareholders and the other shareholders will have different
definitions of utility. Indeed, their utility priorities may be in direct
contravention to each other. This will make monitoring and bonding more
difficult, as the agents will have to serve two masters rather than just one.\textsuperscript{168}

And yet, in light of the fact that government equity holdings go hand in hand
with government bailouts, the other shareholders will be the beneficiary of the
government subsidy. On the other hand, they will be adversely affected by the
distorted incentives for risk taking that the government subsidy entails will also
generate. Balancing these benefits against their costs will substantially alter
their monitoring costs. The infrastructure of the securities markets has a difficult
time gauging the risk of bankruptcy, with share prices tending to fall dramatically
near a bankruptcy event. The share prices of Fannie and Freddie are an acute
eexample.\textsuperscript{169} Shareholders have to gauge the likelihood of the Treasury giving
further bailouts, or deciding to take the firm into receivership. This sort of
political risk is difficult for them to gauge, as the skills needed to do it are quite
distinct from other calculations particular to securities analysis. The risk of
bankruptcy, coupled with a corollary risk that the government will fail to bailout
a firm sufficiently to protect its equity holders, may be the sort of tail end, black
swan event that is currently being explored as prone to bounding the rationality
of investors.\textsuperscript{170}

\textsuperscript{166} Michael C. Jensen and William H. Meckling, Theory of the Firm: Managerial
Behavior, Agency Costs and Ownership Structure, Journal of Financial Economics,

\textsuperscript{167} Michael C. Jensen and William H. Meckling, Theory of the Firm: Managerial
Behavior, Agency Costs and Ownership Structure, Journal of Financial Economics,

\textsuperscript{168} When risk and reward are disjoined, incentives for well informed and prudent
management of risk are abandoned. In Fannie and Freddie’s case, this took the form of
improper hedging of interest rate risk. Peter Wallison, Moral Hazard on Steroids: The
OFHEO Report Shows that Regulation Cannot Protect U.S. Taxpayers (July 2006),
available at www.aei.org, page 4. Wallison at 10 The perverse incentives created by this
government backing do not only impose costs on the guaranteed firms. They also
enhance systemic risk within the financial system, defined as the risk that a failure within
one institution can result in failure to linked institutions sufficient to cause large scale
shocks to the economy. Peter Wallison, The Evolution of a Policy Idea: How
Restrictions on the Size of the GSEs’ Portfolios became the Central Issue in Reform of

\textsuperscript{169} Yahoo Finance graph, available at
http://finance.yahoo.com/q/bc?s=FNM&t=5y&l=on&z=m&q=m&q=l&c=.

\textsuperscript{170} Taleb, Nassim Nicholas, The Black Swan: The Impact of the Highly Improbable.
Random House; 1 edition (April 17, 2007)
Jensen and Meckling postulated that agency costs for monitoring and bonding would depend on the cost of measuring the manager agent’s performance and evaluating it, the cost of devising and applying an index for compensating the manager that would correlate with the principal’s welfare, and the cost of devising and enforcing corporate policies.\textsuperscript{171} The indeterminate nature of government’s interest and their incongruent relationship to the goals of most other shareholders will drastically increase these agency costs for the entire operation, which will be evidenced by a discount in the value of minority shares in the company.

Jensen and Meckling also postulated that firms where capital markets are characterized by rational expectations of profit maximization, a firm’s debt to equity ratio will be reflective of the agency costs of monitoring that firm’s managers. Governments as shareholders, with their unique willingness to ignore profit maximization in the value of their shares and bailout the debt of entities in which they hold an interest, seriously threatens this function of outside ownership. The sort of triangular agency that results from government ownership, where Treasury becomes both control-shareholder principal and agent of the taxpayer, but results in an inefficient use of resources, would also limit Coase’s rule\textsuperscript{172} that firms will exist only where the cost of market activity exceeds the cost of direct authority.

\textbf{B. Contractarian Theory}

The contactarian model tries to consider what rules the constituents to the contracts at the nexus of the corporation would adopt if there were a hypothetical bargain.\textsuperscript{173} This view, also known as the nexus of contracts theory of the corporation, also supports the notion that a corporation is a product of bargained agreements. The contractarian model of corporate law supports the use of default rules which shareholders, companies, and constituencies are free to modify by contract.\textsuperscript{174}

Macey argues that the theory of the firm implies that the law should respect the legal arrangements accepted by those within the firm, as it explicitly calls for regulatory respect for private ordering.\textsuperscript{175} The contractarian model is in many ways a precursor to two subsequent corporate theories, the shareholder primacy model and the director primacy model. Both of those offshoots of the

\textsuperscript{174}Bainbridge Cornell at 860.
contractarian approach accept shareholder wealth maximization as the
determining factor in designing default rules to govern the corporate enterprise,
but they differ in the appropriate allocation of power between shareholders and
Corporate Directors.

With the government being a controlling, immune shareholder, two distinct
consequences complicate the description. First, government can change the rules
of the game. Not only that, it can change them after the other parties forming the
nexus of contracts have made their bargains. So, looking at the problem from
one direction, globally speaking, though the other parties are free to contract
around, the lack of predictability limits contractual freedom and increases
transaction costs. Further, the government’s immunity means that, as a
participant in the process, it is immune from the rules, default or otherwise.
Therefore the use of hypothetical bargains becomes an uneasy exercise in
examining the government as shareholder, as all of the participants to the bargain
but one enjoy immunity from rules enforcing those bargains, and the immune
party also has the ability to change those rules and has discretion in how it
enforces them.\textsuperscript{176}

The contractarian approach also takes the view that the welfare of constituencies
like labor or the community can be more efficiently seen to through government
welfare regulation, without altering corporate profit maximization goals.\textsuperscript{177} But
this view is warped by the presence of a controlling government shareholder.
Evidence suggests that the conflicts a government collectively face on regulating
entities they own are resolved in favor of preferential treatment for the
government owned firm.\textsuperscript{178} Thus, welfare regulation is no longer a reliable
backstop to any negative externalities from the subset of corporate action that
may maximize firm profits but result in a net decrease in social wealth. This
regulatory preferential treatment also has the effect of harming the competitive
position of non-government owned firms.

\textsuperscript{176} To offer an example of how the government changes the rules, consider the response
to AIG’s payment of pre-arranged bonuses. See
\url{http://www.cnn.com/2009/POLITICS/03/16/AIG.bonuses/index.html}
\textsuperscript{177} Bainbridge Cornell at 877
\textsuperscript{178} Fannie and Freddie also demonstrate the governments give preferential regulatory
treatment to private corporations in which they have effective control. For a substantial
period of time, Fannie and Freddie were exempt from securities regulation for their
publicly traded equity or debt. It was only in 2002 that they were finally required to
register, just prior to the revelation of accounting scandals that ultimately limited their
ability to comply with those registration requirements. Peter J. Wallison, The Fannie
Freddie Time Bomb, The International Economy, October 1, 2002, at page 1. Wallison
has also showed that Fannie and Freddie were not effectively policed for antitrust
violations owing to their favored status by the Executive branch. Peter J. Wallison,
Applying the Microsoft Decision to Fannie Mae and Freddie Mac, AEI White paper,
available at \url{www.aei.org}. A legislative provision was also inserted into Fannie and
Freddie’s charter to prevent shareholder lawsuits in the event of a government takeover.
Holman W Jenkins, Rethinking the Fannie and Freddie Takeover, Wall Street Journal,
March 4, 2009, A13. Six weeks before their takeover their chief regulator, James
Lockhart, declared them both adequately capitalized. Holman W Jenkins, Rethinking the
C. Shareholder Primacy Theory

Shareholder primacy includes two bedrock principles: That maximization of long term shareholder value is the only legitimate objective of the corporation, and that designing ways to assist shareholders in exerting control through their powers, including the power to vote at annual meetings will minimize the agency costs that result from the separation of ownership from control in publicly traded and diffusely held corporations. It is a direct outgrowth of the principal/agent model.

Absent incentives for proper accountability to shareholders, shareholder primacy scholars urge that management will be tempted to excessively reward their efforts, engage in inappropriate levels of risk, self-deal, reject efficient offers for control of the company, and over-invest the resources of the firm. Shareholder primacy scholars urge that creating mechanisms whereby shareholders can exercise control over the corporate policies and membership of the Board of Directors can reduce these inefficient temptations.

One of the primary objections to shareholder primacy is the argument that some special interest groups may purchase shares and use their equity powers to vote in directors, or advance policies, that harm the interests of most shareholders in long term price appreciation. Bebchuk defends shareholder primacy by observing that changes to corporate policy or elections of new directors will require approval of a majority of the shareholders. Bebchuk further argues that, since most companies are majority owned by groups of financial institutions who tend to support management and focus on share value, the special interest objection is unwarranted.

In this context, however, the majority vote limitation is no longer present. The government would be a controlling, and particularly powerful, equity holder for many of the companies participating in TARP. Even if the government did not own a majority of outstanding shares, it would be able to carry a majority of votes in corporate elections with as low as 20% ownership stakes, owing to the low voting rates of retail investors and portfolio diversification requirements for pensions and mutual funds. Thus if the government’s motives in exercising its control rights are suspect, then the majority buffer present in most shareholder

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179 See generally Lucian Bebchuk, The Case for Increasing Shareholder Power, infra.
185 See Roe infra
voting contests will no longer be present to protect the other shareholders from this problem.

Deciding whether or not to accept an acquisition offer for the corporation is particularly prone to conflicts of interest for corporate managers. Acquirers typically are able to offer a premium to the shareholders for the company because they intend to run the company more efficiently. This may mean replacing the company’s management, altering its compensation structure, laying off workers or closing factories. Under the shareholder primacy norm, if the premium offered for the company’s shares is more than the underlying value of the company in the market, then a Board objective of maximizing shareholder wealth may require acceptance of the offer. Concerned with the prospect of losing their position, however, management may block the offer. Shareholder primacists therefore argue that management should be required to put the question to a shareholder referendum.

And yet the government has an interest in limiting acquisition activity that mirrors the joint interest of labor and management. Mark Roe has examined how the securities laws evolved as a result of an interest group alliance between labor and management to limit the ability of financial intermediaries to advance interests of shareholder wealth maximization. Government institutions were the source of these laws and an ally of the interest groups that supported them. If the government responds to interest group pressure even through the buffer of independent agency rulemaking, it would be even easier for it to advance that objective through decisions on voting its TARP shares, which are subject to the discretion of the Treasury Secretary.

In addition to the effects of actual acquisitions on shareholder value, the prospect of a takeover has disciplining effects on managerial decisionmaking. There is substantial evidence that antitakeover protections result in both managerial shirking (failure to properly management the business) and greater managerial self-dealing. Thus if management feels that Treasury is unlikely to vote in favor of tender offers for the bank, it will be less likely to maximize returns on the bank’s shares.

Bebchuk’s view therefore does not consider the notion that the shareholder electorate would include a control shareholder with significant immunity not

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186 See Bebchuk, infra, generally.
187 See Bebchuk, infra, generally.
188 See Bebchuk, infra, generally.
189 See Bebchuk, infra, generally.
192 See Roe infra.
shared by the other shareholders, because that was not the circumstance at the
time shareholder primacy developed. For purposes any TARP company in
which the government is a control shareholder, therefore, that analysis would no
longer be applicable.

D. Director Primacy Theory

Bainbridge serves as the leading proponent of the director primacy view, which
shares with shareholder primacy the view that the maximization of shareholder
wealth is the appropriate duty of directors. It modifies the shareholder primacy
view, however, by arguing that resting authority over corporate decisions with a
self-sustaining board of directors is the best way to accomplish that objective.
To the extent that director primacy stands opposed to shareholder power, it is a
fairly easy fit to find opposed to resting control power in a government
shareholder’s hands.

One of the central justifications for the exercise of director discretion is that
directors will be held accountable for maximizing shareholder wealth by private
litigants state corporate law. If Treasury places government nominees onto the
boards of banks, those nominees will arguably be protected by government
immunity from private suit, as they are serving in an official capacity. Director
primacy also seems to argue in favor of director discretion for non-controlled
corporations, particularly since controlled corporations are a rare case among
large publicly traded companies. Therefore discretion for board decisions of
banks controlled by government shareholders doesn’t fit within the efficiency
justifications offered for director primacy.

195 For that matter, neither does the team production model. See note infra. Some other
commentators have expressed concern that the federal government as an investor would
invest without concern for maximizing the value of its securities in different contexts,
including questions of privatizing social security. See Benjamin A. Templin, The Public
that politicians would assert political pressure on the managers of the Social Security
Trust Fund to forgo investments based on the potential return and make decisions based
on criteria that would “achieve other economic, social, or political purposes.” U.S. Gov't
Investing for the Trust Fund, the Federal Budget, and the Economy 3 (1998), available at
Security emphasized in a 2001 report that “Government must not invest Social Security
funds in the stock market.” See President's Comm'n to Strengthen Soc. Sec.,
Strengthening Social Security and Creating Personal Wealth for All Americans 13
more detailed discussion of social investments, see infra notes 364-420 and
accompanying text.”

196 Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate
Governance, 97 Nw. U. L. REV. 547 (2003), also available at

197 Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate
Governance, 97 Nw. U. L. REV. 547 (2003), also available at
And yet, at the same time, director primacy becomes confusing in this area. Where the directors for whom director primacy gives support are selected, directly or indirectly, at the behest of the government shareholder, it becomes a difficult task to parse out how the theory fits the present dynamic.

E. Team Production Theory

Blair and Stout’s team production model serves to justify the discretion that state corporate law vests with the board of directors. The model explains that the members of the team vital to the economic production of the firm join together and submit to the will of a mediating hierarch, the board of directors, who balances the interests of the various groups. It relies on contractarian thinking, but abandons notions of shareholder primacy. Team Production is a stakeholder-focused theory partly aligned with the progressive corporate law view, partly with director primacy, but is coterminous with neither. It also stands opposed to the shareholder primacy view. In part the team production theory rests on the institution of corporate law as a backstop for limitations in the ability of corporate constituencies to contract with each other.

Thus the constituencies opt into their “mediating hierarchy” of the board of directors. Federal sovereign immunity from corporate laws complicates this situation when the federal government becomes a control shareholder. Control shareholders would otherwise have fiduciary duties to the corporation just like directors, but since the Treasury is the control shareholder it escapes this duty. This nullifies the status of the mediating hierarch as a creature bound by corporate law, and makes the hierarch the servant of the control shareholder, who itself is not bound by corporate law.

This model is complicated by the fact that the mediating hierarch in the case of a government-controlled company can become captured by the government. This will result in the hierarch favoring certain groups based on those groups’ ability to influence the political process rather than on the economic contributions those groups make to the collective enterprise. Stout and Blair observe that horizontal relationships between the various parties contributing to production may be at least as important to productive activities as vertical relationships.

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201 Government ownership of banks is most prevalent in poor countries that have poorly defined property rights and underdeveloped financial systems. Greater government ownership of banks within a country is also associated with heavier regulation, greater price controls and higher black market exchange rates. It is also correlated with lower tax compliance, higher corruption index numbers, and lower productivity. See Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, Government Ownership of Banks, The Journal of Finance, Volume LVII, February 2002, available at http://ssrn.com/abstract=236434,
within the firm. But in the government controlled case, that relationship is moved outside the firm and becomes an exercise in political rather than economic rents. The team production model relies in part on a corollary observation by Zingales and Rajan that members of an economic team suffering from coordination problems can give control rights to a third party who can control the team’s assets and reward the team members, in return for which the outsider is rewarded with a share of the team’s profits which then gives the outsider an incentive to choose an efficient and productive team. A later section of this article explores how the incentives of the controlling hierarch in this case will shift from efficiency toward extraction of political rents. Indeed, Stout and Blair compare outside governmental oversight to internal hierarchs and find that internal hierarchs are more efficient monitors of the firm because those internal decisions are made by individuals with greater knowledge, as internal mediation has significant advantages over external mediation since in conflicts with repeat players the internal player will have more institutional knowledge of the individuals involved.

Stout and Blair argue that the fact that public corporation law insulates directors from control by any one group means that they are able to serve the interests of the entire corporate team contributing to the economic growth of the organization. In the government controlled case, however, not only is the government able to rest control from the board, even worse...its concern for maximizing the value of the enterprise is clouded by its interest in serving political ends. Put another way, the members of the team most able to exert political pressure on the government will be able, through the governments holdings, to capture the board of directors.

The consequences of on corporate constituency capturing the board are noted by Blair and Stout, the constituency will use its power over the board to seek opportunistic rents from other members of the productive team thus discouraging team specific investments. In reference to a contested shareholder election in which all corporate constituencies have a voice, Blair and Stout ask that we “imagine the chaos likely to attend an election in which a firm’s creditors, executives, rank and file employees, and other stakeholders with unique and often conflicting interests could vote on their favorite candidates.”

203 See section, supra, on interest group theory of government ownership for a discussion on how that rent extraction would occur.
208 See Margaret M. Blair and Lynn A. Stout, A Team Production Theory of Corporate Law, 85 VA. L. REV. 247, 313 (1999).
through a corporate election it will occur within the political process of interest
group pressure on the executive branch.

F. Progressive Corporate Law Theory

Progressive corporate law, also part of the corporate social responsibility
movement, defines the duty of directors and officers as to society at large, rather
than to specific shareholder wealth maximization. Reich analyses one of the
problems of requiring corporations to fulfill public interest functions and serve as
a nexus for transfer payments that would otherwise fit within the federal
government’s bailiwick. Employer sponsored healthcare is government
subsidized through the tax code, and corporate social responsibility advocates
fight for more expansive coverage. But Reich argues that the distortionary
effects on the labor market from employer sponsored healthcare make it an
inefficient system.\textsuperscript{209} Reich also argues that corporate social responsibility serves
as a smokescreen by legislators to evade their responsibilities.\textsuperscript{210} Balancing the
interests of so many divergent groups clouds the metric of success, which
increases transaction costs for all concerned. Directors are able to play a bait and
switch game with financial accountability: when earnings are down, directors can
blame their investments in socially responsible goals, yet can escape
inconvenient social goals by pointing to their need to raise their earnings to
obtain future capital to fund even more significant socially responsible
commitments. As Bainbridge points out, “directors who are responsible to
everyone are accountable to no one.”\textsuperscript{211}

The executive agency overseeing its investment can subvert public transparency
of its public role.\textsuperscript{212} The internal corporate policies of a private bank are not

\begin{footnotesize}
\begin{enumerate}
  \item \textsuperscript{211} Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 Nw. U. L. Rev. 547 (2003), also available at http://ssrn.com/abstract=300860, at 42.
  \item \textsuperscript{212} One critical theory of state ownership, distinct from the interest group theory explored
in the article but also informative, is concerned with managerial incentives. One aspect
of the managerial view, from Vickers and Yarrow, is that states have a difficult time
monitoring managerial competence compared to other market players. Alexander
Muravyev, Federal State Shareholdings in Russian Companies: Origin, Forms and
Consequences For Enterprise Performance, Bank of Finland Institute for Economies in
governments may have an interest in keeping their definition of public interest goals
vague when governing the firm managers that they oversee. See David A. Skeel, Virtual
Privatization: Governance Reforms For Government-Owned Firms, J. CORP. L. STUD. (2002), at 22. Even putting aside the fact that such objectives may not lend themselves to
clear statement, government shareholders may not want to lose political flexibility by
binding to specific outcomes and they may want to avoid binding to specific deliverables
to avoid criticism for failing to meet those goals after the fact. See David A. Skeel,
\end{enumerate}
\end{footnotesize}
subject to FOIA. We have already seen some significant problems with transparency of the Government’s TARP oversight in a recent Oversight Panel report.

Progressive corporate law, also termed corporate social responsibility, takes issue with the very premise of the contractarian model altogether. Bainbridge notes that one of Bratton’s arguments against the contractarian model is that the hypothetical bargains on which the theory relies may not have any one single equilibrium outcome, but face potentially multiple equilibria.\textsuperscript{213} Bratton’s alternative requires judges to use flexible default rules that would examine fiduciarys’ decisions ex post with reference to the intuitive fairness of director decisions.\textsuperscript{214}

Some progressive scholars also urge the necessity of communitarian values in setting up legal regimes.\textsuperscript{215} Bratton’s iteration of progressive corporate law, and his critique of the contractarian model, focuses on the fact that the contractarians ignore the importance of trust and honor as abiding norms in governed relations between parties, which he terms a meditative approach.\textsuperscript{216} He rejects a formalistic approach that would mandate conformity to any one theory of the corporation, in the way that the contractarians do.\textsuperscript{217} Instead, he considers that a meditative legal decisionmaker, whether a judge or a regulator, would be able to conform corporate law to the shifting cultural and social norms of the time.\textsuperscript{218} One of the bones of contention between contractarians and progressives is that the contractarian approach considers only the result of hypothetical bargains without considering the events that actually led to that bargain.\textsuperscript{219} Yet in this context of a control government shareholder with immunity, the debate between whether there has been a bargain or not becomes somewhat irrelevant. There is no bargain, one shareholder has control, is immune from suit by the other shareholders, and any shareholder that does not have sufficient interest group energy to lobby for subsidies from the government is shut out of the bargain. One of the challenges to government ownership is that government sets the rules that typically govern the disclosure of information between the company and its constituent groups. Governments habitually lift regulatory requirements for government owned firms, thus accountability for running the firm becomes difficult no matter what normative theory of corporate law governs its affairs. This also places non-governmental firms in a difficult position, as they are not privy to these same regulatory preferences. So even supposing that some readily identifiable metric for progressive objectives were available, it becomes

\textsuperscript{213} Bainbridge Cornell at 866.
\textsuperscript{214} Bainbridge Cornell at 867.
\textsuperscript{215} Bainbridge Cornell at 874. Yet, the inherent conflict faced by government as a shareholder would undermine this objective. The Treasury and Federal Reserve’s actions in the JP Morgan/Bear Stearns and Bank of America/Merrill crisis evidence those conflicts.
\textsuperscript{216} Bratton, The Economic Structure of the Post Contractual Corporation, 87 Nw. U. L. Rev. 180, 213 (.1992)
\textsuperscript{217} Bratton NWU at 214.
\textsuperscript{218} Id.
\textsuperscript{219} Bainbridge Cornell at 865.
questionable whether constituents of the corporation can actually trust disclosure of those metrics.

Stakeholder proponents also argue that firms are more productive when stakeholders have greater voice in corporate policy.220 There is some significant debate over this question in the literature.221 If it is true that firms with greater employee and stakeholder participation are more productive, the evidence does not suggest that the presence of a government shareholder enhances productivity in this way. In fact, it suggests that government ownership in industry, particularly banks, correlates with decreases in bank health, GDP growth, and access to credit. Interestingly, many noted progressive corporate law scholars reject nationalization of firms directly.222

VIII. Implications for Corporate and Securities Practice

A. TARP Recipients Treated as Affiliates under Securities Laws

If Treasury is a control shareholder in the companies participating in TARP, including the nation’s 8 largest banks, 200 more banks, Chrysler, GM, and AIG, it may result in each of those companies being considered affiliates of each other as part of a controlled group.223 This would then mean that any member of the group who sold securities held in any other member of the group may be required to abide by the strictures of Rule 144 in those transactions to avoid additional and burdensome prospectus and registration requirements.

It may be the case that many, or possibly all, of the companies that have given the federal government shares in exchange for TARP many are considered affiliates of each other. This has enormous implications for their ability to sell shares. Imagine if, every time Goldman Sachs wanted to sell shares from its proprietary trading operation in AIG, Citigroup, GM, or any of the other controlled TARP companies, many of whom are publicly traded and many of

221 See Bainbridge Cornell at FN 97 and 98, citing U.S. Dep't of Labor, High Performance Work Practices and Firm Performance 5-9 (1993), Thomas A. Kochan et al., The Transformation of American Industrial Relations 153-77 (2d ed. 1994) (summarizing case studies showing generally positive but variable results). But see Arnold E. Perl, Employee Involvement Groups: The Outcry over the NLRB's Electromation Decision, 44 Lab. L.J. 195, 204-06 (1993) (summarizing studies finding positive economic effects of those programs), Raymond L. Hogler & Guilleremo J. Grenier, Employee Participation and Labor Law in the American Workplace 103 (1992) (finding that “despite acclaim for the improved productivity achieved through employee participation and ‘Quality Circles,’ the evidence to support the proposition is not altogether convincing, particularly in nonunion workplaces”); David I. Levine, Public Policy Implications of Imperfections in the Market for Worker Participation, 13 Econ. & Indus. Democracy 183, 185 (1992) (noting that most employee involvement plans are unsuccessful, but claiming that those few following Levine's criteria succeed).
222 Bainbridge Cornell at 889.
223 See Securities Act, Section 2(a)(11). See also Regulation C, Rule 405 (Definition of “Control”.)
whom issue restricted securities through various exemption, Citigroup had to register that sale as a public offering, deliver a prospectus, and be subject to Section 11 liability for that registration.

A registration statement must be in effect for the sale of a security. Transactions by any person other than an issuer, underwriter, or dealer are exempt. An underwriter is defined as any person who has purchased from an issuer and any person controlling or controlled by the issuer. Rule 144 offers a safe harbor to being deemed an underwriter. TARP companies sharing the Treasury Department as a control shareholder risk their ability to make use of Rule 144 in their sales of securities of other firms that have given Treasury securities.

Any person who sells securities for the account of an affiliate that person may be constrained in their ability to sell securities of the affiliate under Rule 144. An affiliate is defined as a person who controls, is controlled by, or is under common control with the person with whom he or she is affiliated. This definition captures the same concept that is used in the definition of control person under Rule 405(c). Rule 405 defines control as the ability to influence, directly or indirectly, management decisions.

In light of the SEC’s interest in working with the Treasury Department in dealing with the financial crisis, combined with what has been describes as the SEC’s fight for its survival in the ongoing financial regulatory reworking, once this issue arises it would seem likely the Commission might be spurred to alter Rule 144 to ensure that this problem is avoided. However, the SEC does not have the explicit authority under the Exchange Act to set the parameters of the Section 4(1) and 4(2) exemptions. Hazen observes that Rule 144 is merely the SEC’s interpretation of a statute, and not an actual exemptive rule. Thus the SEC’s ability to alter exemptions in this area, and indeed Rule 144 itself, to protect trading by TARP affiliates does not have the same significance as an exemption given express statutory authorization. The SEC can also choose not to enforce registration and prospectus delivery requirements under this rule, but private plaintiffs have an express private right of action here that the SEC does not affect.

B. Insider Trading

224 Securities Act of 1933, Section 5.
225 Securities Act of 1933, Section 4.
226 Securities Act of 1933, Section 2(a)(11).
227 This is vital, because the exemption found under Section 4(1) exempts a sale from the general registration requirement found in Section 5 of the Securities Act only where an underwriter is not present.
228 Hazen at 381, citing 17 C.F.R. §230.501(b) and §230.501(b).
229 Hazen at 381, citing 17 C.F.R. §230.405.
230 Hazen at 452, citing 17 CFR §230.405(f).
231 Hazen at 452.
232 Although Hazen also notes that the SEC has general exemptive authority, see Hazen at 452, footnote 30, but Rule 144 was adopted prior to Congress’s grant of general exemptive authority to the SEC.
Trading based on inside information is also a violation of Rule 10b-5 of the federal securities laws. And yet, Section 3 (c) of the Exchange Act effectuates an exemption for the U.S. Government from, among other things, insider trading laws.\textsuperscript{233} The Treasury would nevertheless cause tremendous damage to the financial markets if it were to trade its TARP preferred shares using the voluminous inside information it possesses through its regulatory and market interactions with the banks participating in TARP. This discussion is not focused on issues of fairness in insider trading rules.\textsuperscript{234} Rather, as the debate has been more focused on the efficiency of insider trading,\textsuperscript{235} it will examine the efficiency of insider trading by the Department of the Treasury under the unique circumstances of TARP ownership.

Though they also frequently can access inside information from companies’ interaction with state regulators, state pension funds are not immune from insider trading liability. The Alabama State Pension Fund recently had to pay nearly a million dollars to the Liberty Group to settle a claim that they traded in the knowledge that Liberty was soon to receive a favorable licensing decision from another Alabama State Agency.\textsuperscript{236}

In Henry Manne’s seminal text on insider trading, he argues that insider trading does not harm long term investors, that it can serve as a useful compensation tool for executives, and that it contributes to the efficiency of stock market pricing.\textsuperscript{237} In his book, Manne considers the prospect of inside trading by government officials for their personal accounts, and he is critical of the practice. In his book, Manne notes that government officials can, by virtue of their positions, obtain access to valuable information.\textsuperscript{238} Manne notes that they have advance information about corporate mergers, government contract approval, and regulatory product approval. He also observes that executive officials may keep members of Congress informed about valuable information contained inside the government for the purposes of obtaining political favor, and that executives may do the same.\textsuperscript{239}

\textsuperscript{233} See Exchange Act Section 3(c).
\textsuperscript{234} Schotland, Unsafe at Any Price: A Reply to Manne, 53 VA. L Rev. 1425 (1967)
\textsuperscript{236} Available at http://www.cfo.com/article.cfm/10855944/c_10852358?f=TodayInFinance_Inside.
\textsuperscript{238} Henry Manne, Insider Trading and the Stock Market, at 171-180.
\textsuperscript{239} Manne at 179-184.
He notes that one danger of trading by government officials is that they will change their regulatory approvals or their government contract selection process merely to affect their trades. The same principle could apply to when Treasury owns shares as an institution, and is supported by evidence that government’s tend to give regulatory preferential treatment to companies in which they own an interest.

Manne notes that insider trading by government officials may also result in a net transfer of wealth from the market to government officials, implicating concerns about market efficiency in a way that typical insider trading does not. One counter to this argument may be that in the case of TARP companies, the use of insider information in trading ultimately benefits the taxpayer, and thus such a transfer is justified to help cover the cost of the taxpayer funded bailout. However, the dangers that the implicit discount the shares will experience during the time the company’s health is under stress, and the accordant risk that it may obtain further bailout money as a result, may mitigate this justification.

Some of those arguments would also apply to trades by government officials on behalf of the U.S. Government, but few inside trading scholars could have foreseen that the government would take equity positions in much of the automobile and financial sectors. As such, this section will consider the inside trading efficiency debate in light of that unique circumstance. While recognizing the depth and important of scholarship challenging the logic of insider trading laws, and not taking issue with the observations of those scholars in the standard case, this section will seek to counter use of those arguments to support insider trading by the government in its positions acquired through TARP. This situation involves some of Manne’s original concerns about insider trading, but also encompasses a broader universe. Treasury or the Fed can obtain information both as government regulator, and also as control shareholder in these companies. The second avenue of information is a novel concern.

One of the global observations this section will make is that any efficiencies that flow from insider trading by Treasury would occur after its exit trade, and any costs would mostly be evidenced by a discount in the value of TARP shares prior to its exit trade—a time which also happens to coincide with the time during which the health of the TARP company in jeopardy.

One fundamental difference distinguishing the analysis for Treasury as a shareholder is that the benefits of insider trading are measured with the assumption that insiders will be able to engage in continuous trading. But the cost benefit analysis in this situation will be distinctly different, as Treasury only has limited authority to repurchase shares after it sells out its position. So this situation would likely involve one large exit trade, or perhaps a series of large exit trades by the government. Treasury’s decision to exit would also likely correlate with a determination that the financial crisis is over, as that is Treasury’s mandate under the EESA. So the time period that Treasury still feels the financial crisis warrants its continuing to hold shares is also the time period

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240 Manne at 178.
241 Manne at 183-184.
over which the prospect of Treasury’s inside trading looms. Also, the fact that TARP insider trading will involve one or a limited number of discrete trades, after which it will not be permitted, and during which time other entities are prohibited from insider trading, will mean that any efficiencies enjoyed from that practice will be limited.

One of the prerequisites Manne observes is that in order for insider trading to be efficient the trades should be made anonymously, which would not be true for the Treasury’s trades.242 He also observes that insider trading would not harm long term investors, but admits that it may have mixed effects on short term trading.243 While long term bias in securities markets may reduce volatility, and make costs to short term trading less of a concern, this situation is unique. Shares in TARP firms were purchase under the bailout specifically with the assumption that the banks and other companies involved may be insolvent in the short term, and so the time horizon for both short term and long term investors may be the same. Further, for banks specifically, share price has now become an explicit element in the capital adequacy ratios used by the Treasury, the FDIC, and the Federal Reserve to measure bank health and institute corrective action. So during the period over which Treasury holds its shares, any discount flowing from the prospect of insider trading by Treasury would translate into regulatory penalties as well.

Arguments about using insider trading as a device to compensate executives244 wouldn’t be relevant in this context, as Treasury does not offer performance based compensation to its employees, and the Trust created by the Federal Reserve to manage its ownership in AIG also does not offer performance based compensation to the trustees. As Manne notes, the arguments about using corporate insider trading as a compensation device do not apply in the context of government officials.245

Another issue with Treasury as inside trader is that it has a much larger position in TARP firms than most companies. For instance, in Citigroup it holds a 34% position. Treasury will trade in large blocks, making the effect on liquidity much more pronounced. This will be true whether Treasury sells its shares into the general market or back to the company. Either way, it will affect either the short term liquidity of the company in its ability to meet short term obligation, or it will have a more significant impact on the liquidity of the market. Since Treasury will not be able to keep its sales from becoming public knowledge, the effect may be more pronounced than much smaller inside trades occurring continuously over a longer period of time.

Demsetz observes that insider trading may perform a useful function of compensating controlling shareholders for the positive externality of their

242 Manne at 168.
243 Manne at 169.
244 See Manne at 172-173.
245 Manne, Insider Trading and the Stock Market, at 182.
monitoring in minimizing agency costs for other shareholders.\textsuperscript{246} At first blush this seems a relevant benefit, as the paper argues that Treasury is a control shareholder in many of the firms obtaining money from TARP. But the government’s interest in using the corporation to transfer wealth to interest groups, analysed in this article, would introduce agency costs of its own.\textsuperscript{247}

Manne also offers an argument that the predictive power of insider trading makes markets more efficient, relying in part on foundational principles from Hayek concerning the efficiency of the price system in promoting the flow of information.\textsuperscript{248} Two challenges will limit the phenomenon in Treasury’s case. First, and most importantly, Treasury officials are not playing with their own money and do not enjoy compensation from the trades. The career benefits they enjoy from the insider trading are likely to be significantly bounded, as for instance getting high praise for breaking even on TARP but experiencing diminishing marginal returns TARP gains beyond that hurdle. Further, the career choices of Treasury officials, protect through civil service restrictions and limited in performance compensation, are likely to reflect a general tendency toward more pronounced risk aversion than for most other inside traders.

One of the counterarguments that Manne raises to the idea that insider trading may subject the stock market to manipulation is that informed traders, or as he calls them “countermanipulators,” would be able to counterbalance the affect of manipulators. While this may hold in the general case, Treasury is a much larger control shareholder than most other insider traders as was previously explored. Thus Treasury’s insider trades may be expected to strain the budget constraints of the counter-manipulating traders.

One argument Carlton and Fischel raise against insider trading laws is that, if companies permitting insider trading were engaging in activity that was harmful to other shareholders, then its shares would trade at a discount in comparison to other companies.\textsuperscript{249} In this case, I do argue that shares in TARP firms will trade at a discount due to the prospect of insider trading by the government, but a couple of things about this situation are distinct from the hypothetical bargain raised by Carlton and Fischel. First, the insider trading is done by a controlling shareholder, in a market in which insider trading by all other shareholders is prohibited. So the control shareholder would have no incentive to change the rules if it thought its profits to insider trading were greater than the general discount under which the shares trade. Second, this control shareholder purchased shares during an economic recession as part of a bailout. Third, this shareholder also has an interest in causing the underlying firm to engage in non-profit maximizing activities that subsidize interest groups. As such, the government may be able to recoup some of the losses in the value of its shares

\textsuperscript{246} Harold Demsetz, Corporate Control, Insider Trading and Rates of Return, 76 Am. Econ. Rev. 313 (1986).
\textsuperscript{247} See section on political interest groups politics of government ownership, supra.
\textsuperscript{248} Manne at 181-183. Further, as previously mentioned, Treasury’s interest in insider trading would be more bounded than that of other inside traders.
flowing from the subsidizing activity specifically by insider trading. Finally, the control insider will engage in one or a small series of exit trades, after which it will exit the market for good. So the incentives of the controlling shareholder in TARP companies are distorted in a way that prevents the implicit bargain that Carlton and Fischel use to undermine the justification for more general insider trading laws.

Carlton and Fischel also note one benefit of insider trading is that it would permit continuous, rather than discrete, flows of information.\(^{250}\) This benefit would not apply in this situation, again because Treasury’s exit trades would be a one-time event. Carlton and Fischel also urge that insider trading can help deal with the problem of renegotiating agency contracts, and offer that the possibility of insider trading allows for more efficient effective renegotiation of executive compensation, incentivizing managers to continue to develop and acquire appropriate investment opportunities.\(^{251}\) Again, this wouldn’t work for agency bureaucrats, as their rewards for trading will be more attenuated and bounded. Further, remembers any efficiencies that result will be from one discrete trade. Also, Carlton and Fischel also note that executives attracted to insider trading as compensation would likely be those who are least risk averse.\(^{252}\) As noted previously, bureaucrats as a group are likely to be more risk averse, having chosen a profession with lower risk and rewards than the private sector executives in whose companies their department owns shares.

C. State Corporate Law

A focus on Delaware is appropriate, as many TARP participants, including Citigroup, are incorporated in Delaware.\(^{253}\) Treasury certainly also has the option to bring an action in Delaware to pursue its state law shareholder rights. Shareholders are granted certain rights by the corporate laws of a company’s state of incorporation. 60% of the Fortune 500 have chose Delaware as their state of incorporation. Under Delaware law, shareholders have the right to sue the directors of a company for violations of their fiduciary duties as directors. They also have the right to seek an injunction of corporate mergers, seek appraisal of the value of their shares in certain instances, and seek inspection of the books and records of a corporation. These litigation rights will also need to be considered very carefully by the Treasury, and much of the analysis concerning participation in federal securities class actions will also apply to Treasury’s exercise of its state law shareholder rights.

Treasury has previously shown a disregard for the consequences of state corporate law in its conduct of the bailout. Davidoff and Zaring observe that deal protection devices included in the JP Morgan/Bear Stearns merger facilitated by the Treasury included deal protection devices and force-the-vote provisions that

\(^{250}\) Carlton and Fischel at 868.
\(^{251}\) Carlton and Fischel at 870.
\(^{252}\) Carlton and Fischel at 871.
\(^{253}\) Exchange Agreement at 6, 12.
likely ran afoul of *Paramount v. QVC, Blasius* and *Unocal*. Kahan and Rock observe that Delaware’s review of the deal, in which Vice Chancellor Parsons declined to review the underlying deal, represented a strategic decision by the Delaware courts not to allow corporate law to interfere in the government’s execution of the bailout.

Under state corporate law, shareholders that are deemed to be in control of the corporation have a fiduciary duty to other shareholders in the corporation. This means that when they use their influence over the company to cause changes in corporate policy that harm the other shareholders in the corporation, the control shareholders become liable to the other shareholders.

The fact that Treasury is not constrained by control person liability means that it is not constrained by law the way that the other shareholders, directors, and officers are. Regardless of what reforms should be instituted into legal regimes, introducing a new player into an existing structure with power to trump the other players with its sovereign immunity from the rules of the game will cause enormous damages to the economic relations between the various players. It would be like a group of people playing monopoly when one of the players has the right to ignore the rules of the game. The other players will either refuse to play, or turn to lobbying the one player for residual profits rather than playing the game by its rules.

Treasury’s immunity may also support immunity for directors it supports, but only if they are deemed government officials. Veasey outlines some iterations of constituency directors: directors designated by creditors, venture capitalists, labor unions, controlling stockholders, preferred shareholders, and other special shareholder voting arrangements. Veasey observes that “bet the company” scenarios, where the continued existence or a substantial percentage of the assets of a company are at stake, will be particularly prone to conflict between the interests of the corporation and the interests of the shareholders.

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255 Kahan, Marcel and Rock, Edward B., How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware and the Strategic Use of Comity(August 11, 2008). U of Penn, Inst for Law & Econ Research Paper No. 08-17; NYU Law and Economics Research Paper No. 08-40. Available at SSRN: http://ssrn.com/abstract=1254648. If true, that might give Treasury an advantage in litigation in Delaware. Then again, once the national financial crisis cools down it may limit any incentive in favor of comity. Also, the Delaware Court of Chancery’s decision in the *Merrill Lynch* case suggests that Delaware is not unwilling to apply standard principles of corporate law in adjudicating shareholder rights despite a firm’s presence in the center of the financial crisis.


If the government merely uses its implicit leverage as control shareholder, and as guarantor, to encourage the board to take action, those directors will still be subject to fiduciary duty review. This means that private litigants would be able to enjoin director action that violated their fiduciary duty even though they are unable to enjoin Treasury directly because of the EESA. One factor which may also protect constituency directors in this context would be if they constitute a minority of the board of directors, and therefore escape liability where the majority of directors in a transaction are disinterested. Although, the existence of a control shareholder may result in a problem for the individual directors status as disinterested, even though the government remains immune from liability. If the constituency director shares information with the represented constituent it may also run into liability for violation of its fiduciary duty.

One important consequence of being a controlling shareholder is that a controlling or dominating shareholder standing on both sides of a transaction, as in a parent-subsidiary context, bears the burden of proving its entire fairness. With respect to the standard of review for cash out mergers by a control shareholder, Kahn v. Lynch provides that “the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness. The initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction. Id. However, an approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff.”

The independence of special committees that are charged with negotiating interested transactions, who are intended to avoid the defendant being faced with the onerous burden of entire fairness, can become more difficult to establish by virtue of the presence of a control shareholder. The Delaware Court has held that “unless the controlling or dominating shareholder can demonstrate that it has not only formed an independent committee but also replicated a process “as though each of the contending parties had in fact exerted its bargaining power at arm’s length,” the burden of proving entire fairness will not shift.”


262 Weinberger v. UOP, Inc., 457 A.2d at 709-10 n. 7. The Court has also held that “The potential for coercion and unfairness posed by controlling stockholders who seek to acquire the balance of the company's shares by acquisition requires some equitable reinforcement, in order to give proper effect to the concerns undergirding Lynch. In order
sovereign immunity, the Treasury can escape damages awards for violations of its fiduciary duty to shareholders. However, Delaware Courts can still use its equity power to set aside or enjoin transactions which result from violations of the controlling shareholder’s fiduciary duty.

Consider, for instance, that consolidation through merger is a frequent method by which banks grow. What is more, when banks are on the verge of liquidation, the Comptroller, the FDIC and the Fed tend to try to facilitate a merger or acquisition of the troubled bank to avoid exposing the FDIC to substantial drawdowns. Indeed, an acquisition is often considered preferable to a resolution because the response from counterparties and depositors to a merger rather than a liquidation is better for the overall health of the troubled bank. A case in point is the situation in which Bank of America seems to have been pressured to follow through with its acquisition of investment bank Merrill Lynch. 263

The effect of federal sovereign immunity would depend on the effect it would have on Chancery’s exercise of its judicial powers. Despite the fact that the federal government is immune, the corporation itself is not, and therefore theoretically the Court of Chancery could still enjoin transactions even if it could not hold the control shareholder liable for doing them. If the government control shareholder is able to evade participation in the suit, they could simply ignore subpoenas for information.

D. Shareholder Voting

One of the basic rights afforded to shareholders is the right to vote in elections for the Board of Directors. That right establishes the basis for the balance of power between shareholders and the management of the company. Pursuant to the purchase agreements and changes to TARP participants’ charters, the preferred shares purchased through the capital purchase program are non-voting shares. 264 However, the Treasury retains significant leverage to affect Board decisions for firms participating in TARP.

to address the prisoner's dilemma problem, our law should consider an acquisition tender offer by a controlling stockholder non-coercive only when: 1) it is subject to a non-waivable majority of the minority tender condition; 2) the controlling stockholder promises to consummate a prompt § 253 merger at the same price if it obtains more than 90% of the shares; and 3) the controlling stockholder has made no retributive threats.” In re Pure Resources, Inc., Shareholders Litigation 808 A.2d 421, 445 (Del.Ch.,2002). Delaware Courts have also found that “the majority stockholder owes a duty to permit the independent directors on the target board both free rein and adequate time to react to the tender offer, by (at the very least) hiring their own advisors, providing the minority with a recommendation as to the advisability of the offer, and disclosing adequate information for the minority to make an informed judgment. For their part, the independent directors have a duty to undertake these tasks in good faith and diligently, and to pursue the best interests of the minority.” In re Pure Resources, Inc., Shareholders Litigation 808 A.2d 421, 445 (Del.Ch.,2002)

263 http://republicans.oversight.house.gov/media/pdfs/20090625briefingmemo.pdf
264 See section supra, background of TARP.
One exception to the federal government’s agreement not to vote its TARP preferred shares is a provision permitting the holder of the preferred shares to nominate two “preferred directors” to the Board in the event that the participating firm falls behind on its preferred dividend payments for six successive quarters. The Treasury preferred shares also retained the right to vote on any mergers or exchange activity and on new issuance of shares. In addition, the government mandated certain corporate governance changes for firms participating in TARP. Assuming that Treasury maintains the legal authority to waive those provisions, it could offer to do so in exchange for other changes in corporate policy.

More important to this analysis is Treasury’s decision to permit TARP participants to convert their preferred stock into common voting equity. Citigroup has accepted this, and other banks might as well. Collective action constraints and rational apathy by shareholders, particularly retail investors, can leave shareholders with as little as 20-30% of voting equity with the ability to control the board. That means that Treasury may be able to control the board in most any TARP bank, particularly the nine largest banks, that convert their TARP preferred shares into common voting equity.

In 2003 and 2007, the Securities and Exchange Commission considered proposals to include shareholder nominees on the corporate ballot. (For a summary of the battle for shareholder representation on corporate boards, and the arguments on either side.265 Though it ultimately failed, the SEC is currently considering a new access proposal.266 Though the Treasury has given up voting rights in the preferred shares that it holds, that does not necessarily mean that it has given up the right to nominate prospective directors for other shareholders to vote on under a future SEC Proxy Access Rule. Treasury will certainly be able to nominate candidates in banks in which it holds common voting equity, and would not need even to hold a control stake in that circumstance.

Governments can make particularly active shareholders. For example, state comptrollers and treasurers were the most vocal advocates of shareholder proxy access when the 2003 reform proposal was under consideration.267 Karmel asserts that state run pension funds and labor unions have more willing to fight to obtain influence over the corporate ballot than mutual funds or other financial intermediaries.268

E. Securities Class Actions

Section 3(c) of the Exchange Act exempts the federal government from coverage

267 Roberta S. Karmel, Should a Duty to the Corporation be Imposed on Institutional Shareholders? 60 BUS. LAW 1, 10 (November 2004).
268 Roberta S. Karmel, Should a Duty to the Corporation be Imposed on Institutional Shareholders? 60 BUS. LAW 1, 13 (November 2004).
of the Securities Exchange Act. But most of those suits are prosecuted by private plaintiffs who have been granted an implied private right to sue that is shared with the Securities Exchange Commission. The implied private right of action under 10b-5 is a creation of judicial fiat. So even though Treasury is likely not subject to 10b-5 because of Section 3(c), it may still be able to exercise its implied private right of action.

The right to join in, and in some cases serve as lead plaintiff in, private litigation against firms covered by the federal securities laws for violations of disclosure laws, registration requirements, fraud provisions and other rules is a powerful one. According to Cornerstone Research, since 1999 roughly a hundred federal securities class actions settle every year with an aggregate value that tends to track anywhere from $1 billion to $6 billion. In some blockbuster years that amount is higher, such as in 2006 when the securities plaintiffs bar recovered $17 billion (half of which was a result of the Enron case).

Institutional Investors are the lead plaintiff in 60% of securities class actions. The other plaintiffs in the class rely on the lead plaintiff to manage the litigation on their behalf and look out for their best interests. As the largest shareholder in the financial services and automotive sectors, the Treasury may have to face the prospect of getting involved in securities class actions.

To get an idea of the potential size of this activity, the California Pension Fund (“CalPERS”) provides a useful comparison. CalPERS has roughly $250 billion in assets under management, less than half the current cost of TARP investments. In 2008 alone CalPERS recovered $925 million through serving as lead plaintiff in securities class action litigation. Given that TARP investments could increase, and that the financial services sector is more prone to litigation risk owing to its place at the center of the economic recession, Treasury participation in federal securities class actions could potentially amount to billions of dollars per year.

One relevant question that should be considered is whether Treasury would be an appropriate lead plaintiff. Is there a conflict when the government has an interest in the long-term health of the defendant? Typically lead plaintiffs do not have an incentive to help the defendant, but the federal government’s interest in

\(^{269}\) See Section on Insider Trading, Supra.
\(^{272}\) See Securities Class Action Clearinghouse.
\(^{273}\) Available at www.calpers.ca.gov.
\(^{274}\) Available at www.calpers.ca.gov.
prevention of systemic stress to the banking system may compromise Treasury’s suitability as a lead plaintiff.275

One argument against Treasury exercising its shareholder litigation rights would be that it would be a bad idea to sue banks that are already under severe stress such that they pose a systemic threat to the health of the nation’s banking system. The counter to that argument would be a new iteration of the moral hazard argument common to banking and insurance regulation: a bank may have carte blanche to violate the securities laws if it knows that its control shareholder will not penalize the bank by instituting litigation out of fear of harm to the financial system.

There are a number of mechanical issues with Treasury as a securities plaintiff. First, damages in securities class actions are measured in a number of ways, depending on the type of news that triggers the action. It could be triggered by news causing the share price to rise, in which case those that sold during the fraud period suffer harm, or it could be triggered by news that causes the share price to fall, in which case those who bought during the fraud period can sue for the harm they have suffered.276 The standard method to award damages in the event of bad news is to award the difference between the price paid by the buyer and the market price after the corrective disclosure.277

Concerns of systemic interest would argue against government participation in “bad news” securities class actions for troubled firms if the class action award itself risks the long term viability of the firm. One exception would be class actions instituted after the underlying bank has entered liquidation, in which case the effect of the class action on the bank is no longer a problem. Booth has argued that efficiency losses from shareholder class action litigation make them more trouble than they are worth. He observes a downward spiral effect, that the prospect of payout causes the stock price to fall more than it would otherwise,

Another open question is who will manage those rights? Will the DOJ or the SEC play a role? The DOJ and the SEC have expertise in securities fraud enforcement, which is a form of litigation relatively similar to private litigation, but there's a conflict here as well. Plaintiffs typically piggyback on SEC enforcement actions. For instance, 20% of settled securities class actions since 1999 have also involved companion SEC actions, and the recovery of a private action tends to double when the SEC is also involved. Would the agency that is charged with managing these rights contract out the representation to a private plaintiff? This may be fraught with controversy, as the securities class action bar is a generous donor to political campaigns. Another interesting question is whether the Private Securities Litigation Reform Act, which governs the rights of lead plaintiffs in federal securities class actions, should be changed in light of the fact that the federal government may become the dominant player in securities litigation? Should there be any safe-harbors in light of the fact that TARP purchases are intended to ensure the health of the nation’s banking system?


which increases the expected payout, which increases the stock’s price decreases, etc.\textsuperscript{278}

One of the elements shareholder plaintiffs are required, that may be difficult for Treasury to show, is reliance on the securities law violation in deciding whether to buy or sell. The Reliance requirement is frequently presumed in 10b-5 cases based on the efficient capital markets hypothesis.\textsuperscript{279} The reliance requirement is frequently treated synonymously with a requirement of transaction causation.\textsuperscript{280} Basic v. Levinson adopted the fraud-on-the-market theory to permit a presumption of reliance, on the theory that efficient markets would incorporate all publicly available information into changes in price, and price is a central element in the decision of whether or not to buy a security.\textsuperscript{281} The fraud on the market theory is a principle which does not completely establish reliance, but serves as a rebuttable presumption which can be rebutted by showing that the plaintiff would have purchased the securities even if the truth were known.\textsuperscript{282} This may make it difficult for Treasury to join in actions alleging misstatements in TARP participants’ financial statements that hid bad news, since it is likely that Treasury purchased shares precisely because they were decreasing in value and would have done so sooner if bad news were released earlier. Treasury may not face this issue if it sues on the basis of sales prior to the release of good news, however. Fannie Mae ran into some difficulty with allegations of earnings management, or that it smoothed earning to hide good results. If banks engage in a similar strategy, Treasury may be able to join in those actions after it sells its TARP shares.

Dura Pharmaceuticals also holds that plaintiffs must also establish loss causation as well as transaction causation.\textsuperscript{283} Loss causation relates to proof of economic harm, where transaction causation requires proof that the violation caused the plaintiff to engage in the transaction in question. Central Bank and Stoneridge both leave some room to go after entities other than those in which federal government is invested as primary actors.\textsuperscript{284}

\begin{footnotesize}
\textsuperscript{284} Roberta S. Karmel, When Should Investor Reliance Be Presumed in Securities Class Actions? BUS. LAW (forthcoming November 2007), also available at
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IX. Proposed Solutions

This paper will now close with three recommendations that will begin to remedy the problems outlined in this paper.

A. Fiduciary Duties for the Federal Government as Shareholder

Control person liability under state corporate law would be rare for pension funds and mutual funds, since ERISA and mutual fund regulations prohibit owning more than a certain threshold in companies, but if somehow they did own a control stake they would be subject to fiduciary duties in their exercise of shareholder control. ERISA and the federal securities laws provide fiduciary duty responsibilities to private pensions and mutual funds, respectively. Further, state codes will often govern fiduciary responsibilities to state pension funds. Calpers, for instance is subject to a codified fiduciary requirement in the California Constitution. Calpers is subject to a requirement to act for the exclusive purpose of providing benefits to participants and beneficiaries, and to engage in a prudent process for making all decisions related to the operation of the plan, including decisions related to the plan’s investments and services.\(^\text{285}\) The prudent person standard, common to trust law, governs.\(^\text{286}\) The California Constitution further provides that a California public pension’s “duty to its participants and their beneficiaries shall take precedence over any other duty.”\(^\text{287}\) Reference is also made to “fiduciary care and loyalty required of a retirement board”\(^\text{288}\). This rule, also known as the exclusive purpose rule, has an analogue provision in ERISA which has been interpreted to prohibit a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives.\(^\text{289}\) The California Courts have also limited authority of judicial review over whether California retirement plans have met their fiduciary duty obligations.\(^\text{290}\)

http://ssrn.com/abstract=1001743, at 35-36. See also Stoneridge Investment Partners, LLC v. Scientific-Atlantica, Inc. Typically the exposed players include investment banks and accountants. With respect to the first, Treasury will face a conflict as it likely holds control positions in those banks as well. With respect to the second Treasury might have more flexibility. Another curious consequence of Treasury’s TARP holdings involved SEC FAIR FUNDS distributions. The SEC can use civil monetary penalties and enforcement settlements to establish a “FAIR Fund” for the benefit of victims of securities violations. If the victim turns out to be the Treasury department, will the SEC be as active in seeking fair funds?


\(^{287}\) California Constitution, Article XVI, section 17.

\(^{288}\) West's Ann.Cal.Const. Art. 16, § 17

\(^{289}\) DOL Interpretative Bulletin 94-1

\(^{290}\) Proposition 162 removed the Legislature's authority to meddle in the Board's
One of the central provisions of ERISA as interpreted by the Department of Labor is that plans have a fiduciary duty to vote their shares in the best economic interests of the plan participants, defined to exclude the interest a participant may have in minimizing downsizing by a firm in which the retirement plan is investing.291

TARP is a program intended to minimize the cost of the bailout to the taxpayer by permitting the government to participate in the equity upside of bailed-out banks. Thus administration of the TARP program equity is similar in nature to the administration of a retirement plan. Treasury has also noted that it plans to place its common equity in Citigroup, as well as investments in Treasury’s new capital assistance program, into a trust set up to manage the government’s investments, with the objective of the trustees being to protect and create value for the taxpayer as a shareholder over the term of Treasury’s TARP holdings.292 As the author has testified before the House Oversight Committee, the terms of that trust do not adequately ensure fiduciary duties are met.293

Treasury’s deal sheet for the Citigroup conversion indicates that the trust in which it will hold the common equity will be subject to the Emergency Economic Stability Act (“EESA”) that appropriated the TARP money.294 EESA’s stated objectives are potentially conflicting.295 Thus a trust subject to this statement of purpose of the EESA will presumably be free to vote shares in favor of interests that threaten the long term health of the bank in which Treasury is invested and explored throughout this article.

A statement of fiduciary principles is little use, however, unless the beneficiary of those principles is able to sue its fiduciary for violations. By contrast, the Resolution Trust Corporation (“RTC”), established to effectuate a government bailout of the S&L industry, was created by enabling legislation that significantly

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291 See ERISA § 404(a)(1) and Labor Reg. § 2550-404a-1. See also Labor Reg. § 2509.94-2, 29 C.F.R. Pt. 2509 (Interpretive Bulletin relating to written statements of investment policy, including proxy voting policy or guidelines).
295 12 U.S.C.A. § 5201. It has four principal purposes, to ensure that such authority and such facilities are used in a manner that “protects home values, college funds, retirement accounts, and life savings; preserves homeownership and promotes jobs and economic growth; maximizes overall returns to the taxpayers of the United States; and provides public accountability for the exercise of such authority.”
waived sovereign immunity. It provided that the RTC may “sue and be sued in its corporate capacity in any court of competent jurisdiction.”296 Plaintiffs were also permitted to sue the RTC in state court.297 Therefore, it would not be without precedent for Treasury to establish a code of fiduciary duty which defines its obligations to taxpayer beneficiaries of TARP as well as other shareholders in TARP banks.298

B. Frozen Options

My second proposal to limit the inherent drawbacks to Treasury holding common equity, but also let the taxpayer participate in the benefits of the bailout and thereby minimize the cost of TARP, would be to issue to the Treasury something I would call frozen options. These would be options to purchase common stock that governments are not permitted to exercise, but which subsequent purchasers in the market would be permitted to exercise. This rests on the argument noted previously that holding common equity is not a necessary part of the bailout.299

296 U.S.C. section 1441a(b)(10). See also L.E. Creel, Litigation Against The Resolution Trust Corporation, Practicing Law Institute Order No. A4-4295, April 1, 1990, at 91. It further subjected the RTC to chapter 5 of Title 5 of the U.S. Code, the Administrative Procedures Act, which is the source for open rulemaking requirements that permits the public to participate and oversee administrative rulemaking.

297 547 F 2d 1072 (9th Cir 1976).

298 This would have the mutually reinforcing effect of assuring other shareholders that it does not intend to use its power as a shareholder to take action that will result in damage to the long term health of TARP participants. This will i) assist banks in raising private capital to enhance their tangible common equity ratios to reflect private shareholder interest in obtaining the residual profits of a banks loan risk and ii) increase the value of Treasury’s TARP shares, thus helping it to minimize the cost of TARP to the taxpayer. Wilson offers a different view for using common equity in bank capital injections. Wilson constructs a model demonstrating that purchases of common stock are always the most efficient method for government’s to induce new lending by banks, as opposed to purchases of preferred stock, notes, or other instruments or public-private partnerships. He justifies the use of common equity over preferred stock not by the effect that one or the other will have on a firm’s ability to obtain equity capital from the market, but by the incentives that infusions of common equity give banks to lend compared to the incentives that a similar injection of preferred stock offer. One of the assumptions in their model is that governments are unable to contract with firms directly regarding their lending policy. Wilson compared the incentive effects of using preferred stock, common equity, or direct purchases of troubled assets on bank’s, and finds that each of them involves a subsidy to the bank to induce subsequent lending. Wilson compared the incentive effects of using preferred stock, common equity, or direct purchases of troubled assets on bank’s, and finds that each of them involves a subsidy to the bank to induce subsequent lending. Wilson, Linus and Wu, Yan, Common (Stock) Sense about Risk-Shifting and Bank Bailouts (December 29, 2008), available at http://ssrn.com/abstract=1321666, at 4. That assumption does not hold, however, when the government holds equity control over banks, because the government will then have the ability to use its powers as a shareholder to influence corporate policy with the same effect as contracting over the firms lending policy. Wilson compares the incentive effects of using preferred stock, common equity, or direct purchases of troubled assets on bank’s, and finds that each of them involves a subsidy to the bank to induce subsequent lending. Wilson, Linus and Wu, Yan, Common (Stock) Sense about Risk-Shifting and Bank Bailouts (December 29, 2008), available at http://ssrn.com/abstract=1321666, at 46. It concludes that common equity purchases require the lowest subsidy to induce efficient lending on the basis that banks voluntarily participating in a bailout are less likely to shift inefficient levels of risk to common shareholders than to creditors. Wilson, Linus and Wu, Yan, Common (Stock) Sense about Risk-Shifting and Bank Bailouts (December 29, 2008), available at http://ssrn.com/abstract=1321666, at 48. Accepting the conclusion and method of this
With respect to the banking and financial sector, the federal government, post-TARP, has three basic sources of authority. It regulates industry lending and financial practices. It often, though not always, serves as the lender of last resort in the event other sources of liquidity dry up. And now, as this paper has demonstrated, it also holds an equity interest in TARP participants. Some may argue that the first two powers permit the government to sufficient ability that the shareholder power that attends share ownership is unnecessary, and thus that a focus on shareholder equity is unimportant.

With respect to the technical problems that accompany TARP ownership listed above, that argument is not particularly useful. The securities laws, and corporate law, are built around the powers and responsibilities of equity stockholders. Option holders do not have the power to sue under the Delaware code, nor can they join in federal class action litigation. Option holders have never been determined control shareholders by virtue of their option holdings. As such, getting rid of the federal government’s equity holdings would go a long way toward undermining the factors that make the federal government a control shareholder.

With respect to the theoretical aspects of this paper, the argument becomes a little more interesting. It is true that the federal government obtains substantial power through its regulatory authority and as a liquidity provider. However, with respect to its regulatory authority, industry also has substantial power to push back against its regulator through the lobbying and political interaction process. But when the government becomes both a regulator and a shareholder, the power it holds inside the company and the power it holds from outside interact in a cumulative way. The government can stop a company from pushing back against new regulation through exercise of its new ability to select, directly or indirectly, the Board of Directors and chief executives. It can also give preferential regulatory treatment to the companies it does control to help them gain market share.

On the issue of liquidity provision, we have seen the government demonstrate that, though generous, its flexibility as a lender of last resort is not without limit. Further, the power that the federal government may obtain as a lender will also depend on existing economic conditions. As the prospect for needing a government loan in the future become more remote, the power afforded to the

analysis shouldn’t necessarily lead us to believe common equity is the preferable method for a government bailout. This paper will show that despite common stock recapitalizations, governments are pressured to use the control powers of their common stock to require inefficient changes in corporate policy, including lending, employment practices, M&A decisions, facility closures, and the like, that will alter Wilson’s analysis and lead to the conclusion that the incentive distortions from government held common equity are greater because of the control element of the common equity. This will subsequently damage the value of a bank’s shares, minimizing its ability to obtain subsequent capital from private markets and increasing the odds of subsequent need for additional bailout and government guarantee.
government by its status as lender of last resort will continue to wane. Giving government equity upside as part of a bailout dilutes the interest of equity holders, imposing a penalty on them for investing in a business that needed rescue. Bank equity holders are forewarned: Invest more resources to monitor the business decisions of your investments, or else. But there are many ways to participate in the upside of a company. If you let Treasury choose the method, it will inevitably reach for the one with the most political power. Frozen options are the best way to limit these challenges to the bailout.

C. Sales Plan

My final recommendation is that Treasury should establish a sales plan for its TARP frozen options, similar to the 10b5-1 sales plans that executives file with the SEC. Treasury should adopt a similar plan that follows the same requirements of the SEC’s exemption, in spite of its exemption from the Securities Exchange Act.

The first requirement of the SEC’s sales plan exemption is that the written 10b5-1 plan must have been crafted before the individual creating the plan become aware of any material, nonpublic information. This may be difficult at this

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300 That is not to say that the powers of the government as guarantor of a company’s obligations cannot result in dramatic market distortions. The market for corporate debt imposes a certain discipline on a company’s management by requiring higher interest payments if it perceives a company’s business position as overly risky. Peter Wallison, Moral Hazard on Steroids: The OFHEO Report Shows that Regulation Cannot Protect U.S. Taxpayers (July 2006), available at www.aei.org, page 1. When the government guarantees the private institution’s debt, however, this discipline is muted. The financial institution can continue to borrow money and invest it in riskier projects without a need to balance that against an increasing interest rate for the funds it borrow itself or a need to offer up more collateral for the debt. This is because private markets tend to regard U.S. backed private debt similarly to U.S. debt itself, and investors assume that Treasuries carry no risk of default. See Peter J. Wallison, Regulating Fannie Mae and Freddie Mac: Now It Gets Serious (Continued), available at www.aei.org, at page 4. Thus government backed private debtors can continue to borrow at what are interest rates effectively subsidized by the federal guarantee. This was particularly true for Fannie and Freddie, even in spite of the fact that the government explicitly warned that it would not guarantee the GSE’s debt, though it eventually did so. Peter Wallison, Moral Hazard on Steroids: The OFHEO Report Shows that Regulation Cannot Protect U.S. Taxpayers (July 2006), available at www.aei.org, page 2. In effect, the markets called their bluff, and the markets ended up being right. This discipline is further distorted by the fact that the government actually has motives to require the guaranteed institution to take risks that present negative value propositions for the company. 301 In 2001, the SEC adopted an exception to insider trading liability to permit persons to make trades while in possession of material non-public information, as long as the information was not a part of the person’s decision to trade. Brandon C. Parris, Rule 10b5-1 Plans, Staying Out of Trouble, Business Law Today, (2008). 302 Exchange Act Rule 10b5-1(c)(1)(i)(A). Treasury could appoint a non-partisan panel of experts to design its plan, and negotiate with the various TARP participants concerning whether they will purchase the securities in advance of the date under which Treasury has the right to sell them. In order to ensure that the panel makes its determinations on the basis only of publicly available information, it should be required to disclose the
point, as the Treasury and Federal Reserve are likely in possession of significant inside information. The second requirement of a 10b5-1 plan requires that its terms either specify in reasonable detail the amount and price of the securities to be purchased or sold and the dates for such purchases or sales, or a written formula or algorithm or computer program that determines the amount and price of the securities to be purchased or sold and the dates for such purchases or sales. The third requirement of a 10b5-1 plan is that the terms of the 10b5-1 plan do not permit the executive to exercise any subsequent influence over how, when, or whether purchases or sales would be effected under the plan, and also that if the terms of the 10b5-1 plan permit a third party to exercise such subsequent influence, such third party does not do so at a time when aware of material, nonpublic information.

Treasury should establish a clear timeline for its ownership of bank stocks through binding to a sunset provision issued, either through legislation or codified rule, and subject to challenge if Treasury later changes its mind. It should also establish a clear sales plan, similar in nature to the 10b-5 sales plans that private executives file with the SEC to prevent allegations that they have engaged in insider trading. This will prevent misuse of inside information by the Treasury Department (or the trust that holds the assets on behalf of Treasury, which if staffed by Treasury personnel will also share Treasury’s immunity from insider trading rules as well as its access to inside information about the bank it owns).

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information that Treasury and the Federal Reserve share with it and that it uses to craft the sales plan.

Exchange Act Rule 10b5-1(c)(1)(i)(B). This measure could be informed by the publicly available results of the stress tests. It could even be crafted such that the algorithm delays trades until certain measures of a company’s health or profitability substantially improve, or until such time as the formulas indicate that the government should close out its investment and liquidate its holdings.

Exchange Act Rule 10b5-1(c)(1)(i)(B)(3). This requirement would need some implementing legislation to adequately ensure. Such legislation should specify a significant penalty for Treasury if it violates this requirement. One simple way to guarantee a penalty would be to lift the government’s immunity under Section 3(c) of the Exchange Act. Alternatively, the legislation implementing this plan could specify a penalty for its violation, such as a rescission for any affected purchaser of securities from the government, including TARP recipients repurchasing their own securities.