

BUILDING BETTER BAILOUTS: THE CASE FOR A LONG-TERM INVESTMENT APPROACH

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Abstract

The Article seeks to fill a crucial gap in the Dodd-Frank Wall Street Reform and Consumer Protection Act: the failure to create a framework for dealing with future financial bailouts. It argues that the federal government’s ad hoc, “break even” approach to the recent bailouts not only shortchanged taxpayers, but more importantly failed to provide deterrence against the type of reckless risk-taking that led to the financial crisis. This Article argues that the key to legitimizing future bailouts and limiting moral hazard is to institutionalize a long-term investment-oriented approach that delineates clear contours and conditions for aid. It calls for establishing an independent agency, the Federal Government Investment Corporation (FGIC), to serve as an investor of last resort, which would make bailout monies contingent on beneficiaries sharing both risks and long-term returns with taxpayers. The FGIC would establish express, ex ante conditions for providing aid that would temper corporate risk-taking, protect taxpayers, and establish bounds to bailouts. Tying government bailouts to shared sacrifices with managers, shareholders, and creditors of beneficiaries, proportional profit sharing with taxpayers, and corporate governance reforms would help to ensure that future bailouts serve a productive purpose.

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* Associate Professor, George Washington University Law School. I would like to thank many of my colleagues at the George Washington University Law School, as well as participants in the University of North Carolina Law School faculty workshop, for their thoughtful comments. I would also like to thank Carson Le and Rachel Zelman for their research assistance.

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INTRODUCTION

Since the financial crisis has subsided, politicians have responded to backlashes at Wall Street profits by renouncing bailouts en masse. Republicans who voted for bailouts now decry this government aid as misguided,¹ while Democrats have optimistically proclaimed that the Dodd-Frank Wall Street Reform and Consumer Protection Act was so comprehensive that it will make corporate bailouts a relic of the past.² The

1. See, e.g., Carl Hulse & David M. Herszenhorn, *Bank Bailout Is a Potent Issue for Fall Elections*, N.Y. TIMES, July 10, 2010, <http://www.nytimes.com/2010/07/11/us/politics/11tarp.html> (observing how Republican incumbents who voted for the Troubled Asset Relief Program (TARP) now treat bailouts as “toxic” because of the popular backlash).

2. See, e.g., Sewell Chan, *Finance Bill Consensus on a Point: No Bailouts*, N.Y. TIMES, Apr. 16, 2010, <http://www.nytimes.com/2010/04/16/business/16fail.html> (discussing the Obama

reality is quite different, as the prospect of bailouts will continue to shape financial markets and risk-taking.³ The question is not whether bailouts will happen, but rather how, when, and to what degree government intervention will be necessary to support financial firms during a crisis.⁴ The challenge is how to create a lasting framework to ensure that bailouts serve their avowed purpose of mitigating systemic risks, yet safeguard taxpayers' interests in the process.⁵

This Article argues that the federal government should approach

Administration's belief that the financial reform bill would ensure that "[t]axpayers should never again have to bail out giant financial institutions"); see also David Zaring, *A Lack of Resolution*, 60 EMORY L.J. 97, 121–29 (2010) (discussing the Dodd-Frank Act's focus on winding up distressed financial companies and Congress' express disavowal of future bailouts).

3. See Steven L. Schwarcz, "Idiot's Guide" to Sovereign Debt Restructuring, 53 EMORY L.J. 1189, 1195 (2004) (observing how "bailouts increase 'moral hazard' by rewarding and encouraging bad policies by governments and excessive risk-taking by banks"); Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 971–72 (2009) (discussing how the potential for bailouts continues to spur banks' excessive risk-taking).

4. See, e.g., Mariya Deryugina, *Shaping Global Financial Reform: A Symposium for Private and Public Sector Leaders*, 28 REV. BANKING & FIN. L. 683, 707–08 (2008) (discussing the academic consensus that "government bailouts of large systemically significant institutions . . . are inevitable . . . to prevent systemic disruption").

5. The financial crisis has led to a myriad of proposals about how to preempt future crises. Some commentators have sought to reduce risk by curbing the size of financial institutions. See, e.g., Markus Brunnermeier et al., *The Fundamental Principles of Financial Regulation*, 11 GENEVA REPORT ON THE WORLD ECONOMY 1, 26 (2009) (calling for asset limits on banks to avoid the creation of "national champions" that are "so large, so massively interconnected, and so iconic . . . that no government would ever allow them to fail"). Others have called for mandatory insurance on all financially related institutions to limit systemic risk exposure. See, e.g., Lasse Pedersen & Nouriel Roubini, Comment, *A Proposal to Prevent Wholesale Financial Failure*, FIN. TIMES, Jan. 29, 2009, at 11. Other ideas for potential ex ante reforms include tying bankers' compensation to the degree banks engage in risk mitigation by linking banker pay to their companies' public subordinated debt, see Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. (forthcoming 2011), available at <http://ssrn.com/abstract=1546229> (last visited Oct. 15, 2011); compartmentalizing different financial markets through firewalls that are reminiscent of the Glass-Steagall Act of 1933, see GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 26–28 (2009), available at http://www.group30.org/images/PDF/Financial_Reform-A_Framework_for_Financial_Stability.pdf; and imposing capital structure reforms designed to mitigate systemic risk and improve resiliency, see Viral V. Acharya, *A Theory of Systemic Risk and Design of Prudential Bank Regulation*, 5 J. FIN. STABILITY 224, 233–35 (2009). Other commentators have embraced the Administration's proposal for financial reform that empowers regulators to seize and wind up systemically important entities to facilitate swift responses to financial crises. See, e.g., Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?*, 82 TEMPLE L. REV. 449, 462–63 (2009). What distinguishes this Article's proposal is that it seeks to institutionalize an independent agency as an investor of last resort and to delineate clear bailout criteria ex ante. This approach would equip the investor of last resort to respond to future crises in a proactive way, rather than simply place faith in regulatory reforms or limits to mitigate systemic risks.

bailouts as long-term investments, so that aid may stabilize financial markets during crises, yet simultaneously deter beneficiaries from reckless risk-taking in the future. During the recent crisis, the federal government gave financial firms aid on generous terms based on a “break even” approach for its overall investments. The government prematurely liquidated investments without imposing meaningful reforms on beneficiaries or reaping returns to justify the government’s assumption of risk.⁶ The net result was to magnify moral hazard by failing to create disincentives for firms to sustain high leverage, recklessly speculate, and to seek bailout aid when bets go awry.⁷

This Article proposes institutionalizing a long-term investment approach to ensure that bailouts combine taxpayer returns with shared sacrifice by beneficiaries and structural reforms to mitigate moral hazard. It calls for the creation of an independent agency, the Federal Government Investment Corporation (FGIC), which would serve as an “investor of last resort” during financial crises. The FGIC would seek to depoliticize future bailouts by establishing clear contours and conditions for aid and mandating that beneficiaries share risks and returns with the federal government.⁸

6. See, e.g., Robert B. Reich, *The Obama Agenda and the Enthusiasm Gap*, WALL ST. J., Aug. 3, 2010, <http://online.wsj.com/article/SB10001424052748703999304575399420815017804.html> (lamenting the fact that “TARP increasingly looked to many Americans like a giant political payoff,” as “60% of [poll] respondents felt that ‘large banks’ had been helped ‘a lot’ or ‘a fair amount’ by government economic policies, but only 13% felt that the ‘average working person’ had been”).

7. See, e.g., Elizabeth F. Brown, *The New Laws and Regulations for Financial Conglomerates: Will They Better Manage the Risks than the Previous Ones?*, 60 AM. U. L. REV. 1339, 1388–89 (2011).

8. During the recent crisis, the federal government assumed a role of liquidity provider of last resort, as multiple government agencies provided emergency support to the financial sector at nominal cost or break even rates at best. A number of academics have recognized the significance of this emergency liquidity provider role in stabilizing the economy during financial crises. See, e.g., Stanley Fischer, *On the Need for an International Lender of Last Resort*, 13 J. ECON. PERSPECTIVES 85, 85–89 (1999) (calling for international cooperation to provide emergency liquidity for financial markets due to the limited financial capacities of individual governments); Xavier Freixas et al., *The Lender of Last Resort: A Twenty-First Century Approach*, 2 J. EUR. ECON. ASS’N 1085, 1085–87 (2004) (providing a comparative perspective on the government’s role in providing emergency liquidity during financial crises); Steven L. Schwarcz, *Too Big to Fail?: Recasting the Financial Safety Net*, in *THE PANIC OF 2008: CAUSES, CONSEQUENCES AND IMPLICATIONS FOR REFORM* 94, 105–06 (Lawrence E. Mitchell & Arthur E. Wilmarth, Jr. eds., 2010) (calling for the creation of an equivalent of the market maker liquidity provider role for individual stocks for debt markets as a whole to ensure liquidity for emergency sales of debt); Robert M. Solow, *On the Lender of Last Resort*, in *FINANCIAL CRISES: THEORY, HISTORY, AND POLICY* (Charles P. Kindleberger et al. eds., 1982) (laying out the government’s indispensable role in providing emergency liquidity). This Article argues that the federal government cannot simply serve as a liquidity provider that provides implicit and explicit subsidies to failing financial firms on an ad hoc basis. Instead, this Article makes the innovative argument that the federal government should embrace the mantle of a long-term investor and establish clear ex ante bailout conditions both to compensate taxpayers for the

The FGIC would serve as the bailout complement to the Federal Deposit Insurance Corporation (FDIC) and fill financing gaps during future crises.⁹ While the FDIC's function is to wind up insolvent banks and systemically important financial institutions,¹⁰ there is no single government institution currently in a position to address future bailouts.¹¹ For example, during the current crisis, policymakers cobbled together a hodgepodge of bridge loan sources, including emergency lending and guarantees from the Federal Reserve, FDIC-backed loans, and Troubled Asset Relief Program (TARP) investments administered by the Treasury Department.¹² Consolidating investment functions in a single institution would make the nature and scope of the U.S.'s role as an investor more transparent.¹³ This approach would centralize accountability for beneficiaries and make it easier to monitor the federal government's stewardship in administering bailouts.¹⁴

The objective of the FGIC would be to establish express, ex ante conditions for receiving aid that temper corporate risk-taking, protect taxpayers, and establish clear contours for bailouts. First, aid would be contingent on managers, shareholders, and creditors of beneficiaries facing

government's assumption of risk and to provide disincentives for over-reliance on bailouts and leveraged speculation.

9. See Helen A. Garten, *A Political Analysis of Bank Failure Resolution*, 74 B.U. L. REV. 429, 472–75 (1994) (discussing the evolution of the FDIC's bank liquidation and alternative resolution procedures); Stanley V. Ragalevsky & Sarah J. Ricardi, *Anatomy of a Bank Failure*, 126 BANK. L.J. 867, 868–70 (2009) (discussing the role and workings of the FDIC).

10. The Dodd-Frank Act designated commercial banking groups with assets of \$50 billion or more as "systemically important financial institutions" (SIFIs), and empowered the Financial Stability Oversight Council—in consultation with the Federal Reserve—to determine which non-bank financial institutions should be treated as SIFIs. See Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 ORE. L. REV. 951, 993–96 (2011). SIFIs are subject to special prudential standards and are potentially subject to Orderly Liquidation Authority (OLA) wind-ups. In contrast, this Article embraces a broader conception of "systemically significant" firms that may be potential bailout beneficiaries. One premise of this Article is that firms that are smaller than \$50 billion may still raise systemic risks, and therefore the FGIC would have discretion to offer bailouts without being restricted to particular firm capitalization thresholds.

11. See Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 216 (2009) (discussing the shortcomings of having the government fail to provide market liquidity during a crisis).

12. See Joe Nocera, *Lessons from the Financial Crisis*, 52 ARIZ. L. REV. 1, 9 (2010) (discussing the broad range of measures that the federal government used to address the financial crisis).

13. Consolidation of this investor role in the FGIC would reduce the conflict of interests other agencies face from simultaneously assuming regulatory and bailout roles. See Richard W. Painter, *Bailouts: An Essay on Conflicts of Interest and Ethics when Government Pays the Tab*, 41 MCGEORGE L. REV. 131, 154–57 (2009).

14. See Colleen M. Baker, *Regulating the Invisible: The Case of Over-the-Counter Derivatives*, 85 NOTRE DAME L. REV. 1287, 1374–76 (2010) (discussing how the financial crisis and bailouts have led to demands for greater accountability).

upfront reductions in their respective stakes (based on the scale of the FGIC's investment) to deter overreliance on bailout funds and excessive risk-taking. Second, the FGIC would assume a proportional stake in beneficiaries and tie FGIC returns to beneficiaries' returns over a long-term period. Third, FGIC investments would be contingent on bailout beneficiaries implementing corporate governance reforms, including the appointment of independent directors in proportion to the government's stake and adoption of substantive reforms to target the roots of systemic risk.¹⁵

A significant challenge this proposal faces is how to avoid having FGIC investments cause government overstretch and excessive entanglement with the private sector. Not only must the conditions the FGIC imposes be draconian enough to deter corporations from seeking FGIC funds except *in extremis*, but also the FGIC must face limits on when it is able to make investments, the level and duration of those investments, and the degree of control it can exert over private companies.

The FGIC must face constraints that place prospective beneficiaries on clear notice about the contours of potential aid and the FGIC's limits. It would restrict eligibility for FGIC investments to systemically significant institutions and require the FGIC to certify that funding is necessary to address systemic risks.¹⁶ The FGIC would be required to establish capital requirement guidelines (analogous to capital requirements that commercial banks currently face) to ensure that bailout beneficiaries have a realistic prospect of repaying those investments.¹⁷ These guidelines would serve to

15. Under the TARP, the Treasury Department has the right to appoint two government directors to boards of bank beneficiaries who miss their payment obligations for six consecutive quarters (i.e., 1.5 years). Only nine tiny banks are at or one missed payment away from this milestone, and the Treasury Department has yet to act on appointing directors. See OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 72 (2010), available at http://sigtarp.gov/reports/congress/2010/July2010_Quarterly_Report_to_Congress.pdf. This Article argues that the independent appointment of directors should serve as much more than a belated afterthought for failing companies and should instead constitute a quid pro quo for any bailout aid. See *infra* Subsection III.B.3.

16. This Article has a broader conception of "systemically significant" financial firms or institutions than the Dodd-Frank Act's view of SIFIs—commercial banking groups and other financial institutions with \$50 billion or more of assets who face special prudential standards and are potentially subject to OLA wind-ups. See Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 993–96 (2011). The FGIC would have discretion to designate smaller firms as "systemically significant" and eligible for bailouts if the firms' "default" or "danger of default" "would have serious adverse effects on financial stability or economic conditions in the United States." *The Wall Street Reform and Consumer Protection Act*, H.R. 4173, 111th Cong. § 1603(b), (d) (2010).

17. See, e.g., J.W. Verret, *Treasury, Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. REG. 283, 301 (2010) (discussing how financial regulators can shape a bank's business model by adjusting capital requirements); see also Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 26–28 (2010) (arguing that the design of capital requirements is key for shaping banks' risk-taking).

delineate the dividing line between the respective roles of the FGIC and FDIC in investing in and winding down systemically significant institutions.

The FGIC would also face substantive limits on the amount and duration of its investments in a particular institution to prevent de facto nationalization of private enterprises. Investments would need to be capped at a percentage of the equity holdings of beneficiaries to ensure that the other stakeholders will still have significant skin in the game.¹⁸ The duration of investments should also be limited to a five-year period, a time frame designed to be sufficient to provide support for the financial industry through a cyclical correction and rebound. Lastly, concerns about entanglement suggest that directors for beneficiaries' boards should be selected by an independent panel to represent the government's stake, in order to heighten oversight of beneficiaries without having direct government involvement in the day-to-day operation of the business. Similarly, the FGIC could mandate that beneficiaries adopt systemic reforms as an ex ante condition for receiving bailout monies, so that bailouts do not paradoxically "stabilize" industry lobbyists on Capitol Hill and therefore stymie reforms.¹⁹

Skeptics would argue that there is no point in imposing limits on bailouts because if a crisis is large enough, politicians and regulators will suspend the rules once again just as they did during the current crisis.²⁰ It is true that politicians always have the ability to nationalize failing companies or to federalize private sector debt or liabilities with no strings attached. Nothing short of a constitutional amendment can fully constrain this power.²¹ However, just as the existence of the FDIC has caused the process for winding down banks to become less politicized,²² the FGIC's objective

18. See Onnig H. Dombalagian, *Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation*, 85 IND. L.J. 777, 836 (2010) (discussing how the absence of "skin in the game," that is, a direct financial stake, skewed the incentives of issuers of securitizations).

19. The \$251 million that financial institutions spent during the first half of 2010 to blunt the scope and impact of financial reforms is a telling indicator of how much the bailouts empowered lobbyists at the expense of taxpayers and the public interest. See Joshua M. Brown, *How Wall Street Uses Your Money to Lobby Against You*, CHRISTIAN SCI. MON., Aug. 3, 2010; see also Eric Lichtblau, *Ex-Regulators Get Set to Lobby on New Financial Rules*, N.Y. TIMES, July 27, 2010 (discussing how 150 former banking regulators signed up as lobbyists this year in order to profit from the 243 financial rules and sixty-seven studies that regulators will conduct to implement the Dodd-Frank Act).

20. See Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 472–73 (2010) (discussing how regulators have routinely suspended prompt corrective action rules when systemically important companies stumble).

21. See Robert W. Adler, *Unfunded Mandates and Fiscal Federalism: A Critique*, 50 VAND. L. REV. 1137, 1209 n.334 (1997) (suggesting that only a constitutional amendment could impose limits on Congress' spending powers).

22. See Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1647 & n.308 (2008) (discussing how the

would be to reduce politicians' role in the bailout process by establishing clear, settled expectations of the tradeoffs beneficiaries face for receiving bailouts.²³

Part I of this Article will delineate the distinctiveness of bailouts from other forms of government interventions, such as nationalizations, federalizations, and wind-ups.²⁴ Part II will lay out the shortcomings and costs of the recent bailouts and underscore the need to create a framework to deal with future crises. Part III will make the case for institutionalizing an investor of last resort and lay out a blueprint for the FGIC to ensure that beneficiaries shoulder the risks and returns of future bailouts with taxpayers.

I. NATIONALIZATIONS, FEDERALIZATIONS, BAILOUTS, AND WIND-UPS

A. *The Inevitability of Government Intervention During Financial Crises*

However much policymakers have sought to appease public outrage by proclaiming the end of bailouts,²⁵ it has not changed the reality that circumstances may require the government to intervene to support or wind up private companies.²⁶ The question is how to condition the triggers,

institutional design of the FDIC makes bank wind-ups less politicized); *see also* Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503, 511 (2000) (discussing how institutional design can mitigate the politicization of financial regulatory agencies).

23. This proposal's approach is designed to lay the groundwork for proactive intervention, rather than reactive regulation that is focused on the last crisis. *See* Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 419–22 (2006) (discussing how policymakers myopically focus on the last crisis when designing regulation); *see also* Heidi M. Schooner, *Regulating Risk Not Function*, 66 U. CIN. L. REV. 441, 479–82 (1998) (discussing the problem of reactive regulation).

24. Remarkably little has been written on the theoretical foundations for emergency government interventions in the economy. Cheryl Block wrote an insightful public choice analysis of politicians' incentives for shadow bailouts that anticipated responses to the recent financial crisis. *See* Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L.J. 951, 953–57 (1992). Cheryl Block has also written a more recent article that documented the off-budget accounting that obscured the costs of bailouts and called for transparency and on-budget accounting for public bailouts through use of the tax system and other regulatory regimes. *See* Cheryl D. Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149, 152–54 (2010). Adam Levitin recently wrote a thorough survey piece chronicling different approaches towards bailouts and focusing on the intersection of bailouts and bankruptcy resolutions. Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 461–90 (2011). In contrast, this Article is the first to develop the distinctions of bailouts from other forms of government interventions, such as nationalizations, federalizations, and wind-ups. Additionally, this Article lays out an innovative policy approach for institutionalizing bailouts by calling for the formation of an independent agency to serve as a standing bailout investor of last resort.

25. *See, e.g.*, Chan, *supra* note 2 (discussing how the Obama Administration believes that the financial reform bill will eliminate the need for future bailouts).

26. *See, e.g.*, Mariya Deryugina, *Shaping Global Financial Reform: A Symposium for Private and Public Sector Leaders*, 28 REV. BANKING & FIN. L. 683, 707–08 (2008) (discussing the

contours, and consequences of government intervention. Part of the problem is that bailouts became an open-ended concept throughout the financial crisis, and neither policymakers nor academics grappled with the basic challenge of defining bailouts and their proper scope.²⁷ The amorphousness of what constitutes a bailout may have initially provided political cover during the crisis by allowing the Bush and Obama Administrations to provide aid with little strings attached to an ever-growing array of financial and nonfinancial firms.²⁸ But in the long run, the absence of a coherent framework for (or understanding of) bailouts aroused a backlash.²⁹ Disapproval surged as citizens witnessed large-scale transfers from the public to private sector that benefited Wall Street, yet appeared to offer taxpayers very little in return for the risks the government assumed.³⁰

This Article seeks to fill these theoretical and practical gaps concerning what constitutes bailouts by distinguishing bailouts from three other forms of emergency government interventions: nationalizations of companies, federalizations of private debt and liabilities, and wind-ups of financial firms. Nationalizations and federalizations are political decisions for the government to take over private enterprises or to assume private debts or liabilities respectively. Both entail clear expectations of significant losses at the time liabilities are assumed and potentially for the foreseeable future. For example, during the financial crisis, the federal government nationalized the mortgage intermediaries of Fannie Mae and Freddie Mac and took on losses of \$160 billion, a figure that may ultimately rise to \$1 trillion.³¹ Similarly, the federal government routinely federalizes private pension shortfalls when the Pension Benefit Guaranty Corporation takes over failing companies' pension plans.³²

academic consensus that “government bailouts of large systemically significant institutions are inevitable . . . to prevent systemic disruption”).

27. See Levitin, *supra* note 24, at 443–45 (discussing the amorphousness of the concepts of systemic risk and bailouts).

28. See Jim Puzzaghera & Martin Zimmerman, *Bush Extends Aid to Carmakers*, L.A. TIMES, Dec. 20, 2008, at 1 (discussing how the Bush Administration extended TARP aid to General Motors and Chrysler, even though the Emergency Economic Stabilization Act of 2008 only deemed financial institutions eligible for bailout aid).

29. See Hulse & Herszenhorn, *supra* note 1 (discussing how both Republican and Democratic supporters of the TARP legislation have faced significant political backlashes).

30. The juxtaposition of record profits for Wall Street firms against 10% unemployment understandably led many to the question the purpose of bailouts. See, e.g., Reich, *supra* note 6 (documenting the scale of discontent).

31. See Lorraine Woellert & John Gittelsohn, *Fannie-Freddie Fix at \$160 Billion with \$1 Trillion Worst Case*, BLOOMBERG (June 13, 2010, 7:00 PM) (discussing \$160 billion in losses from the Fannie and Freddie bailouts with upwards of \$1 trillion in potential total losses); see also Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 488 (2009) (observing that the federal government assumed liability for \$5.14 trillion in mortgage-backed securities and guarantees from Fannie Mae and Freddie Mac).

32. See Richard L. Kaplan, *Enron, Pension Policy, and Social Security Privatization*, 46

In contrast, wind-ups consist of the federal government temporarily assuming control of insolvent banks or systemically important financial firms to expedite their liquidation.³³ The FDIC has long bypassed bankruptcy proceedings for insolvent banks by conducting swift, depoliticized sales to minimize losses and any impact on the economy.³⁴ Bailouts are distinguishable from nationalizations, federalizations, and wind-ups because the government does not assume direct control of either corporate beneficiaries or their existing liabilities. Instead, bailouts entail government investments to provide private enterprises with liquidity and stability during financial crises, which must be linked with investment returns and conditions to cover the government's assumption of risk and to mitigate moral hazard.³⁵

1. Nationalizations and Federalizations

Nationalizations consist of the government taking control of private enterprises.³⁶ The closely related concept of federalization entails the government assuming private debts or liabilities with no strings attached. Both nationalizations and federalizations are political decisions, made when Congress or the President decides that a faltering enterprise is too significant to the economy to allow it to fail. Therefore, the federal government assumes direct control of a private enterprise or takes on the corporation's debt or liabilities with a likelihood of continued losses for the foreseeable future. The possibility of nationalization of companies or federalization of losses creates a clear moral hazard for externalizing the costs of risk-taking onto the government.³⁷ However, it is difficult to

ARIZ. L. REV. 53, 57 (2004) (discussing how the Pension Benefit Guaranty Corporation federalizes pension liabilities of failing companies); *see also* 29 U.S.C. § 1305 (2006) (laying out the PBGC's mandate).

33. The federal government directly assumes control of failing enterprises in the case of FDIC and Government Supervised Entity receiverships (for example, in the case of Fannie Mae and Freddie Mac). *See* 12 U.S.C. §§ 1811–35A, § 4617 (2006). Additionally, bankruptcy resolution systems under Chapters 7, 11, and 13 allow corporations to work through the bankruptcy court to reorganize or wind down. *See* 11 U.S.C. §§ 701–07; 11 U.S.C. §§ 1101–16.

34. *See* Richard M. Hynes & Steven D. Walt, *Why Banks Are Not Allowed in Bankruptcy*, 67 WASH. & LEE L. REV. 985, 1007–09 (2010) (discussing the rationale for the FDIC's bypass of bankruptcy proceedings).

35. *See* Block, *supra* note 24, at 155–56.

36. *See* Pryia Alagiri, Comment, *Give Us Sovereignty or Give Us Debt: Debtor Countries' Perspective on Debt-for-Nature Swaps*, 41 AM. U. L. REV. 485, 508 (1992). Takings form a subset of nationalizations. *Id.* As the recent crisis highlighted, the government may serve as the receiver of last resort in assuming control of insolvent, systemically important companies, such as Fannie Mae and Freddie Mac. *See* Robert Higgs, *Cumulating Policy Consequences, Frightened Overreactions, and the Current Surge of Government's Size, Scope, and Power*, 33 HARV. J.L. & PUB. POL'Y 531, 547 (2010). While these moves can be framed in takings terms, they are more akin to abandonment, as the net value of most nationalizations in the United States is generally negative.

37. *See* Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at

imagine that opportunistic politicians will be completely held back from assuming control of politically sensitive enterprises or liabilities when the crisis is large enough.³⁸

The word “nationalization” is rarely heard in U.S. politics, as politicians and policymakers shy away from characterizing government takeovers of private companies as such.³⁹ American politicians generally act as if nationalizations occur only in distant, authoritarian countries—certainly not here, not because of our popular faith in free enterprise and concerns about government entanglement in the economy.⁴⁰ There is some truth to this distinction, as the Takings Clause in the U.S. Constitution dictates that nationalizations in the United States are generally tools for the government’s assumption of liabilities, rather than for government expropriation of assets from the private sector.⁴¹ Nonetheless, the federal government has used nationalizations of corporations and federalizations of liabilities as policy tools to combat crises. The government merely engages in semantic gamesmanship when it characterizes this activity as a “bailout” rather than a “nationalization” or “federalization.”⁴²

For example, the government’s assumption of control of Fannie Mae and Freddie Mac meant it assumed liability for at least \$160 billion in mortgage-backed securities and guarantees (with upwards of \$1 trillion of potential losses).⁴³ Politicians have gone to great pains to avoid framing

the New York University Law School: Financial Regulation and the Invisible Hand (Apr. 11, 2007), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20070411a.htm> (discussing how confidence in the availability of government intervention may undermine market discipline towards banks taking excessive risks).

38. Even a constitutional amendment may not stand in the way of nationalizations or federalizations in a large enough crisis. The nation’s experience during the Great Depression demonstrated how limiting interpretations of federal powers under the Constitution will likely give way under strong pressures for government intervention. See Richard H. Fallon, Jr., *The Supreme Court, Habeas Corpus, and the War on Terror: An Essay on Law & Political Science*, 110 COLUM. L. REV. 352, 373 (2010) (“Franklin Roosevelt won broad acceptance for his constitutional vision in the context of the Great Depression.”).

39. See, e.g., Christine A. Klein, *The Environmental Deficit: Applying Lessons from the Economic Recession*, 51 ARIZ. L. REV. 651, 656 (2009) (observing how the “flirtation with nationalization was astounding” during the depths of the financial crisis as the “idea of nationalization would have been [politically] radioactive” just months earlier (internal citations and quotation marks omitted)).

40. See, e.g., Simon Romero, *Moving Clocks Ahead, Reaching Back in Time*, N.Y. TIMES, Aug. 26, 2007, at WK3 (discussing the scope of Venezuela’s nationalizations under President Hugo Chavez).

41. See, e.g., Terri L. Lilley, Note, *Keeping NAFTA “Green” for Investors and the Environment*, 75 S. CAL. L. REV. 727, 728–29 (2002) (discussing how takings law tempers the force of nationalization by requiring compensation when the government takes property on behalf of the public).

42. See Higgs, *supra* note 36, at 547.

43. See Woellert & Gittelsohn, *supra* note 31. Fannie Mae and Freddie Mac are public–private hybrids due to their government mandate as mortgage market intermediaries. See Anca

this move as a nationalization.⁴⁴ But the reality speaks for itself, as federal government officials decided the mortgage intermediary roles of Fannie Mae and Freddie Mac were too central to the stability of the housing sector to allow them to fail.⁴⁵ There is no realistic possibility of redeeming the federal government's investments in Fannie Mae and Freddie Mac.⁴⁶ However, politicians responded to political pressures and macroeconomic concerns about the stability of the housing loan industry by having the federal government assume direct liability and receivership control.⁴⁷

The federal government similarly nationalized General Motors (GM) on the ground that too many jobs were interconnected with the domestic automobile industry to let GM fail and go through a standard bankruptcy.⁴⁸ The government's infusion of \$50 billion of capital into GM gave the government control and exposed the government to the potential for large-

Bogdana Rusu, *Rethinking Markets and Financial Institutions*, 14 GEO. PUB. POL'Y REV. 1, 2 (2008). However, the fact that they were publicly traded companies whose profits (and losses) presumably fell on their private sector owners establishes them as private firms for bailout purposes. *Id.*

44. See James B. Lockhart, Director, Federal Housing Finance Agency, Announcement of Fed. Hous. Fin. Agency Conservatorship of Fannie Mae and Freddie Mac 5–6 (Sept. 7, 2008), available at <http://www.fhfa.gov/GetFile.aspx?FileID=23> (spinning the nationalization of Fannie Mae and Freddie Mac as a mere “statutory process designed to stabilize a troubled institution with the objective of returning the entities to normal business operations”); see also Michael Abramowitz & Dan Eggen, *Administration Decided in Late August that Takeover Was Needed*, WASH. POST, Sept. 9, 2008, at A08 (discussing how the Bush Administration framed the government takeovers of Fannie Mae and Freddie Mac).

45. See James B. Lockhart, Director, Federal Housing Finance Agency, Speech to the National Press Club: FHFA's First Anniversary and the Challenges Ahead 14 (July 30, 2009), available at <http://www.fhfa.gov/webfiles/14715/FHFA1stAnnSpeechandPPT73009.pdf> (noting that “President Obama has stated clearly his Administration's intent that [Fannie Mae and Freddie Mac] will continue to play a key role in helping the mortgage market recover”); see also Carrie S. Lavargna, *Government-Sponsored Enterprises Are “Too Big to Fail”*: Balancing Public and Private Interests, 44 HASTINGS L.J. 991, 1014 (1993) (predicting correctly that “the massive size of [Fannie Mae and Freddie Mac] and their importance to other financial institutions make them ‘too big to fail’”).

46. See Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151, 1191 (2010) (discussing how the government has kept Fannie Mae and Freddie Mac “afloat” through massive infusions of capital that it is unlikely to recoup).

47. See Julie Andersen Hill, *Bailouts and Credit Cycles: Fannie, Freddie, and the Farm Credit System*, 2010 WIS. L. REV. 1, 58–60 (discussing how policymakers believed that Fannie Mae and Freddie Mac provided essential secondary market facilities, ensuring that mortgage funding does not depend solely on cyclical markets).

48. For example, President Obama claimed that the GM and Chrysler bailout “saved more than a million jobs.” See Kate Andersen Brower & Nicholas Johnston, *Obama Making Sales Pitch for Auto Bailouts to Skeptical Voters*, BLOOMBERG (July 30, 2010), <http://www.bloomberg.com/news/2010-07-30/obama-trumpeting-success-of-automaker-bailouts-to-skeptical-u-s-voters.html>. Although General Motors formally went through a Chapter 11 reorganization to shed liabilities, nationalization by the federal government drove this process. See Robert M. Fishman & Gordon E. Gouveia, *What's Driving Section 363 Sales After Chrysler and General Motors?*, 19 NORTON J. BANKR. L. & PRAC. 351, 362, 369 (2010).

scale losses,⁴⁹ even though a significant portion of these monies was recouped following GM's government-overseen bankruptcy and initial public offering.⁵⁰ Nonetheless, this initially open-ended financial commitment appeared to be driven by the political reality that automobile plants and jobs affected too many congressional districts for politicians to ignore GM's plight, rather than by assessments of financial viability.⁵¹

Nationalizations and federalizations of liabilities are not limited to large corporate entities, but also extend to the government's assumption of smaller, individual liabilities during crises. The classic case of federalization of smaller liabilities is the government response to catastrophe, such as floods, hurricanes, or terrorist attacks.⁵² The logic is that for small-impact events, parties need insurance coverage to be made whole. But if a catastrophe is large enough, then politicians may indulge the opportunity to grandstand and make everyone whole whether they were insured or not.⁵³ For example, under government flood insurance, if a creek overflows, affected households will likely be eligible for payments only if the owners paid for government flood insurance. But if a *river* overflows, then politicians' cry for bailouts generally ensures that both insured and uninsured parties are made whole.⁵⁴ The possibility that the government will assume the risk of liability therefore creates a moral hazard, deterring increasing numbers of those living by rivers from paying for flood insurance. There is little point of paying into a system if both insured and uninsured parties ultimately will receive the same payout.⁵⁵

49. See, e.g., Bill Vlasic, *Chief Says G.M. Is Adapting Its Culture*, N.Y. TIMES, Oct. 8, 2009, at B3 (discussing how 60% of General Motors was owned by the United States following the government's investment of \$50 billion in the company).

50. See Nick Bunkley & Bill Vlasic, *General Motors Files for an Initial Public Offering*, N.Y. TIMES, Aug. 18, 2010, at B1 (noting that GM seeks to use the bailout money to lower the federal government's ownership stake to below 50% and to finance the company's continued overhaul).

51. See David E. Sanger & Jackie Calmes, *President to Promote Auto Bailout as a Success*, N.Y. TIMES, July 29, 2010, at B1 (detailing the Obama Administration's argument that the nationalization of General Motors was a success because only 279,000 automobile-related jobs have been lost and the toll on automakers and their suppliers would have been much greater without the government's intervention); John Crawley, *Taxpayer Loss on Auto Bailout Narrows*, REUTERS (June 1, 2011, 8:00 PM), <http://www.reuters.com/article/2011/06/02/us-usa-autos-treasury-idUSTRE7505RJ20110602> (noting that government bailout loss estimates have fallen to less than 20% and the U.S. Treasury has recovered approximately half of the loans made to GM and Chrysler).

52. See Jeffrey Manns, Note, *Insuring Against Terror?*, 112 YALE L.J. 2509, 2526–32 (2003) (discussing federalization of private liabilities from terrorist attacks).

53. *Id.* at 2526–28 (discussing the role of problem construction in lobbying for federalization of catastrophic liabilities).

54. See Michelle Boardman, *Known Unknowns: The Illusion of Terrorism Insurance*, 93 GEO. L.J. 783, 784–85 (2005) (discussing how victims of cataclysmic losses will be compensated by the state or federal government whether or not they have insurance).

55. See Anne Gron & Alan O. Sykes, *Terrorism and Insurance Markets: A Role for the*

The example of flood insurance underscores the moral hazards that are intrinsic to government intervention in assuming private sector liabilities. If individuals or corporations receive the upside of risk-taking, but can externalize the negative aspects of the risk onto the government, it invites excessive speculation. In a conventional insurance context, such as automobile insurance, risk-taking that causes accidents is factored into future premiums, so that drivers are forced to pay for their mistakes over time.⁵⁶ In contrast, under nationalizations and federalizations, beneficiaries historically walk away without having to internalize the costs of government intervention in either an immediate or a prospective way.⁵⁷

In spite of the moral hazards posed by nationalizations and federalizations, nothing short of a constitutional amendment can formally constrain politicians' ability to prop up corporations with no strings attached.⁵⁸ Nonetheless, this Article argues that creating clear depoliticized channels and parameters for winding up and bailing out companies would make it more difficult for politicians to engage in corporate giveaways at the public's expense.

2. FDIC Wind-Ups

In nationalizations and federalizations, the federal government assumes the costs or liabilities of a company and generally faces the prospect of losses for the foreseeable future.⁵⁹ Wind-ups represent the other end of the spectrum of government intervention: assumption of control of insolvent companies with the objective of selling the companies or liquidating their assets to minimize losses.⁶⁰ While nationalizations and federalizations are ad hoc political decisions, the FDIC has provided a well-settled institutional framework for liquidating insolvent financial institutions in a swift, nonpolitical way.⁶¹

While judicially supervised bankruptcies exist under Chapters 7 and 11

Government as Insurer?, 36 IND. L. REV. 447, 449–50 (2003) (discussing the moral hazard posed by government compensation for insured and uninsured parties).

56. See A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 932–33 (1998) (discussing how insurance serves the valuable purpose of forcing the cost-internalization of damages).

57. Cf. Gron & Sykes, *supra* note 55, at 450.

58. See Adler, *supra* note 21, at 1209 n.334 (suggesting that only a constitutional amendment could impose limits on Congress' spending powers). It is unclear that a constitutional amendment limiting federalizations or nationalizations would even be desirable, as extraordinary actions may be sometimes necessary to prop up the economy or systemically important companies.

59. See *supra* notes 35–37 and accompanying text.

60. See Ragalevsky & Ricardi, *supra* note 9, at 868–69.

61. See *id.* Of course, there are exceptions to this rule, such as the shotgun marriage between Merrill Lynch and Bank of America that then-Secretary of the Treasury John Snow brokered during the recent financial crisis. These exceptions are noteworthy for being anomalous deviations from the normal workings of the FDIC in winding up insolvent financial firms. See *infra* Subsection II.B.1.

of the Bankruptcy Code,⁶² the paradigm case for governmentally subsidized and administered bankruptcies are FDIC wind-ups of banks. In that instance, the FDIC administers a public insurance fund for winding up insolvent financial firms and faces a mandate of minimizing losses from bank failures.⁶³ Wind-ups of insolvent firms generally occur at a net loss to the FDIC fund, which is covered by insurance premiums imposed on all FDIC-insured banks. If FDIC losses are significant enough to deplete its insurance fund, the FDIC can impose additional surcharges on FDIC-insured banks to cover the difference.⁶⁴

The FDIC's governing principle for wind-ups is that it must pursue a "least-cost resolution" in liquidating failed banks, that is, employing means which cost the insurance fund the lowest in terms of losses.⁶⁵ The trigger for FDIC action is generally a financial institution's breach of FDIC capital requirements, which raises concerns about the bank's solvency or suggests that the bank is in "unsafe or unsound condition."⁶⁶ If the FDIC examines the institution and concludes that it is in a "severely weakened condition,"⁶⁷ the FDIC will order a "capital call" and issue a "prompt corrective action" notice, detailing steps the bank needs to take to restore its solvency.⁶⁸ If the institution is unable to recapitalize or is still operating in an unsafe manner,⁶⁹ the FDIC begins to implement the "least-cost resolution" of the bank.⁷⁰ While the FDIC has many resolution tools at its

62. See 11 U.S.C. §§ 701–07 (2006); 11 U.S.C. §§ 1101–16 (2006).

63. 12 U.S.C. § 1823(c)(4)(A) (2006); see also 12 C.F.R. § 360.1 (2010).

64. For example, during the current crisis, shortfalls to the FDIC insurance fund led the FDIC to request advances on several years of FDIC insurance premiums totaling \$45 billion. See Stephen Labaton, *Banks to Prepay Assessments to Rescue F.D.I.C.*, N.Y. TIMES, Sept. 29, 2009, at A1.

65. 12 U.S.C. § 1823(c)(4)(A) (2006); see also 12 C.F.R. § 360.1 (2010).

66. The FDIC has the authority to close financial institutions for numerous reasons, such as transacting business in "an unsafe or unsound condition," termination of deposit insurance, or being convicted for money laundering offenses. 12 U.S.C. § 1821(c)(5)(C) (2006). The FDIC may also close banks because of "inadequate corporate governance, weak risk management, and lack of risk diversification—lending concentrations." FED. DEPOSIT INS. CO., OFFICE OF THE INSPECTOR GENERAL, OBSERVATIONS FROM FDIC OIG MATERIAL LOSS REVIEWS CONDUCTED 1993 THROUGH 2003, AUDIT REPORT NO. 04-004 II-1 (2004), available at <http://www.fdicogig.gov/reports04/04-004.pdf>.

67. Ragalevsky & Ricardi, *supra* note 9, at 870; see also 12 U.S.C. §§ 1821 (c)(5)(L), 1831o(b) (2006).

68. See Ragalevsky & Ricardi, *supra* note 9, at 870; see also Garten, *supra* note 9, at 476–77 (discussing the development of prompt corrective action procedures).

69. The institution must recapitalize within ninety days of a notice for prompt corrective action, although the FDIC can accelerate this time frame if the financial institution's circumstances warrant a swift resolution. Ragalevsky & Ricardi, *supra* note 9, at 870.

70. 12 U.S.C. § 1823(c)(4)(A) (2006); 12 C.F.R. § 360.1 (2010). The FDIC or its primary regulator (Office of the Comptroller of the Currency, Office of Thrift Supervision, or National Credit Union Administration) will send the institution a "failing bank letter" which triggers the FDIC's review of the financial institution and the effort to resolve the bank's solvency issues. FED. DEPOSIT INS. CO., FDIC RESOLUTIONS HANDBOOK 6–7 (1998), available at <http://www.fdic.gov/bank/historical/reshandbook/index.html>.

disposal,⁷¹ the FDIC generally sets up a bidding process for the failing bank and/or its deposits to other financial institutions in order to minimize losses.⁷² Once a bidder wins, the FDIC becomes the receiver of the bank, so that the FDIC can wind down the institution and resolve its liabilities.⁷³

During the financial crisis, the FDIC deviated from its normal “least cost” resolution mandate and instead served as one of many tools of the federal government’s ad hoc efforts. The FDIC exercised its extraordinary authority to “take . . . action or provide assistance”⁷⁴ to banks to “avoid or mitigate” any “serious adverse effects on economic conditions or financial stability.”⁷⁵ For example, the FDIC steered bank bids to preferred buyers who received greater subsidies (such as the sale of Morgan Stanley to Bank of America) and let banks issue over \$300 billion in FDIC-guaranteed bonds, which allowed banks to recapitalize at a much lower interest rate.⁷⁶ These actions stretched the role of the FDIC and blurred the distinction between bailouts and the FDIC’s historic wind-up role.

The Dodd-Frank Act modifies and expands the FDIC’s involvement in winding up institutions whose failure would have “serious adverse effects on economic conditions or financial stability.”⁷⁷ While FDIC banks will continue to be covered under the FDIC insurance fund, the legislation creates a new “orderly liquidation authority” (OLA) funded by the Treasury Department for winding up systemically important financial institutions

71. The FDIC’s tools include: “open bank assistance; conservatorship; creation of a bridge bank or deposit insurance national bank; a purchase and assumption transaction with a healthy bank; an insured deposit transfer; and a depositor payoff.” See Ragalevsky & Ricardi, *supra* note 9, at 875; see also OFFICE OF THE COMPTROLLER OF THE CURRENCY, AN EXAMINER’S GUIDE TO PROBLEM BANK IDENTIFICATION, REHABILITATION, AND RESOLUTION 65–66 (2001).

72. The bidding process and due diligence for the winning bidder typically takes about thirty days. Ragalevsky & Ricardi, *supra* note 9, at 872.

73. The FDIC generally closes the institution and dismisses its officers and directors. FDIC RESOLUTIONS HANDBOOK, *supra* note 70, at 70; 12 U.S.C. § 1821(d)–(f) (2006). After the FDIC pays secured claims, the FDIC covers its administrative expenses as receiver and then pays in descending priority both insured and uninsured deposit liabilities, senior unsecured creditors, general unsecured creditors, and lastly, shareholder claims. 12 U.S.C. § 1821(d)(10)–(11). While the FDIC alternatively may choose to act as a conservator and operate the institution as an ongoing concern, this option is rarely pursued. FDIC RESOLUTIONS HANDBOOK, *supra* note 70, at 69 n.2 (1998).

74. 12 U.S.C. § 1823(c)(4)(G).

75. *Id.*

76. Before the FDIC can take extraordinary actions such as these, the Secretary of the Treasury must consult with the President and receive the approval by a two-thirds majority of the Federal Reserve Board and the FDIC’s Board of Directors. ROBERT S. CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 731–32 (4th ed. Wolters Kluwer 2009).

77. 12 U.S.C. § 1823(c)(4)(G); see also Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections of 12 U.S.C.).

that are not FDIC-insured.⁷⁸

The FDIC will intervene as a receiver for a covered financial company⁷⁹ if: (1) the firm is in or is near default;⁸⁰ (2) its failure would “have serious adverse effects on financial stability”;⁸¹ or (3) there is no private sector alternative to prevent the company’s default.⁸² The OLA extends the FDIC’s typical resolution authority by allowing it to create “a bridge financial company”;⁸³ engage in financing activities, but not assume equity stakes;⁸⁴ appoint itself as the receiver for subsidiaries;⁸⁵ engage the private sector to assist in the management and disposition of assets;⁸⁶ and request assistance from and provide assistance to foreign financial authorities.⁸⁷ In short, the FDIC enjoys sweeping powers to oversee the wind-up of firms related to the financial sector and to dispose of their assets.

78. Dodd-Frank Act §§ 201(a), 203(b), 210(n). Potential SIFIs include a broad range of financial firms, such as bank holding companies, financial holding companies, nonbank financial companies supervised by the Federal Reserve or predominantly engaged in activities the Federal Reserve deems financial in nature, their subsidiaries, and SEC-registered brokers or dealers who are members of the Securities Investor Protection Corporation (SIPC). However, insured depository institutions are not included under the OLA because insured depository institutions are already subject to the FDIC’s resolution authority and procedures. *Id.* § 201(a)(7)–(9), (11).

79. In the case of SEC-registered brokers or dealers, SIPC will oversee the OLA procedures but will receive assistance from the FDIC, which also has the authority to fund a bridge financial company. *Id.* § 208.

80. Dodd-Frank defines “Default or in Danger of Default” to include: (1) a pending or imminent filing of a petition under the Bankruptcy Code; (2) a likely incursion of losses that will significantly diminish or eliminate all of the company’s capital and there is no prospect for the company to avoid these losses; (3) the assets are likely to be “less than its obligations to” its creditors; and (4) the company is or will be unable to honor its obligations. These provisions preempt submission to the typical bankruptcy procedures under the U.S. Bankruptcy Code. *Id.* § 203(c)(4).

81. The FDIC may also intervene if (1) losses to the company’s creditors, counterparties, and shareholders would affect financial stability; (2) the use of the OLA, would be less harmful to the financial system and the U.S. taxpayer; (3) a federal regulator has ordered the company to convert convertible debt instruments; or, (4) the company is not an insured depository institution (though the company may have insured deposit-taking subsidiaries). *Id.* § 203(b).

82. When determining whether an institution will go through the OLA, the Secretary of the Treasury, in conjunction with the Federal Reserve or the FDIC (or the SEC for brokers or dealers), must recommend that the institution in question be liquidated and that the FDIC serve as the receiver. This recommendation must also be approved by a two-thirds majority vote by the Federal Reserve Board and the FDIC Board of Directors (or the SEC for brokers or dealers). *Id.* §§ 202(a), 203.

83. *Id.* § 210(a)(1)(F). This mirrors the FDIC’s pre-Dodd-Frank Act ability to create a “bridge bank” for faltering institutions. 12 U.S.C. § 1821(d)(2)(F) (2006).

84. H.R. 4173, §§ 204(d), 206, 210(b).

85. *Id.* § 210(a)(1)(E).

86. *Id.* § 210(a)(1)(L).

87. *Id.* § 210(a)(1)(N).

3. The Challenges of Delineating Bailouts

While the Dodd-Frank Act both expanded and more clearly delineated the FDIC's role in winding up insolvent companies, Congress has failed to create a parallel institution or framework for handling future bailouts. Bailouts form a middle ground of government intervention between nationalizations and wind-ups of companies. In nationalizations, the government takes complete control; in wind-ups, the government assumes control for a short time for the limited purpose of liquidating the company.⁸⁸ In contrast, this Article argues that bailouts should be understood as investments in private companies to provide liquidity and stability during financial crises. Bailouts must be linked with investment returns and conditions, both to cover the government's assumption of risk and to mitigate moral hazard. In bailouts, the government does not take direct managerial control of the company and only possesses a percentage of the debt or equity holdings of the company. The goal is to preserve beneficiaries as independent concerns and to mitigate the risk of future financial crises.⁸⁹

Bailouts constitute a spectrum of government aid to private companies that come with significant strings attached. In federalizations, the government assumes the liabilities of a faltering company without assuming any creditor status, managerial role, or any other conditions.⁹⁰ Bailouts share the same purpose of federalizations in strengthening the solvency and viability of private enterprises. But while federalizations constitute a form of direct subsidies or grants from the public to private sector, bailouts generally demand ultimate repayment of the principal and may be linked to a range of other quid pro quos for government assistance.⁹¹ Bailout conditions can be as simple as repaying the funds that the Federal Reserve offers a bank for emergency lending, along with a modest level of interest. Alternatively, bailouts may come with extensive strings attached, requiring corporate governance changes or compliance steps designed to safeguard the government's investments or to advance regulatory policy.⁹²

88. See *supra* Subsections II.A.1–2.

89. However, as politicians note, the potential for bailouts creates the choice between “either funding a bank bailout or plunging into an economic crisis.” Jake Tapper & Jonathan Karl, *Financial Reform Bill: Can Democratic Legislation Prevent Future Bank Bailouts?*, ABC NEWS (Apr. 14, 2010), <http://abcnews.go.com/WN/financial-reform-bill-obama-prevent-bailouts-republicans-disagree/story?id=10376893> (quoting President Barack Obama).

90. The classic cases of federalization are the government's assumption of natural disaster or terrorist liabilities from private companies and individuals, where the federal government makes victims whole at no cost to them (if the disaster is large enough). See Manns, *supra* note 52, at 2526–27.

91. See, e.g., J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. REG. 283, 301 (2010) (explaining that the government as a creditor may, at its discretion, impose limitations on bank operations).

92. See *id.* at 303.

Bailouts serve as a hybrid of stabilization, insurance, and investment. Both actual and potential bailouts have significant stabilization value for markets and individual companies. While “too big to fail” was a catchphrase throughout the recent crisis,⁹³ the more significant concern was the degree of interconnectedness between financial and nonfinancial companies.⁹⁴ The specter of a “domino effect”—one company’s default catapulting its partners into failure—drove legislators to make capital infusions into a broad swath of the financial sector.⁹⁵ The recent bailouts arguably succeeded in quelling the panic that was engulfing financial markets. Individual beneficiaries could point to bailout money as a vote of confidence in their continued viability.⁹⁶ As importantly, the liquidity provided by the government allowed financial institutions to meet the demands of depositors without having to dramatically reduce lending and credit lines to other enterprises. While few members of the public have been pleased with the anemic economic recovery, the infusion of capital did serve an important stabilization role that dampened the financial crisis’ impact.⁹⁷

Bailouts also function as de facto creditor insurance because of the strong likelihood of government intervention if there is a broad liquidity crisis. The rationale is that the impact of systemic risk events may be so significant that a federal backstop is necessary to reassure foreign and domestic investors about the viability of American debt and equity markets.⁹⁸ Prospective beneficiaries, however, do not pay into a bailout insurance fund, along the lines of the FDIC for commercial banks, so there is no express assurance to debt or equity holders.⁹⁹ Nonetheless, the

93. See Marcelo Dabòs, *Too Big to Fail in the Banking Industry: A Survey*, in *TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS* 141, 141–43 (Benton E. Gup ed., 2004) (discussing the moral hazard caused by large banks’ expectations of inevitable government support in a crisis).

94. See Brunnermeier et al., *supra* note 5, at 24 (noting that there are some “institutions . . . so large, so massively interconnected, and so iconic as ‘national champions’ that no government would ever allow them to fail”).

95. See Tracy A. Thomas, *Bailouts, Bonuses, and the Return of Unjust Gains*, 87 WASH. U. L. REV. 437, 437–38 (2009) (observing how concerns of a “cataclysmic domino effect” drove policymakers to engage in bailouts).

96. See Deborah Solomon et al., *U.S. to Buy Stakes in Nation’s Largest Banks*, WALL ST. J., Oct. 14, 2008, at A1 (discussing how a primary purpose of bailouts is to restore investor confidence).

97. See, e.g., Ayotte & Skeel, *supra* note 20, at 472–73 (acknowledging that some of the bailout efforts have had “stabilizing effects”).

98. See Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 475–76 n.225 (1997) (discussing how market participants may respond to systemic risk by sending their capital to other markets which could have destabilizing effects on the U.S. economy).

99. Some academics have proposed an insurance approach to address corporate failures across the board. See, e.g., Pederson & Roubini, *supra* note 5; Jeffrey N. Gordon & Christopher Muller, *Avoiding Eight-Alarm Fires in the Political Economy of Systemic Risk Management*

potential for federal bailouts may significantly lower the cost of borrowing for companies, helping to stabilize the economy as a whole.

The implied insurance and stabilization roles are the two rationales policymakers most frequently raise to support bailouts.¹⁰⁰ The problem is that the pursuit of these two objectives by themselves may magnify moral hazards and dangers of overuse or abuse by government and corporate beneficiaries, who may seek to engage in greater risk-taking at the public's expense. This problem is heightened further by the federal government's "break even" approach to overall bailout interventions, an approach that provides few disincentives against firms engaging in excessive leverage and risk-taking.¹⁰¹ In other words, the absence of a mandate for the government to seek long-term investment returns from bailouts not only shortchanges taxpayers, but also may undermine any deterrent effect for financial firms. If companies recognize that they can receive government aid if a financial crisis is large enough, they may be tempted to maximize risks (and profit potential) with the hope of externalizing losses to the government.¹⁰²

For this reason, the federal government needs an investor-oriented approach to temper the moral hazards from pursuing stabilization and insurance goals. A long-term investment approach for bailouts would serve a dual purpose: it would safeguard taxpayers' interests by providing compensation for the government's assumption of risk, and it would create disincentives against firms' leveraging potential bailouts to engage in risk-taking. Establishing investment-oriented conditions would ensure that beneficiaries receive the funding that they need during financial crises, yet are deterred from dipping too early or too far into the government's well and transforming aid into a de facto hedge position.

The logic behind the federal government's role as an investor during financial crises is that the government has a time horizon far longer than most investors and enjoys the wherewithal to borrow large sums at below-market terms because of its taxing power.¹⁰³ This fact creates an arbitrage

(Columbia L. and Econ. Research, Working Paper No. 369, 2010), available at <http://www.ssrn.com/abstract=1553880>. But this Article argues that the deterrent value of an investor-oriented bailout is even stronger, in that companies would not be able to rely on the certainty of a bailout and would face more consequences if they received bailout funds.

100. See, e.g., CONG. OVERSIGHT PANEL, APRIL OVERSIGHT REPORT: ASSESSING TREASURY'S STRATEGY: SIX MONTHS OF TARP 25–26 (2009), available at <http://cybercemetery.unt.edu/archive/cop/20110402034949/http://cop.senate.gov/documents/cop-040709-report.pdf> (detailing the "unprecedented set of steps to stabilize the financial system").

101. See *infra* Sections III.A–B.

102. See Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 210–11, 225 & n.198 (2008) (discussing how the possibility of a government safety net may magnify moral hazards for banks).

103. See, e.g., Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructurings*, 53 EMORY L.J. 1115, 1117–18 (2004) (discussing the advantages sovereign borrowers enjoy over private sector parties).

opportunity. Government investments can allow companies to bridge short-term financial gaps, yet face long-term repayment obligations that extend beyond the time horizon of a crisis. In the process, the federal government can expand overall liquidity through its investments by heightening market confidence.

The dilemma the federal government faces in offering bailouts is determining how to price and condition aid. While there is a spectrum of options at the government's disposal, three methods—federalization, “break even,” and investment approaches—cover the ambit of major possibilities. The federalization of liabilities is the political temptress, as it epitomizes moral hazard in shifting liabilities from the private to public sector.¹⁰⁴ Crises not only fuel financial overreactions, but also political panic.¹⁰⁵ For this reason, politicians' first instinct may be for aid with few strings attached, in order to stimulate the economy at any cost. Politicians' primary constraint may be the fear of backlashes at giveaways to the private sector.¹⁰⁶

By comparison, the federal government's approach of seeking to “break even” on overall bailout investments may seem to be an alluring middle ground. By disavowing any motive other than stabilizing markets, the government may reassure market competitors and investors that the federal government does not intend to usurp their role. The challenge is that a break even approach ignores the significant risk exposure the government is assuming and, just as importantly, such an approach may have marginal deterrent effects, if any.¹⁰⁷ If the “price” of excessive risk-taking is simply a loan on favorable terms, then banks have little to lose and much to gain by pushing the envelope with ever-bolder bets as they seek to leverage the government's superior borrowing power still further.

In contrast, approaching bailouts as investments recognizes that government financing during crises potentially creates windfalls for the private sector and therefore may fuel moral hazard.¹⁰⁸ By adopting an investment approach, the federal government can secure stabilization and

104. See Boardman, *supra* note 54, at 784–85 (discussing politicians' temptations to federalize liabilities).

105. Memories of successful economic slogans such as Bill Clinton's mantra, “It's the economy, stupid,” likely cast shivers down the spines of incumbent politicians and make federalizations tempting. See, e.g., John Harwood, *In Many Venues, Economy Will Take Center Stage*, N.Y. TIMES, Jan. 14, 2008, at A18.

106. See Hulse & Herszenhorn, *supra* note 1 (discussing Republicans' response to the bailout backlash).

107. See Lori Montgomery, *TARP Expected to Cost U.S. Only \$25 Billion, CBO Says*, WASH. POST, Nov. 30, 2010 (discussing the federal government's “break even” objective for overall TARP investments, although noting the disconnect between the TARP losses and the “substantial financial risk” the U.S. assumed with the TARP and other “massive government programs aimed at propping up the financial industry”).

108. See *infra* Sections III.A–B.

insurance goals, while still securing long-term returns for investors and deterring firms from overreliance on state financing. The challenge is pricing investments because during the depths of a crisis, the federal government may be a natural monopoly, serving as an investor of last resort. As such, the federal government could impose monopoly pricing that would compromise the stabilization and insurance purposes of bailouts. Instead, as Part III will explore in detail, the best limiting principle for government investments would be a “proportional share” approach that would link profit-sharing over a set time horizon to the government’s percentage contribution to company capitalizations.¹⁰⁹ This approach would ensure that beneficiaries share both risks and returns with taxpayers and create disincentives against overreliance on bailout funds and excessive risk-taking.

II. THE SHORTCOMINGS OF THE RECENT BAILOUTS

While the federal government sought modest returns for individual bailout investments, there was no clear bailout paradigm, aside from stabilizing the financial system and coming as close to breaking even as possible.¹¹⁰ Part of the problem was that incoherence, ad hocery, and ambiguity defined the government’s initial responses to the financial crisis.¹¹¹ Policymakers could not seem to make up their minds about whether to choose nationalizations, federalizations, wind-ups, or bailouts for faltering firms. In some cases, the government simply let private firms face the hard medicine of bankruptcy without government support, as was the case with the high-profile collapse of Lehman Brothers.¹¹² In other cases, the government effectively nationalized failing companies, such as Fannie Mae and Freddie Mac.¹¹³

While FDIC wind-ups applied consistently to small and mid-size banks, the federal government breached the autonomy that the FDIC normally enjoys and engaged in a hodgepodge of interventions to support sales of large banks. For example, the Treasury Secretary offered assurances over the sales of Wachovia; other fire sales, such as Bear Stearns, enjoyed financial guarantees from the Federal Reserve.¹¹⁴

109. See *infra* Subsection III.A.3.

110. See Ayotte & Skeel, *supra* note 20, at 470 (noting that “it was hard to distill a consistent policy rule from the government’s rescue efforts,” yet arguing that “one guiding principle was its preference to avoid all possible bankruptcy filings”).

111. See Nocera, *supra* note 12, at 9 (defending the Bush and Obama Administrations’ response to the financial crisis by arguing that “[w]hen you are really in the midst of a crisis, there is no plan. You have to take actions on an ad hoc basis and hope for the best”).

112. See Ayotte & Skeel, *supra* note 20, at 470. “Private” bankruptcy entails the use of government bankruptcy procedures and courts, but unlike FDIC bankruptcies, it does not entail government aid or direct intervention. See 11 U.S.C. §§ 701–07; 11 U.S.C. §§ 1101–16.

113. See *supra* notes 43–47 and accompanying text.

114. See Ayotte & Skeel, *supra* note 20, at 469–70, 491–92 n.117 (discussing the Treasury

A. *The Troubled Asset Relief Program*

The Troubled Asset Relief Program (TARP) sought to bring some clarity to the chaos by creating a framework for doling out \$700 billion in bailout money.¹¹⁵ This approach represented a tentative step towards embracing an investor-oriented approach. But in practice the TARP was poorly designed as bank profits dwarfed the (at best) modest returns to taxpayers in the case of each beneficiary (and the overall losses).¹¹⁶

The TARP was originally envisioned as a plan for the Treasury Department to purchase or insure up to \$700 billion of “troubled assets.” These troubled assets included mortgages and related collateralized debt obligations (such as mortgage-backed securities), as well as “any other financial instrument” that the Treasury Department and Federal Reserve deemed necessary “to promote financial market stability.”¹¹⁷ The TARP’s initial purpose was to enhance liquidity of collateralized debt obligations whose underlying mortgage portfolios had become suspect and disfavored by investors amidst the surge in foreclosures.¹¹⁸ In turn, the Treasury Department’s purchases of these assets were intended to help banks firm up their balance sheets and expand lending.¹¹⁹

But this toxic asset purchase plan stumbled as a large-scale solution from the beginning because the Treasury Department lacked a guiding principle for making these investments.¹²⁰ The dilemma was that

Department’s and Federal Reserve’s extraordinary interventions in the wind-ups or emergency sales of many of the major banks and non-bank financial institutions during the crisis).

115. See Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008) (to be codified in scattered sections of 12 U.S.C.); Montgomery, *supra* note 107 (noting how the TARP program constituted a “\$700 billion bailout for Wall Street titans”).

116. Compare Zachery Kouwe, *Wall Street on Track for Record in Profits*, N.Y. TIMES, Nov. 17, 2009, at B8, available at <http://www.nytimes.com/2009/11/18/business/18wall.html> (discussing anticipated bonuses of over \$162 billion for the top six banks in 2009), with Montgomery, *supra* note 107 (discussing how the expected \$25 billion in losses from TARP investments excludes the much larger losses from other “massive government programs aimed at propping up the financial industry”).

117. See Emergency Economic Stabilization Act §§ 3(9)(A)–(B).

118. *Id.* § 2(a)(1).

119. The underlying logic of this approach is that the government could pay a premium for these assets over their market value because asset values would rise to reflect mortgage income streams once the financial crisis subsided. See Schwarcz, *supra* note 102, at 229.

120. The Treasury Department reversed course again on March 23, 2009 and revived a smaller-scale version of this program with the creation of the Legacy Securities Public-Private Investment Program. To date, this program has only \$29.4 billion in financing (half of which is provided by the Treasury), which is being used to purchase mortgage-backed securities. Given that the dollar amount of mortgage-backed securities numbers in the trillions, it is a relative drop in the bucket compared to TARP’s initial vision for purchasing toxic assets. See U.S. DEP’T OF THE TREASURY, LEGACY SECURITIES PUBLIC-PRIVATE INVESTMENT PROGRAM: PROGRAM UPDATE FOR QUARTER ENDED JUNE 30, 2010, at 3 (2010), available at <http://www.treasury.gov/initiatives/>

purchasing mortgages and collateralized debt obligations at market value during a time of crisis would not fix banks' balance sheets, while purchasing these assets at face value would constitute an extraordinary windfall for the financial sector and be a raw transfer from the public to private sector. While the federal government did engage in some purchases of collateralized debt obligations, such as \$50 billion of AIG collateralized debt obligations,¹²¹ the Bush Administration swiftly moved TARP's focus away from direct toxic asset purchases to preferred stock investments in banks under the Capital Purchase Program.¹²²

The logic behind preferred stock investments was that banks could count these monies towards their Tier 1 capital requirements for solvency, theoretically freeing up money for greater lending to the public.¹²³ The Treasury's terms were exceptionally generous, with dividend rates of 5% per year for the preferred stock for the first five years, well below the rates that financial institutions could secure on private markets during the depths of the crisis.¹²⁴ Additionally, the Treasury Department required beneficiaries to issue equity warrants (options to purchase nonvoting shares).¹²⁵ Each TARP beneficiary was required to issue ten-year warrants

financial-stability/programs/Credit%20Market%20Programs/ppip/Documents/External%20Report%20-%202006-11%20vFinal.pdf; see also U.S. DEP'T OF THE TREASURY, LEGACY SECURITIES PUBLIC-PRIVATE INVESTMENT PROGRAM: ADDITIONAL FREQUENTLY ASKED QUESTIONS 9 (2009), available at http://www.treasury.gov/press-center/press-releases/Documents/legacy_security_faqs.pdf.

121. See Matthew Karnitschnig, Liam Plevin & Serena Ng, *U.S. Throws New Lifeline to AIG, Scrapping Original Rescue Deal*, WALL ST. J., Nov. 10, 2008, at A1 (documenting the \$150 billion in government aid to AIG, which included \$60 billion in loans, \$40 billion in preferred stock, and \$50 billion in purchases of distressed assets).

122. See Press Release, U.S. Dep't of the Treasury, Treasury Announces TARP Capital Purchase Program Description (Oct. 14, 2008), available at <http://www.treasury.gov/press-center/press-releases/Pages/hp1207.aspx>. The Bush Administration exploited the exception clause granting discretion to purchase "any other financial instrument" deemed necessary "to promote financial market stability" to largely abandon the initial toxic asset purchase plan. See Emergency Economic Stabilization Act of 2008 §§ 3(9)(A)–(B).

123. A number of commentators have shown that the purchase of preferred stock has done little to increase bank lending. See generally Linus Wilson, *Debt Overhang and Bank Bailouts* (Sept. 12, 2009) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1336288 (arguing that infusions of capital through preferred stock have little impact on bank lending and less effect than other alternatives, such as the purchase of toxic assets).

124. Press Release, TARP Capital Purchase Program, Senior Preferred Stock and Warrants: Summary of Senior Preferred Terms 2, <http://www.treasury.gov/press-center/press-releases/Documents/document5hp1207.pdf> (last visited Sept. 23, 2011). While the preferred stock's dividends would rise to 9% after five years, this provision was moot, as the Capital Purchase Program was designed to incentivize banks either to pay off their obligations by this point or to convert the investment to equity shares. *Id.*

125. See Press Release, U.S. Dep't of the Treasury, Treasury Announces Warrant Repurchase and Disposition Process for the Capital Purchase Program (June 26, 2009), available at <http://www.treasury.gov/press-center/press-releases/Pages/200962612255225533.aspx>. Private banks could alternatively issue equivalent equity or senior debt instruments. *Id.*

that totaled 15% of the TARP investment, divided by the exercise price (which was the average of the beneficiaries' stock price prior to receipt of TARP monies).¹²⁶ In theory, the Treasury Department could redeem its investment by purchasing common stock at prices fixed at the time of its investment, so that it could reap returns from potential stock appreciation.¹²⁷

The warrant approach was designed to give the Treasury Department some degree of exposure to the upside of recovering banks, as it was clear to all observers that the 5% dividend yield bore no relation to the degree of the government's assumption of risk.¹²⁸ Unfortunately, the devil is in the details in two ways. First, the fact that the warrants reflected only 15% of the value of TARP investments placed significant limits on the government's exposure to the potential upside of a recovery.¹²⁹ Second, the ten-year warrants proved to be an illusory time frame. Instead, the government effectively gave beneficiaries the option of when to redeem the warrants and preferred stock once the economy stabilized. In practice, that meant that the banks had every incentive and opportunity to cash out the government's warrants at a low stock price once they could secure financing from the private sector. As a result, the Treasury Department's foray into investing was cut short for most of the major bank beneficiaries. Instead managers and shareholders reaped the returns from a surging stock market within a year of the TARP investments.¹³⁰

1. The Case of Goldman Sachs

Goldman Sachs' handling of TARP and related bailout monies underscores the degree of opportunism by beneficiaries and the modest returns on the government's investments. Goldman Sachs transformed itself overnight from a barely regulated investment bank into a more

126. *Id.*

127. Banks with more than \$500 million in assets were limited to issuing preferred stock to the Treasury Department equal to 3% of their risk-based capital. Banks with \$500 million or less in assets could issue preferred stock to the Treasury Department equal to 5% of their risk-based capital and only had to issue warrants to cover 3% of their risk-based capital. *See* Press Release, U.S. Dep't of the Treasury, Frequently Asked Questions Regarding the Capital Purchase Program (CPP) for Small Banks, available at <http://www.treasury.gov/initiatives/financial-stability/programs/investment-programs/cpp/Documents/FAQonCPPforsmallbanks.pdf> (last visited Sept. 23, 2011).

128. Jon Hilsenrath, *Bailouts Yield Returns Amid Risk*, WALL ST. J., Sept. 2, 2009, at A10, available at <http://online.wsj.com/article/SB125176287995474339.html>.

129. OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, ASSESSING TREASURY'S PROCESS TO SELL WARRANTS RECEIVED FROM TARP RECIPIENTS 1 (2010), available at [http://www.sigtar.gov/reports/audit/2010/Assessing Treasury's Process to Sell Warrants Received From TARP Recipients_May_11_2010.pdf](http://www.sigtar.gov/reports/audit/2010/Assessing%20Treasury's%20Process%20to%20Sell%20Warrants%20Received%20From%20TARP%20Recipients_May_11_2010.pdf).

130. David Milken, *U.S. TARP Warrant Plan Favors Banks, Professor Says*, BLOOMBERG (July 1, 2009, 10:25 AM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aDdsEXq94Pw0>.

regulated bank holding company, in order to be eligible for bailout monies.¹³¹ Goldman Sachs received a direct infusion of \$10 billion in TARP money during the lowest depths of the economic crisis, money that not only stabilized its balance sheets but also was a vote of confidence to equity markets concerning Goldman Sachs' continued viability.¹³² As significantly, Goldman Sachs was the counterparty to a significant percentage of AIG's derivative contracts and received \$12.9 billion of AIG's bailout monies, as well as billions more from other TARP recipients.¹³³ In addition to the TARP aid, Goldman Sachs was allowed to issue \$29 billion of FDIC-guaranteed bonds, letting the company raise money far more cheaply than it could have on its own.¹³⁴ But for over \$50 billion in bailout-related funds, Goldman Sachs' liability exposure during the depths of the crisis could have toppled the company, which meant its continued viability was largely due to the federal government's intervention.¹³⁵

The redemption of Goldman Sachs' preferred stock and warrants underscores how little the United States reaped, given the significant extent of its assumption of risk (and Goldman Sachs' literal and metaphorical debt to the government). In October 2008, the Treasury Department gave Goldman Sachs \$10 billion in TARP monies,¹³⁶ in exchange for \$10 billion of cumulative preferred stock with a 5% annual dividend rate for the first five years, as well as ten-year warrants to purchase up to 12.2 million shares of common Goldman Sachs stock at an exercise price of \$122.90 per share.¹³⁷

From October 28, 2008 to July 22, 2009, Goldman Sachs paid the 5% interest owed on the preferred stock, totaling \$318 million.¹³⁸ Then on July

131. See Lisa Schultz Bressman & Robert B. Thompson, *The Future of Agency Independence*, 63 VAND. L. REV. 599, 625 (2010) (discussing how Goldman Sachs' and Morgan Stanley's conversion to bank holding companies allowed them to access funds on favorable terms from the Federal Reserve's discount window).

132. See U.S. SEC, Form 10-K: The Goldman Sachs Group, Inc. 180, available at <http://www2.goldmansachs.com/our-firm/investors/financials/archived/10k/docs/2008-10k-doc.pdf>.

133. See Paritosh Bansal, *Goldman's Share of AIG Bailout Money Draws Fire*, REUTERS, Mar. 18, 2009, <http://www.reuters.com/article/idUSTRE52H0B520090318>.

134. See Andrew Bary, *How Do You Spell Sweet Deal? For Banks, It's TLGP*, BARRON'S, Apr. 20, 2009, http://online.barrons.com/article/SB124001886675331247.html#articleTabs_panel_article%3D1.

135. See David Leonhardt, *Heading Off the Next Financial Crisis*, N.Y. TIMES, Mar. 25, 2010, at MM36 (discussing how "Goldman and Morgan Stanley might not have survived without government aid").

136. See U.S. SEC, Form 10-K: The Goldman Sachs Group, Inc. 179–80, available at <http://www2.goldmansachs.com/our-firm/investors/financials/archived/10k/docs/2008-10k-doc.pdf>.

137. The warrant total is calculated by dividing 15% of the \$10 billion of TARP investments (that is, \$1.5 billion) by the average Goldman Sachs share price of \$122.90 per share during the twenty-day period prior to receipt of TARP funds. See *id.* at 129.

138. *Goldman Sachs Pays \$1.1 Billion to Redeem Warrants*, CNBC.COM (July 22, 2009, 5:20

22, 2009 (less than nine months after the investment), Goldman Sachs redeemed the warrants for \$1.1 billion, which the Congressional Oversight Panel deemed was within the \$925 million to \$1.25 billion value of the warrants *at that time*.¹³⁹ The 23% annualized return on the TARP money looks impressive at first glance. The problem is that when one begins to break down the numbers and determine how much the early redemption by Goldman Sachs cost taxpayers, the degree of shortchanging becomes clear.

All one must do is examine the contemporaneous purchase of \$5 billion in Goldman Sachs' preferred stock and warrants by Warren Buffett's Berkshire Hathaway to understand how an investor would have approached this same investment. Warren Buffett's September 23, 2008 investment in Goldman Sachs secured 10% dividends on preferred stock, twice the level of dividends that the federal government secured.¹⁴⁰ Buffett also secured five-year warrants that would allow Berkshire Hathaway to convert its \$5 billion investment into the equivalent of \$5 billion of common stock priced on the day of his initial investment (\$115 per share).¹⁴¹ What this means is that if Warren Buffett had converted his preferred shares on the same day as the federal government (July 22, 2009), he would have reaped \$2.7 billion in returns, plus an additional \$357.5 million in dividends over that time. In other words, Warren Buffett's investment yielded more than *double* the rate of return of the federal government, even though he was assuming the same level of risk. By the time Goldman Sachs redeemed Warren Buffett's preferred shares in March of 2011, Buffett had paper profits of \$3.7 billion on a \$5 billion investment, a 74% return that dwarfed the federal government's now more modest-appearing returns.¹⁴² Of course, because Buffett is acting as a long-term investor, he has retained his common stock warrants, as he wisely recognized that Goldman Sachs may have more potential upside in the years to come.

It is safe to say the executives of Goldman Sachs understood this logic when they cashed out the United States' TARP shares well before the full

PM), http://www.cnn.com/id/32085262/Goldman_Sachs_Pays_1_1_Billion_to_Redeem_Warrants.

139. See *Goldman Sachs Warrant Price "Right On"—Watchdog*, REUTERS (July 22, 2009, 4:06 PM), <http://www.reuters.com/article/idUSWBT01149320090722> (referencing Congressional Oversight Committee Chair Elizabeth Warren's opinion that the Goldman Sachs warrants were purchased at a fair price).

140. See Alex Crippen, *Warren Buffett's Goldman Sachs Warrants Rebound from Deep Losses*, CNBC NEWS (Mar. 24, 2009), http://www.cnn.com/id/29860039/Warren_Buffett_s_Goldman_Sachs_Warrants_Rebound_From_Deep_Losses.

141. See Susanne Craig, Matthew Karnitschnig & Aaron Lucchetti, *Buffett to Invest \$5 Billion in Goldman*, WALL ST. J., Sept. 24, 2008, at A1, available at <http://online.wsj.com/article/SB122220798359168765.html#printMode>.

142. See Andrew Frye, *Buffett Generates \$3.7 Billion on 2008 Goldman Sachs Investment*, BLOOMBERG NEWS (Mar. 18, 2011, 4:46 PM), <http://www.bloomberg.com/news/2011-03-18/buffett-generates-3-7-billion-from-goldman-investment-made-during-crisis.html>.

recovery of the stock price.¹⁴³ Goldman Sachs' earnings and compensation to employees totaled almost \$30 billion in 2009, consisting of \$16.2 billion in employee compensation and bonuses (an increase of 37% from the previous year), as well as near-record profits of \$13.39 billion.¹⁴⁴ From this vantage point, the returns on the TARP investment in Goldman Sachs seem very slight relative to the significance of the Treasury Department's injection of capital. The reward for helping Goldman Sachs bridge the depths of the crisis was a premature payout that left Goldman Sachs executives to reap the returns from the Treasury Department's risk-taking.

To add insult to injury, Goldman Sachs held onto FDIC-backed loans of \$29 billion issued under the Temporary Loan Guarantee Program.¹⁴⁵ This means that Goldman Sachs has literally continued to profit from an implicit government subsidy (of lower borrowing costs of at least 2%), translating into even more free profit to \$700 million per year. Similarly, Goldman Sachs never paid a penny to the Treasury for the TARP funds it indirectly received through TARP bailouts of AIG and other financial institutions that owed Goldman Sachs funds.¹⁴⁶ Even these monies pale in comparison to the value of the implicit government backstop, which allows Goldman Sachs to maintain a leverage ratio of 20:1, a level the market likely would not tolerate but for faith in future government bailouts.¹⁴⁷ The bottom line is that Goldman Sachs has profited, and will continue to profit, from explicit and implicit government subsidies. It would not be difficult to tailor future bailouts in order to provide taxpayers with a greater percentage of the return attributable to government intervention and, in the process, to provide firms with deterrence against excessive risk-taking.

While Goldman Sachs deserves some blame, most of the fault for the poorly planned and executed bailouts rests with the federal government. The federal government failed to secure warrants that reflected the scale of significance of its investments, as warrants covered a meager \$1.5 billion of the bailout aid.¹⁴⁸ By allowing Goldman Sachs to redeem the warrants early at the time of Goldman Sachs' choosing, the federal government let

143. See, e.g., Eric Dash, *Treasury to Auction Off Big-Bank Warrants*, N.Y. TIMES, Nov. 20, 2009, at B3, available at <http://www.nytimes.com/2009/11/20/business/20bank.html> (estimating that if the federal government had held onto the Goldman Sachs warrants for another four months and benefited from the stock rise, the government would have almost doubled its investment and received upwards of \$2.1 billion, rather than the \$1.1 billion it received in July 2009).

144. See Tomoeh Murakami Tse, *Goldman Sachs Earns \$13 Billion in 2009*, WASH. POST, Jan. 22, 2010, at A13, available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/01/21/AR2010012101044.html>.

145. See Bary, *supra* note 134.

146. See Mark Pittman, *Goldman, Merrill Collect Billions After Fed's AIG Bailout Loans*, BLOOMBERG NEWS (Sept. 29, 2008, 12:41 AM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aTzTYtlNHSG8>.

147. See Bary, *supra* note 134.

148. See *supra* notes 137–38 and accompanying text.

most of the rewards serve as a windfall for Goldman Sachs executives and investors. The returns would have been even more substantial if the federal government sought warrants for the more than \$50 billion that directly and indirectly flowed to Goldman Sachs through the government's bailout of AIG and other financial institutions and FDIC-backed loans. Instead, the government stood by while Goldman Sachs executives reaped enormous profits at the public's expense and celebrated the taxpayers' billion dollars of actual returns. It is little wonder that bailouts have become a virtually pejorative term for shortchanging taxpayers and failing to provide deterrence against future financial risk-taking.

B. *Assessing the True Costs of Bailouts*

Goldman Sachs' substantial benefit from government aid is only one slice of the larger bailouts, and it is worthwhile to underscore the true costs of the bailouts. Defenders of the TARP point to the \$25 billion in losses from TARP investments to argue that the bailouts were not poorly run and that losses were less than anticipated.¹⁴⁹ TARP proponents also point to the fact that banks have not only repaid \$276 billion in loans, but have also paid \$45.8 billion in dividends on preferred stock investments, \$1.4 billion in interest on loans, and \$9 billion in proceeds from warrants, as evidence that the federal government has received returns for its \$475 billion in TARP investments.¹⁵⁰ There is some truth to this claim, as direct subsidies (and losses) from public transfers to the financial sector could have been more substantial, and the swift recovery of asset and equity prices mitigated this loss exposure.

But this analysis overlooks a deeper truth. Bailouts to banks were only part of a much larger set of multitrillion dollar transfers from the public to the private sector to address the financial crisis that almost doubled the national debt in a span of three years.¹⁵¹ Part of this story was the nationalization of Fannie Mae and Freddie Mac, a move that has set up the United States as the express backstop for \$5.14 trillion in mortgage-backed securities and guarantees, \$148 billion in direct bailout aid, and upwards of

149. See Montgomery, *supra* note 107 (discussing how the expected \$25 billion in losses from TARP investments excludes the much larger losses from other "massive government programs aimed at propping up the financial industry"); see also Deborah Solomon, *Light at the End of the Bailout Tunnel*, WALL ST. J., Apr. 12, 2010, at C1 (noting a higher figure of \$89 billion in projected TARP losses, but also observing that these losses do not include losses from Fannie Mae and Freddie Mac and other forms of support for housing and financial markets).

150. These returns are based on \$475 billion in direct investments of TARP money. See PRO PUBLICA, WHERE IS THE MONEY? EYE ON THE BAILOUT, <http://projects.propublica.org/bailout/main/summary> (last visited Sept. 23, 2011).

151. See CONG. BUDGET OFFICE, FEDERAL DEBT AND THE RISK OF A FISCAL CRISIS 2 (2010), available at http://www.cbo.gov/ftpdocs/116xx/doc11659/07-27_Debt_FiscalCrisis_Brief.pdf (noting that the federal debt held by the public rose from 36% of GDP in 2007 to 62% of GDP in 2010).

\$1 trillion in potential losses.¹⁵² Another part of the story is the stimulus package of \$790 billion¹⁵³ and related stimulus measures totaling an additional \$399 billion,¹⁵⁴ which were designed to spur demand and revive the economy from the financial crisis (and substantially added to the national debt).

An equally important part of the story is the shadow bailout that indirectly benefited financial institutions. The Federal Reserve has committed \$6.4 trillion to an array of initiatives to prop up the economy and has, to date, made \$1.5 trillion of actual expenditures.¹⁵⁵ The most significant of these efforts is the \$775.6 billion in purchases of mortgage-backed securities held by Fannie Mae and Freddie Mac, \$295.3 billion of U.S. government bond purchases, and \$109.5 billion in loans to banks backed by toxic assets.¹⁵⁶ Other aspects of the shadow bailout include the \$308.4 billion of FDIC-guaranteed bank loans under the Temporary Liquidity Guarantee Program and the \$45.4 billion that the FDIC has lost on bank bailouts.¹⁵⁷

While the ultimate tally of losses remains to be seen, it is clear that the financial crisis cost taxpayers immense sums.¹⁵⁸ The true cost of bailouts will not be known for years to come due to its impact in exacerbating an already spiraling national debt. It may be unrealistic for financial institutions to shoulder all of the losses that taxpayers face and ironically thwart the stabilizing purpose of bailouts in siphoning off funds for lending. But the government's approach to bailouts meant that the government faced substantial risks and losses at a time when TARP

152. See Davidoff & Zaring, *supra* note 31. The Congressional Budget Office's debt numbers do not include the nationalization of Fannie Mae and Freddie Mac's debt and the IOU's that the federal government owes to the Social Security and Medicare Trust funds. Inclusion of these figures would place debt levels much higher. See *id.* at 2–3; Edmund L. Andrews & Stephen Labaton, *Mortgage Giants Agreeable to Rescue Plan, but Its Cost Is Unknown*, N. Y. TIMES, Sept. 6, 2008, at A27.

153. See Shailagh Murray & Paul Kane, *Congress Reaches Stimulus Accord*, WASH. POST, Feb. 12, 2009 (documenting the cost and rationale for the main stimulus package).

154. Additional stimulus packages include the \$168 billion spent on the Economic Stimulus Act of 2008, \$8 billion in unemployment benefit extensions, \$195 billion for student loan guarantees, \$25 billion for the Advanced Technology Manufacturing program, and \$3 billion for the "Cash for Clunkers" Car Allowance Rebate System. See David Goldman, CNNMONEY.COM'S BAILOUT TRACKER, <http://money.cnn.com/news/storysupplement/economy/bailoustracker/> (last visited Sept. 23, 2011).

155. *Id.*

156. *Id.*

157. *Id.*; see also Edmund L. Andrews & David E. Sanger, *U.S. Is Finding Its Role in Business Hard to Unwind*, N. Y. TIMES, Sept. 13, 2009, at A1, available at <http://www.nytimes.com/2009/09/14/business/14big.html?pagewanted=all> (discussing the scale and role of the Temporary Liquidity Guarantee Program in the bailouts).

158. As importantly, the financial strain on the government may make it more difficult for the government to repeat its current approach of borrowing immense sums at low interest rates when future financial crises arise. See Hill, *supra* note 47, at 76 n.540.

beneficiaries went from life support to reaping exceptional profits from the bailouts and related government interventions.

1. The Costs of Ad Hocery

The costs of the government's bailout extend well beyond dollars and cents. Another "cost" of the program was the loss of legitimacy of the bailout method because of the shifting, ad hoc nature of these bailouts. This Article has focused on the Capital Purchase Program of TARP because this initiative has modest investment features that are relevant to this proposal's investor-oriented approach. But the Capital Purchase Program was only one of a dizzying range of TARP-financed bailout programs that the federal government embraced. For example, the Systemically Significant Financial Institutions Program (in spite of its seemingly broad nature) was a tailor-made bailout whose sole purpose was financing the Federal Reserve Bank of New York's purchases of AIG's toxic assets.¹⁵⁹ Other narrowly designed TARP initiatives included the Targeted Investment Program, which was "targeted" towards covering Bank of America's potential losses from its Treasury Department-brokered purchase of Merrill Lynch,¹⁶⁰ and the Auto Supplier Support Program, which was created solely to nationalize General Motors and to provide financing for Fiat's takeover of Chrysler.¹⁶¹ These TARP programs were soon complemented by a myriad of other initiatives: to purchase asset-backed securities consisting of student, automobile, credit card, and small business loans;¹⁶² to make loans to small businesses;¹⁶³ to make loans to

159. See U.S. DEP'T OF THE TREASURY, THIRD TRANCHE REPORT TO CONGRESS 1–2 (2008), available at <http://www.financialstability.gov/docs/TrancheReports/TrancheReport3a.pdf> (detailing the rationale for creating a specially tailored bailout program for AIG); William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 971–72 (2009) (discussing the financing and transactions for the AIG bailout).

160. See Press Release, Federal Reserve, Treasury, Federal Reserve, and the FDIC Provide Assistance to Bank of America (Jan. 16, 2009), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20090116a.htm> (discussing how this program covered Bank of America's losses that stemmed from the acquisition of Merrill Lynch).

161. Press Release, U.S. Dep't of the Treasury, Treasury Announces Auto Supplier Support Program (Mar. 19, 2009), available at <http://www.treasury.gov/press-center/press-releases/Pages/tg64.aspx>; Anna Malik, *U.S. to Sell Remaining 6 Percent Stake in Chrysler to Fiat*, NEWS RICKEY, June 3, 2011, <http://news.rickey.org/u-s-to-sell-remaining-6-percent-stake-in-chrysler-to-fiat/4528>; see also George W. Bush, *Remarks on the American Auto Industry: December 19, 2008*, GPO ACCESS 1568, 1569 (2008), available at <http://www.gpoaccess.gov/wcomp/v44no50.html> (discussing President Bush's rationale in unilaterally extending TARP funds to automakers).

162. See Anh P. Nguyen & Carl E. Enomoto, *The Troubled Asset Relief Program (TARP) and the Financial Crisis of 2007–2008*, 7 J. BUS. & ECON. RESEARCH 91, 94 (2009) (discussing the creation and contours of the Troubled Asset Loan Facility).

163. See Elizabeth Williamson, *Obama Rolls Out Small Business Lending Program*, WALL ST. J., Feb. 3, 2010, <http://online.wsj.com/article/SB10001424052748704022804575040722955784294.html> (discussing the creation of the \$30 billion Small Business Lending Program, which was

community development banks;¹⁶⁴ and to restructure underwater mortgages.¹⁶⁵

This byzantine system of bailouts was tailor-made for giving sweetheart deals to favored companies and made oversight and accountability more difficult.¹⁶⁶ It is little wonder that much of the public was left disillusioned about bailouts when so many companies and sectors of the economy had their own special bailouts and distinctive terms. This type of policymaking on the fly is prone to panicked overreactions, as well as opportunism, abuse, and capture by beneficiaries. Because both beneficiaries and policymakers faced no clear guidelines as to where TARP monies could extend next, it was easier for policymakers to push the bounds of bailouts and to scale back conditions on bailout monies. The absence of a clear bailout framework also encouraged companies to pressure politicians into having bailouts extend to previously uncovered risks such as credit derivatives, a problem the specially tailored bailout for AIG underscored.¹⁶⁷ The myriad of specially tailored bailouts raised the moral hazards for future bailouts, as companies may have greater incentives to magnify risk-taking to ensure that a debacle in their economic sector will capture the government's attention.

Ad hoc bailouts also sharpened conflicts of interests among banking regulators. For example, the expansion of the Federal Reserve's lending window into a de facto bailout fund during the early stages of the crisis placed the Federal Reserve in the contradictory position of propping up the

funded with TARP money).

164. See U.S. DEP'T OF THE TREASURY, TROUBLED ASSETS RELIEF PROGRAM, MONTHLY 105(A) REPORT, 14–15 (2010), available at http://www.treasury.gov/initiatives/financial-stability/briefing-room/reports/105/Documents105/March%202010%20105%28a%29%20monthly%20report_final.pdf (discussing the creation of the Community Development Capital Initiative announced in October 2009).

165. See U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE: UPDATED DETAILED PROGRAM DESCRIPTION 3–5 (2009), available at http://www.treasury.gov/press-center/press-releases/Documents/housing_fact_sheet.pdf.

166. The Dodd-Frank Act specifically limits the Federal Reserve's ability to make emergency loans to an individual company unless it is part of a program with broad-based eligibility. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1101(a)(2), 124 Stat. 1376, 2113 (2010) (to be codified at 12 U.S.C. § 343). The rationale for this limit is to guard against politically driven favoritism in the Federal Reserve's short-term lending through its discount window. The FGIC proposal would be partly consistent with this Federal Reserve limitation. Companies would need to meet the FGIC's capital requirements for eligibility for the broad-based program of bailout aid. However, the FGIC would enjoy discretion to tailor the terms of the bailout program to the company's particular circumstances and the overall economic context as part of its long-term investment approach. While this discretion would deviate from the limitations the Federal Reserve now faces, other safeguards this proposal lays out to establish the independence of the FGIC would seek to diminish the risk of politically driven favoritism in future bailouts. See *id.*

167. See Sjostrom, *supra* note 159, at 963–69, 979 (discussing how AIG successfully lobbied for specially tailored bailouts of its derivatives' losses).

financial institutions that it was supposed to regulate. Similar problems arose from the large-scale use of FDIC-backed bonds and the Treasury Department's TARP loans during later stages of the crisis. Having regulators simultaneously serve as lenders of last resort meant that regulatory mandates were likely to be subordinated or suspended in the process. Banking regulators failed to implement the prompt, corrective action requirements for financial institutions whose capital fell below required thresholds.¹⁶⁸ The absence of a clear bailout framework that delineated between regulatory and bailout roles made it easy for regulators to let their bailout roles supersede their primary responsibilities.

Lastly, ad hocery produced bailout relief without consequences. The federal government failed to tie bailout monies to significant changes on the part of the financial industry, and the modest conditions attached to TARP monies fell away as soon as the preferred stock and warrants were cashed out.¹⁶⁹ This fact meant that the government not only missed the chance to impose stronger conditions *ex ante*, but also gave up whatever leverage it had before it attempted substantive reforms.¹⁷⁰ For example, the TARP legislation imposed limits on executive pay and even allowed clawbacks to be imposed on bonuses.¹⁷¹ But these populist measures had little effect, as banks simply steered bonuses into stock options.¹⁷² Once TARP beneficiaries repaid their bonuses, the Treasury Department lacked the leverage and the political will to use clawbacks on the \$1.6 billion in bonuses that it deemed illegitimate.¹⁷³ Ironically, the financial institution executives who steered their firms to the brink of financial ruin cashed in on the stock market's surge following the government's large-scale intervention, while the government reaped little for its own massive assumption of risk and failed to exercise the recoupment tools it had.¹⁷⁴

168. See Shelley Smith, *Reforming the Law of Adhesion Contracts: A Judicial Response to the Subprime Mortgage Crisis*, 14 LEWIS & CLARK L. REV. 1035, 1070–71 (2010).

169. See David I. Walker, *The Challenge of Improving the Long-Term Focus of Executive Pay*, 51 B.C. L. REV. 435, 467 & n.159 (2010) (discussing how Goldman Sachs and other banks eagerly repaid their TARP monies to escape TARP conditions and scrutiny from federal regulators).

170. See Eric Dash, *10 Large Banks Allowed to Exit U.S. Aid Program*, N.Y. TIMES, June 9, 2009, at A1 (lamenting the fact that the Obama Administration had failed to impose reforms on banks as a condition of loans and was allowing banks out of the TARP without having implemented substantive reforms).

171. Simone M. Sepe, *Making Sense of Executive Compensation*, 36 DEL. J. CORP. L. 189, 232 n.184 (2011).

172. See Jim Puzzanghera & Nathaniel Popper, *Pay Czar Assails Bankers' Bonuses*, L.A. TIMES, July 24, 2010, at A1.

173. See *id.* (noting that Pay Czar Kenneth R. Feinberg criticized seventeen banks for giving excessive bonuses, but failed to exercise his powers to order a bonus clawback).

174. See Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 272–73 (2010) (arguing that TARP pay arrangements tying executive compensation to common

The limits of the government's ad hocery underscore the desirability of clearer institutional approach.

C. *The Shortcomings of the Dodd-Frank Act: The Bailout Gap*

The recently enacted Dodd-Frank Act sought to address the systemic risks that lay at the roots of the financial crisis in a number of ways, such as by imposing limits on banks' proprietary trading and heightening oversight of derivatives transactions.¹⁷⁵ But the bill created a "bailout gap" by failing to create a comprehensive framework for government financial intervention in the (likely) event reforms fail to preempt future crises.¹⁷⁶ To Congress's credit, the Dodd-Frank Act has made the circumstances and scope for FDIC wind-ups clearer by expanding the FDIC's role in liquidating insolvent financial companies.¹⁷⁷ Creating a broader framework for the swift liquidation of insolvent institutions is a step of progress that reduces uncertainties about this facet of financial crisis management.

However, Congress failed to address the need for an institutional framework to handle future bailouts and left a haze of uncertainty about how future bailouts would be addressed. This fact means that, at best, an ad hoc framework exists for dealing with financial and non-financial companies that need financing during future crises. This omission casts a shadow of significant unknowns over the marketplace as companies have been left with a wait-and-see approach towards what future cases may require government intervention short of a winding down of the firm.

Policymakers may simply be so optimistic about the efficacy of reforms in the Dodd-Frank Act that they believe there will be no need for future bailouts.¹⁷⁸ But more realistically, a majority in Congress has made the calculation that expressly acknowledging and addressing the need for bailouts would expose them to populist anger in the short term, and they would prefer to defer this difficult problem for future Congresses to handle.¹⁷⁹ The unfortunate truth is that our country may not be able to

stock appreciation created incentives for bank executives to return TARP monies and cash in their profits).

175. See Nathaniel Popper & Walter Hamilton, *Financial Reform Package Wouldn't Change Wall Street Much*, L.A. TIMES, June 26, 2010, at 1.

176. See David Zaring, *A Lack of Resolution*, 60 EMORY L.J. 97, 105 (2010) (discussing how the Dodd-Frank Act sought to prevent future bailouts of financial institutions).

177. See Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 204, 124 Stat. 1376, 1454 (2010) (to be codified at 12 U.S.C. § 5384) (delineating the FDIC's criteria for winding up systemically important companies).

178. See Brady Dennis, *Congress Passes Financial Reform Bill*, WASH. POST, July 16, 2010, at A01 (discussing the faith that Dodd-Frank places in regulatory changes and the preemptive detection of problems).

179. See, e.g., Jacob E. Gersen & Eric A. Posner, *Timing Rules and Legal Institutions*, 121 HARV. L. REV. 543, 573-74 (2007) (discussing problems created by rules allowing Congress to delay dealing with the resolution of public policy issues).

shoulder another crisis like the one it has recently undergone without a clear blueprint for addressing and resolving bailouts because of the staggering costs involved and the huge stakes for the economy and the national debt.¹⁸⁰ While wind-ups provide a way to deal with insolvent corporations, policymakers need to have a framework in place for otherwise solvent corporations that need capital injections to survive.

III. THE CASE FOR INSTITUTIONALIZING AN INVESTOR OF LAST RESORT

Congress' implicit approach to planning for bailouts has been to advise companies to "mind the gap" in the financial system during future crises.¹⁸¹ Companies face uncertainty concerning whether they could secure public or private financing when the private sector faces another liquidity crisis. As a result, companies still have perverse incentives to take on larger size and risks, so that the impact of their defaults would be so destabilizing to the economy that the federal government would have little choice but to bail them out. But the irony is that financing gaps may affect even fiscally responsible companies. The recent financial crisis underscored how swiftly otherwise solvent companies can come to the brink of failure due to a nationwide credit squeeze or liquidity crisis (triggered by their more reckless peers). The price of filling that gap through last-minute fixes may be far too costly—by either leaving out firms that merit aid or in having desperation bailouts that throw money at beneficiaries so quickly that opportunism abounds.¹⁸²

A. *A Blueprint for the Federal Government Investment Corporation*

The role of investor of last resort for the government is designed to overcome this gap by institutionalizing a credible commitment to handle bailouts in a structured way. The FGIC would seek to depoliticize bailouts by vesting authority for bailouts in an independent agency whose role in investing in distressed companies would parallel the FDIC's role in winding up insolvent firms.¹⁸³ The FGIC would seek to provide taxpayers

180. See, e.g., NICOLETTA BATINI ET AL., INTERNATIONAL MONETARY FUND, UNITED STATES: SELECTED ISSUES PAPER, IMF COUNTRY REPORT NO. 10/248 54 (2010), available at <http://www.imf.org/external/pubs/ft/scr/2010/cr10248.pdf> (noting that "closing the fiscal gap requires a permanent annual fiscal adjustment equal to about 14 percent of U.S. GDP" and raising questions about the United States' ability to sustain funding of such large-scale government deficits in the long run).

181. Just as subway systems advise passengers to "mind the gap," the onus is on companies to avoid falling through the cracks of the financial system during a crisis.

182. See Levitin, *supra* note 24, at 499–501 (discussing the implications of false negatives and positives on the efficacy of bailouts).

183. See Lisa Schultz Bressman & Robert B. Thompson, *The Future of Agency Independence*, 63 VAND. L. REV. 599, 611–15 (2010) (laying out the merits of independent

with long-term returns commensurate with the risks they assume in offering financing to systemically important companies and to deter companies from over-reliance on government aid in the process.

The irony is that the federal government did take tentative steps towards creating an investor of last resort role during the recent crisis through the TARP.¹⁸⁴ If policymakers were candid with the American public, they would acknowledge that the recent bailouts transformed the federal government into a sovereign wealth fund (or perhaps a more apt term, given the U.S.'s degree of public indebtedness: a sovereign "debt" fund), "boasting" a pool of un(der)regulated capital with vast holdings.¹⁸⁵ Making this role explicit by institutionalizing and delineating its contours would provide greater clarity and direction for financial markets.¹⁸⁶

The FGIC's existence would entail vesting significant discretion in an independent agency. It would be naïve to think that a "one size fits all" approach to bailouts would work, so policymakers would need to give the FGIC discretion concerning whether to invest and how to tailor the terms of investment, while laying out guidelines and principles to temper this discretion.

1. Crafting an Investor Paradigm for the FGIC

While the virtues of creating an institutional framework for handling bailouts may be clear, it may be harder to persuade policymakers of the merits of an investor paradigm. After all, the guiding principle of the FDIC is to minimize costs for each bank failure and to break even overall while handling wind-ups.¹⁸⁷ Similar "break even" approaches apply to both the Federal Reserve's emergency lending to banks and TARP loans from the Treasury Department.¹⁸⁸ The government's oft-raised claims of coming

agencies).

184. *See infra* Section II.A.

185. *See infra* Subsection III.D.3.

186. The FGIC would build not only on the experiences of sovereign wealth funds in other countries, but also on significant precedents of independent federal institutions. The federal government has embarked on two other distinctive experiments: the Reconstruction Finance Corporation (RFC) and the Resolution Trust Corporation (RTC), each of which operated failed companies as going concerns for periods of time. *See, e.g.*, GARY SHORTER, CRS REPORT FOR CONGRESS—THE RESOLUTION TRUST CORPORATION: HISTORICAL ANALYSIS 2–5 (2008) (discussing the RTC's role in winding down failed banks over a multiyear time horizon); Walker F. Todd, *History of and Rationales for the Reconstruction Finance Corporation*, 28 *ECON. REV.* 22, 23–27 (1992) (discussing the history of the RFC).

187. *See* 12 U.S.C. § 1823(c)(4)(A) (2006); *see also* 12 C.F.R. § 360.1 (2010) (laying out the FDIC's break-even mandate).

188. *See, e.g.*, Emergency Economic Stabilization Act of 2008, H.R. 1424, 110th Cong. § 134 (2008) (mandating that the TARP break even within five years of its enactment or that the Treasury Department impose a surcharge on the financial industry).

close to breaking even on certain portions of the TARP investments underscore the fact that this has been the guiding principle for bailouts, as well.¹⁸⁹

Just as significantly, the question remains as to what an investor paradigm would look like for the FGIC. As the investor of last resort, the FGIC would effectively serve as an equivalent of a monopoly or natural monopoly (since it would act as a bridge financier for distressed companies when the market was no longer able or willing to do so).¹⁹⁰ As a monopolist, the investor of last resort could extract extraordinarily high prices for its financing services.¹⁹¹ For example, if the federal government had acted as a profit-maximizing investor during the recent financial crisis, it could have easily taken over most of the American financial industry at its nadir at fire sale prices.¹⁹² That outcome would have effectively conflated the role of bailouts with nationalization of the banking industry and undercut the bailouts' purpose of supporting the independent viability of systemically important companies.

2. The Natural Monopoly Analogy

One potential way to preserve yet temper an investor paradigm would be to treat an investor of last resort agency like a natural monopoly by using rate regulation.¹⁹³ Natural monopolies in contexts such as water or electricity provision could charge prohibitively high rates to consumers if unconstrained by regulatory oversight.¹⁹⁴ These entities are generally monopolists in a given area because of the prohibitive cost of building a parallel distribution system.¹⁹⁵ To address this risk, natural monopolies

189. See Solomon, *supra* note 149.

190. Natural monopolies exist in contexts where only one company can cost-effectively provide services. The classic case is water, a context in which it would be prohibitively expensive to have two parallel sets of pipes to carry the water to houses. See Shubha Ghosh, *Decoding and Recoding Natural Monopoly, Deregulation, and Intellectual Property*, 2008 U. ILL. L. REV. 1125, 1138–39. In the investor-of-last-resort context, the concept is that no entity other than the government may be in a position to provide financing.

191. See STEPHEN BREYER, *REGULATION AND ITS REFORM* 15–16 (1982). As discussed later in Part III, one other check on the investor of last resort would be the risk that politicians would nationalize or federalize the problem through direct legislation to take over a prospective beneficiary.

192. See Klein, *supra* note 39, at 656–67.

193. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 363 (6th ed. 2003) (“The law’s traditional answer to the problem of natural monopoly was public utility or common carrier regulation.”).

194. See William Michael Treanor, *Supreme Neglect of Text and History*, 107 MICH. L. REV. 1059, 1061 (2009) (discussing how even libertarians recognize that rate regulation is permissible in the natural monopoly context to the extent there is market failure preventing competitive prices).

195. See ALFRED E. KAHN, 2 *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* 123 (1971) (describing a natural monopoly as a context in which “one company can serve any given number of subscribers . . . at lower cost than two” (emphasis omitted)); Lincoln L. Davies, *Power*

must secure state agency consent for setting rates and therefore can only pursue reasonable rates of return rather than profit maximization.¹⁹⁶ The problem of applying rate regulation to the FGIC is that such a system would be difficult to administer and time consuming, running counter to the need for swift investment in companies to resolve crises. As importantly, rate regulation oversight may introduce significant politicization to bailouts.¹⁹⁷ The investor of last resort would always be at the mercy of rate regulators who would face industry pressure to keep rates of return artificially low and/or to steer investments towards politically connected groups.

3. The Proportional Share Approach to Investing

The limits of rate regulation suggest the virtue of establishing a clearer, easily administrable principle to shape the investment decisions for the investor of last resort. The most straightforward way to temper the government's monopoly power, while securing an investment return, would be to implement a "proportional share" principle for government investments in distressed companies. The FGIC would receive convertible preferred stock with a value that is proportional to the distressed company's overall capitalization.¹⁹⁸ In other words, if a company has a market capitalization of \$50 billion and the investor of last resort invests \$25 billion, then the federal government should receive convertible preferred shares with a value that is one-third of the outstanding stock. The virtue of preferred stock is that the investment would have both equity and debt dimensions and a set time horizon. Convertible preferred stock would have priority over ordinary shareholders for any distributions,¹⁹⁹ and this stock would have a multiyear time frame in which the federal government alone would have the option of converting it to common stock (and reaping the returns of an economic rebound). To avoid excessive entanglement of

Forward: The Argument for a National RPS, 42 CONN. L. REV. 1339, 1347–48 (2010) (discussing electric utilities acquiring the role of 'natural monopoly' due to the cost of building a second parallel electrical system).

196. See Jim Rossi, *Universal Service in Competitive Retail Electric Power Markets: Whither the Duty to Serve?*, 21 ENERGY L.J. 27, 34–35 (2000) (laying out the rationale for rate regulation of natural monopolies).

197. See Joseph P. Tomain, *The Past and Future of Electricity Regulation*, 32 ENVTL. L. 435, 450 (2002) (discussing how rate regulation is a "politically charged" process).

198. This approach contrasts significantly with the TARP warrants covering only 15% of the value of the Treasury Department's preferred stock purchases. See Press Release, U.S. Dep't of the Treasury, Treasury Announces Warrant Repurchase and Disposition Process for the Capital Purchase Program (June 26, 2009), available at <http://www.treasury.gov/press-center/press-releases/Pages/200962612255225533.aspx>.

199. See Michael A. Woronoff & Jonathan A. Rosen, *Understanding Anti-Dilution Provisions in Convertible Securities*, 74 FORDHAM L. REV. 129, 144 & n.81 (2005) (discussing convertible preferred stock's priority in bankruptcy).

the investor of last resort in the private sector, investments should be limited to 50% of the equity value of any recipient.²⁰⁰

The proportional share approach represents a middle ground for guiding a government investment paradigm. First, it would limit the FGIC's ability to secure monopoly prices for its investments without subjecting the process to slow and (potentially) politicized rate regulation. Second, this approach would limit the FGIC's ability to play favorites and to impose different financial demands for investments based on the influence of a given company. The fact that the proportional share would be linked to the equity stake at the time of investment (or at the time news leaks about an industry bailout, to avoid an artificial surge in the equity price) would mean that the market would have already factored in the relative risk of a given company into its stock price.²⁰¹ The potential for government investment may artificially prop up equity prices (even during the height of the market).²⁰² Nonetheless, markets would reflect the risk factors facing a given company, and the proportional share principle would mitigate risks of sweetheart deals for politically connected corporations.

Third, it is worth stressing that each marginal government dollar would be worth far more to the company than earlier equity or debt investments of equal value in the company. Because government investments would occur during periods when credit would come at a high price if it is available at all, the government would be in a position to demand a much higher premium than the proportional profit share. Lastly, the existence of an investor of last resort would create tremendous leverage. The markets would understandably view noninvestment by the investor of last resort as a vote of no confidence in the viability of a troubled company. That means that the federal agency would otherwise have leverage to dictate terms, unless it faced the proportional share constraint or other substantive limits.

200. Privately held companies would not have as clear a benchmark for determining the proportional share because of the absence of publicly traded stock. However, establishing a proximate market value for these companies would be a straightforward, though more costly, task, which is routinely conducted for firm valuation in the mergers and acquisitions context. *See* Wulf A. Kaal, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability*, 28 REV. BANKING & FIN. L. 581, 585–86 (2009).

201. This approach is analogous to the valuation timing for assessing the value for takings of real property. Under well-settled law, the timing for determining the market value of seized property in a given area is when the plan is made for a government project (or when news of that plan leaks), even if a particular parcel has not been selected for purchase at that time. This approach is designed to ensure that private parties do not reap a windfall from speculative investments concerning the seizure of land or the benefits from a given government investment. *See, e.g.*, *United States v. Miller*, 317 U.S. 369, 374–79 (1943).

202. *Cf.* Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1390–91 (2006) (explaining that “liquidation protection” serves as a “valuable device” which “provide[s] additional protection to the going-concern value of a business”).

B. *Principles for Establishing a Bailout Framework*

The proportional share approach would establish the investment lens (and limits) for the investor of last resort. However, it is equally important to delineate who will be potentially bailed out, to what degree, and with what consequences. This Article lays out three principles to guide bailouts: (1) deterrence of prospective beneficiaries by reducing the stakes of managers, shareholders, and creditors, (2) alignment of interests with the FGIC for recouping the government's investment, and (3) linkage of corporate governance and systemic risk reforms to bailout investments.

1. Deterrence of Each Level of Stakeholder to Mitigate Moral Hazard

The key to designing bailouts is deterrence, in order to mitigate moral hazard and overreliance on government funds. Bailouts will always be a possibility in an extreme crisis, but they must come with a significant impact on all levels of stakeholders to make government intervention a last resort. For this reason, managers, shareholders, and creditors must face reductions in their stakes as a *quid pro quo* for government aid, so that no stakeholders would have an interest in prematurely pushing for bailout assistance.

Transforming bailouts into long-term investments would implicitly impact managers and shareholders by diluting their stakes in proportion to the government's investment, but creditors would not be directly affected. Thus, the sticking point to ensure shared sacrifice would be reductions of creditors' stakes.²⁰³ Bailouts during the current crisis were remarkably pro-creditor.²⁰⁴ Creditors emerged largely unscathed in most instances of government intervention—with a few notable exceptions, such as the nationalization of General Motors.²⁰⁵ However, tying reductions in creditors' stakes to bailouts is not unprecedented (outside of bankruptcy, where reductions to creditors' stakes are the norm). For example, the Pension Benefit Guaranty Corporation routinely exacts this type of *quid*

203. The bipartisan bias in favor of creditors may reflect fears about the effect of defaults on the trillions of dollars of public and private indebtedness owed to foreign creditors. While the potential for reductions of creditors' stakes may deter some creditors (even in an environment where confidence in other major debt markets, such as the European Union, has been shaken), bankruptcies would likely impose far deeper cuts on creditors. Additionally, creating a system of greater predictability for bailouts may mitigate concerns about bailout-related losses by safeguarding a greater percentage of creditors' investments.

204. See Hill, *supra* note 47, at 57 (observing that the Treasury Department's bailout strategy of taking preferred stock and warrants for common stock served to preserve bondholders' investments).

205. See, e.g., Davidoff & Zaring, *supra* note 31, at 488–89 (discussing the government's logic in protecting the \$5.14 trillion in mortgage-backed securities that Fannie Mae and Freddie Mac had outstanding because of concerns about the reactions of foreign investors who held a significant percentage of this debt).

pro quo on beneficiaries of corporate pensions.²⁰⁶

Reductions to creditors' stakes could be accomplished through a number of different means. The simplest approach would be a direct reduction in their holdings, analogous to the bankruptcy treatment for creditors, in which creditors would recoup a set percentage less of their investments as a condition for a bailout. Reductions could be accomplished through more indirect means, such as postponement of payments to creditors (as they lose the time value of money). Alternatively, creditors' interests could be diluted, based on the scale of government investment and priority for government investments in bankruptcy. Imposing uniform reductions to stakeholders' interests would provide a clear signal to corporate stakeholders of the tradeoffs for bailouts. However, it may make the most sense to give the FGIC discretion to tailor the particular combination of direct cuts, deferral, and dilution to the beneficiary at issue.²⁰⁷ For example, a bailout beneficiary with large amounts of short-term debt may require a different approach than a beneficiary burdened with debt with longer maturities. Similarly, the FGIC can condition the degree of reduction of creditors' interests to the speed, sustainability, and degree of recovery, so that stakeholders and the FGIC benefit from a swift and lasting rebound.

2. Alignment of Interests with the FGIC

Second, the FGIC would seek to align the interests of bailout beneficiaries with the FGIC to ensure that the government reaps the returns of its investments. The FGIC would tie taxpayer returns to the long-term returns of bailout stakeholders to ensure that taxpayers reap returns that are proportional to their investments. The federal government did receive modest returns on dividends and warrant sales from some TARP investments that partly offset significant overall losses.²⁰⁸ However, the

206. The PBGC automatically imposes cuts on pension beneficiaries who receive benefits above a set maximum when it takes over pensions from ailing corporations. *See* Richard L. Kaplan, *Enron, Pension Policy, and Social Security Privatization*, 46 ARIZ. L. REV. 53, 57 (2004); *see also* Disclosure to Participants; Benefits Payable in Terminated Single-Employer Plans, 67 Fed. Reg. 71,470 (Dec. 2, 2002) (codified at 29 C.F.R. pts. 4011, 4022) (setting a cap of approximately \$3,600 in monthly pension benefits covered by the PBGC).

207. One issue that arose during the recent bailout was that the TARP program's one-size-fits-all approach to repayment may have squeezed smaller banks with less access to capital to repay their loans. Empowering the FGIC to tailor bailout packages to the circumstances of beneficiaries may temper this concern. *See* Daniel Wagner, *Small Banks Struggling Despite Bailouts*, ASSOCIATED PRESS, July 14, 2010, available at http://www.msnbc.msn.com/id/38240491/ns/business-small_business/t/small-banks-struggling-despite-bailouts/ (discussing the limitations of the "one size fits all" bailout approach used for TARP monies).

208. TARP recipients have paid \$45.8 billion in dividends on preferred stock investments and \$1.4 billion in interest on loans. The federal government has also received \$9 billion from warrant sales. *See* PRO PUBLICA, THE STATE OF THE BAILOUT, <http://bailout.propublica.org/main/summary> (last visited Sept. 23, 2011).

government gave in to beneficiaries' pressure for early redemptions, which allowed beneficiaries to pay off the investments well before their stock prices recovered. As a result, the federal government bore almost all of the risk in capitalizing banks and stabilizing nonfinancial companies during the peak of the crisis. Nonetheless, early redemptions left corporate managers and other stakeholders with nearly all of the profits.²⁰⁹ While the early redemptions were a sign of success in stabilizing financial markets, they also underscored how poorly designed and executed the bailouts were in failing to uphold taxpayers' financial interests.

This approach of shortchanging taxpayers should change for future bailouts. Instead of a short-term time horizon, the FGIC would be able to lock in its investments for up to a five-year period and would be able to engage in gradual draw-downs of its investments at its discretion. Not every crisis will progress from the depths of near collapse back to a semblance of normalcy as quickly as the recent crisis did, and these time parameters will provide flexibility to deal with a more extended crisis. Additionally, the five-year period for government stakes is designed to provide the FGIC with adequate time to reap the true returns for its assumption of risk, while guarding against a permanent, creeping transformation of the economy.

This approach would also seek to use interconnectedness for a productive purpose.²¹⁰ Locking in the government's stake in corporate beneficiaries over a five-year time horizon would impose limits and oversight on managers, as well as equity and debt holders. For example, during the recent crisis, managers at Goldman Sachs and other bailout beneficiaries slipped out of the TARP executive pay "handcuffs" as soon as possible, and months later doled out record bonuses to themselves.²¹¹ Strangely enough, Goldman Sachs and other major banks were happy to hold onto their hundreds of billions of dollars of FDIC-backed bonds, which came with no strings attached and allowed them to secure credit on favorable terms.²¹²

If the federal government had remained a significant stakeholder in Goldman Sachs and other beneficiaries, the government would have potentially had a proportional share in profits arising from the bailouts and would have limited the private windfall from public support. There is no

209. *See supra* Subsection II.A.1.

210. Throughout the crisis, interconnections have been correctly blamed for magnifying systemic risks. *See Brunnermeier et al., supra* note 5, at 25. Interconnecting the financial fates of the FGIC and corporate beneficiaries is designed to do the opposite by making it more difficult for formerly distressed companies to go back to their wayward ways.

211. *See Tse, supra* note 144.

212. *See Monthly Reports Related to the Temporary Liquidity Guarantee Program: Term at Issuance of Debt Instruments Outstanding*, FED. DEPOSIT INS. CORP. (Aug. 19, 2010), http://www.fdic.gov/regulations/resources/tlgp/type_term07-10.html (documenting that over \$292 billion of FDIC-guaranteed debt is still outstanding).

reason why the federal government should not share in proportional returns for up to a five-year period, even after the beneficiaries have paid their loans to limit windfalls, if the government's aid made that revenue stream possible. A related point is that by interconnecting the FGIC with beneficiaries, it may allow the FGIC to tailor the ultimate reduction in stakeholders' stakes to companies' success in turning their fortunes around.

3. Linkage of Bailouts to Corporate Governance and Systemic Risk Reform

The third facet of bailout reform would entail linking bailout aid to corporate governance and systemic risk reform. One of the problems of bailouts is that government dollars swooped in to save the day, but the aid did little to change the underlying incentives of financial and nonfinancial entities to take destabilizing risks (so long as they follow large enough herds). The paradox of the current approach to bailouts is that, by serving as stabilizers, they removed the sense of political and economic urgency to regulatory reform. Even worse, the stabilizers empowered the perpetrators of excessive risk taking to leverage their windfall profits to lobby and stymie reform.²¹³

Because bailouts undercut pressure for reform, the FGIC should make substantive reforms a condition of bailouts up front, at the time when the government's leverage is at its peak. For example, it was clear before the bailouts that vast, undisclosed over-the-counter derivative liability exposure had magnified systemic risks in the financial sector.²¹⁴ The financial reform bill dealt with this issue in a watered-down way that will do little to change the inner workings of banks or their systemic risk exposure. For example, the controversial Lincoln Amendment to the Dodd-Frank Act will eventually require banks to relocate derivative trading outside of the FDIC-insured banking operations, but allows firms to keep derivatives trading within the bank holding company.²¹⁵ This fact means that bank holding companies can still indirectly leverage FDIC-guaranteed funds for their derivatives operations. This approach also does little to change the likelihood of government intervention if a major derivatives' participant faces a risk of default.²¹⁶

213. See Binyamin Appelbaum, *On Finance Bill, Lobbying Shifts to Regulations*, N.Y. TIMES, June 26, 2010, at A01 (discussing how banks have responded to the aftermath of the financial crisis by hiring legions of lobbyists and financial regulation lawyers).

214. See Baker, *supra* note 14, at 1349–50.

215. See Edward Wyatt, *For Securities Industry, Finance Law Could Bring New Light to Derivatives*, N.Y. TIMES, July 15, 2010, at B7.

216. The legislation formally bars federal assistance to swaps entities. However, the legislation carves out an important exception, which allows banks to receive federal assistance if the derivatives business is separately incorporated, yet under the same bank holding company umbrella. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 716, 124 Stat. 1376, 1648 (2010) (to be codified at 15 U.S.C. § 8305).

The irony is that it would have been simple during the financial crisis to require each bank receiving aid to divest its derivative and proprietary trading operations completely (even if, for the sake of stability, the date for divestment was delayed until after the crisis subsided). Economic crises generally do not sneak up out of nowhere, and the current crisis was no exception, as numerous government and academic observers had documented the roots of systemic risks before the crisis reached its climax in late 2008 and early 2009.²¹⁷ Given the awareness of the problems, the FGIC would have been in an ideal position to impose systemic risk exposure changes as a quid pro quo for aid.

Bailout conditions that are designed to mitigate systemic risks would seek to address externalities of excessive risk-taking. Another complementary condition would be to enhance internal monitoring of risk-taking by requiring beneficiaries to seat truly independent directors on their boards. Many academics have commented on the sham of independent directors being hand-selected by existing boards and failing to play any significant oversight role.²¹⁸ For this reason, the FGIC could require beneficiaries to have independent directors selected by an outside body in proportion to the stake of the FGIC's investment. Having an independent body appoint the directors would formally separate the government's financial and managerial roles and thus mitigate entanglement between the government and beneficiaries. But it would also ensure that beneficiaries face more meaningful internal scrutiny to help reduce the likelihood of a repeat of their financial overstretch. This approach may be particularly significant for financial firms, as true outsiders may be less likely to be drawn into the conventional wisdom of risk-taking that enveloped the industry during the run-up to the financial crisis.

4. A Boom-Time Role for a Crisis Agency

One legitimate question about the FGIC is what the agency would be doing during prosperous times when the need for bailouts was a distant prospect. The vice and virtue of the existing ad hoc system of bailouts has been that regulators could shift hats from their regulatory mode to focus on bailouts when crises arise. In theory, agencies could leverage their regulatory expertise and make a smoother and more rapid transition from

217. See, e.g., Allen Ferrell & Atanu Saha, *Securities Litigation and the Housing Market Downturn*, 35 J. CORP. L. 97, 106–08 (2009) (providing an overview of when academics and policymakers began to recognize the root causes of the subprime mortgage crisis).

218. See, e.g., Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 610–15 (1982) (discussing the difficulty of creating an adversarial atmosphere among a group of corporate directors by introducing an outside director); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 874–76 (1991) (discussing the potential problems of relying on outside directors); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 903 (1996) (same).

intervention to propping up the financial sector.²¹⁹

The problem is that simultaneously wearing regulatory and bailout hats raises an inherent conflict of interest. During a crisis, the Federal Reserve and other regulators will face strong incentives to systematically subordinate their regulatory role in favor of bailouts.²²⁰ That is what happened during the current crisis, as enforcement of longstanding rules gave way to ad hocery solutions.²²¹ The moral hazard inherent in this approach is that when enforcement of regulatory constraints may matter the most to mitigate the scope of financial overstretch, rules may instead be marginalized by conflicting mandates. As a result, industry players will have less incentive to respect regulatory constraints even during boom times because of confidence that rules will be rolled back when the boom goes bust.

To avoid this conflict of interest, the FGIC would not have a direct regulatory mandate that would potentially conflict with its bailout role. Overseeing long-term bailout investments would mean that a core staff would have ongoing responsibilities monitoring bailout beneficiaries, even at the height of the economic cycle. If the FGIC were self-funded (a possibility discussed in Section III.D.), its personnel would also manage the agency's investment portfolio to ensure that the fund met its own liquidity guidelines.²²² But even these roles would likely be insufficient in both ensuring that the FGIC's core staff would be gainfully occupied and keeping their skills in assessing financial risks sharp so that they would be ready to intervene during future bailouts.

For this reason, it would be important for the FGIC to have a complementary "peace-time" function that would strengthen skills and understanding of financial markets without rising to the level of a conflicting regulatory role. One role the FGIC could play is to serve as a watchdog in monitoring both industry and regulators. The FGIC could assess the health of the financial sector, identify weaknesses and stressors, and make recommendations to regulators about how to address gaps in the system.²²³ This approach would ensure that the FGIC is constantly

219. See, e.g., Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?*, 82 TEMP. L. REV. 449, 462–63 (2009) (discussing the virtue of integrating regulators' monitoring role with the ability to intervene to support faltering companies).

220. Regulators may also wish to avoid admitting regulatory failure and therefore hold off on intervention until the cost to the taxpayers will be dramatically higher. See John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 822 (2011).

221. See Anna Gelpern, *Financial Crisis Containment*, 41 CONN. L. REV. 1051, 1057 (2009) (arguing that "suspending regulations" to contain the crisis was "neither good, nor bad, but unavoidable").

222. See *infra* Subsection III.D.1.

223. This role would complement the vision for the Financial Services Oversight Council and

generating the type of information it would need in order to make informed decisions about bailouts on short notice.

This “think tank” role would also support the FGIC’s function in leveraging bailouts to require beneficiaries to implement financial reforms. Congress and regulators grappled only with forward-looking reforms after bailouts had stabilized the banking industry and put banks in a position to stymie significant changes.²²⁴ In contrast, the FGIC could serve as both a watchdog and policy incubator, so that reform ideas could be considered and debated at an earlier point. This approach would potentially enable the FGIC to implement reforms during the course of the bailout process when the government’s potential influence would be at its peak. Policymakers could thereby avoid the predictable pitfall that occurred during the current crisis when reforms quickly fell to the wayside as bailouts replenished banks’ strength.²²⁵

One related problem is how FGIC staffing would work, as it would likely need to grow quickly in the midst of future economic crises. The FDIC offers an example of how accordion-like an agency can be in having a core staff expand to meet greater need for its services. For example, FDIC employment grew 80% from 2007 to 2010 in response to their expanded crisis role—from approximately 4,500 employees in 2007 to 8,150 employees in 2010.²²⁶ The FGIC could similarly grow from a smaller core staff in response to future crises. While crises frequently hit a peak during a rapid period of strain to the financial system, the gathering storm of risk factors often take much longer to coalesce,²²⁷ giving the FGIC time to gradually build its staffing strength.

C. *The Need to Impose Limits on the FGIC*

While it is important for the FGIC to exercise independence and discretion in investment decisions, part of the appeal of institutionalizing an investor of last resort is the ability to impose limits on its discretion to

provide another set of eyes within the government examining and making recommendations about potential systemic risk concerns. See Lisa Schultz Bressman & Robert B. Thompson, *The Future of Agency Independence*, 63 VAND. L. REV. 599, 627–30 (2010) (discussing the role of collaborative relationships under the plan for the Financial Services Oversight Council).

224. See Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U.L. REV. 1, 2 (2010) (discussing how “[f]inancial regulation is often reactive”).

225. See, e.g., Binyamin Appelbaum, *On Finance Bill, Lobbying Shifts to Regulations*, N.Y. TIMES, June 26, 2010, at A01 (discussing the financial industry’s effective lobbying to undercut the Dodd-Frank Act and its regulatory implementation).

226. See *FDIC Statistics at a Glance*, FED. DEPOSIT INS. CORP., <http://www.fdic.gov/bank/statistical/stats/2011mar/fdic.html> (last updated May 24, 2011).

227. See, e.g., Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 185 (2009) (discussing the factors that ultimately led to the financial crisis of 2008).

guard against government overstretch.²²⁸ One concern is that FGIC investments could lead to excessive entanglement between the public and private sector. Even during the best economic periods, there are companies which need financing that the market will not provide because of the companies' poor prospects. During a liquidity crisis, such a wide spectrum of companies may seek aid that the FGIC could be overwhelmed both in terms of handling the volume of requests and in its financial wherewithal. Creating too expansive a role for the FGIC as an investor of last resort may cause the FGIC to overextend itself by propping up companies that are not competitive or by taking on so many investments that it cannot effectively screen the investment-worthiness of companies. For this reason, the FGIC would need to have a clear, yet limited mandate to provide financing to firms whose insolvency would heighten systemic risks.

Policymakers debated the contours of what constitutes systemic risk throughout the financial crisis in order to determine when government intervention was needed.²²⁹ Most definitions of systemic risk center on default risk that would adversely impact the broader economy, although the lack of a precise definition of systemic risk suggests the need to give regulatory agencies flexibility in determining and addressing such dire circumstances.²³⁰ Understandings of systemic risk range from “something . . . that is a good deal bigger and worse than the failure of any single institution”²³¹ to “significant losses to financial institutions or substantial financial-market price volatility”²³² to an entity whose “failure . . . to meet its obligations to creditors and customers would have significant adverse consequences for the financial system and the broader economy.”²³³ However, no clear consensus exists concerning what degree of adverse impact constitutes systemic risk.²³⁴

228. In contrast, it may be far harder to oversee ad hoc bailouts because they are designed on the fly and may evolve quickly. *See* Dombalagian, *supra* note 18, at 835–36 (discussing the danger of ad hoc oversight and limits becoming “window dressing”).

229. *See* Schwarcz, *supra* note 102, at 194–95.

230. *Id.* at 196–97.

231. Darryll Hendricks, *Defining Systemic Risk 1* (Pew Econ. Pol’y Dep’t: Fin. Ref. Project, Briefing Paper No. 1, 2009).

232. Schwarcz, *supra* note 102, at 198.

233. *Establishing a Framework for Systemic Risk Regulation: Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs*, 111th Cong. 75 (2009) (statement of Daniel K. Tarullo, Member, Federal Reserve Board of Governors).

234. For example, some policymakers argue that systemic risk is attributable to a high correlation of asset returns that increases the likelihood of joint bank failure, *see* Acharya, *supra* note 5, at 232–35, while others focus on the increasing cost of capital caused by the default or failure of one firm. *See* Schwarcz, *supra* note 102, at 204 (describing systemic risk as “the risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility”). Other academics focus on

The Dodd-Frank Act defines systemic risk as a “default” or a “danger of default” that “would have serious adverse effects on financial stability in the United States.”²³⁵ Just as for academic understandings of systemic risk, the threshold for damage to the economy is not self-evident under this statutory definition. Therefore, the Act defers to the expertise and experience of the Federal Reserve Board, which must certify that a firm’s potential default raises this concern in order for the FDIC to assume receivership over a systemically important company.²³⁶

The FGIC would face a similar mandate of certifying that the danger of a beneficiary’s potential default raises systemic risks to justify making an investment.²³⁷ Requiring the FGIC to certify that these systemic risk factors are met to justify its investments would limit the scope of the FGIC’s investments. At the same time, this approach would recognize the need for flexibility because what falls within the parameters of having “serious adverse effects on financial stability” may vary from one crisis to another.²³⁸

Limiting the FGIC’s role to systemically significant companies would be a controversial part of this proposal. The dividing line between “too big” or “too interconnected” to fail and less significant companies would be hotly contested. However, the myriad of smaller companies and individuals would still have recourse to the political process. Just like flood or other catastrophe victims, these parties can seek to have Congress federalize their losses through legislation. It might be desirable to have all potential beneficiaries face the quid pro quo that comes with FGIC investment (to mitigate the need for future bailouts and recoup money for the taxpayers). However, this Article’s approach recognizes both the limits of what policymakers can expect of the FGIC’s capabilities and the political reality that Congress may face overwhelming pressure to engage in federalization of losses for smaller entities and individuals if the scale of a crisis is large enough.

Another concern is the level of investment risk that the FGIC could

political effects of institutional failure, positing that a firm was “too big to fail” and put the economy at risk if the median voter did not tolerate the economic effects of a failure. *See* Levitin, *supra* note 24, at 446–51.

235. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 203(b), 124 Stat. 1376, 1451 (2010) (to be codified at 12 U.S.C. § 5383(b)).

236. *Id.* § 5383(a)(1)(A), (b).

237. Part of the problem is that perception, rather than reality, shapes market volatility and views of systemic risk. Therefore, the focus of managing systemic risk in a broad sense should be on mitigating panics and seeking to contain market anxieties until the panic subsides and bridge financing is no longer needed by beneficiaries. Ultimately, in spite of the imprecision of the concept of systemic risk, there is a virtue in requiring the government to make the case publicly for why systemic risk applies to justify its decisions and the extent of its bailout commitments.

238. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 203, 124 Stat. 1376, 1450 (2010) (to be codified at 12 U.S.C. § 5383(b)).

assume. One danger of bailouts is that they may creep into full-blown nationalizations as companies need more and more loans to stay afloat. Once the FGIC begins to invest loans, it may face perverse incentives to send bad money after good money in an effort to justify or preserve its initial investment.²³⁹ For this reason, it would be desirable to establish minimum capital requirement guidelines for beneficiaries to ensure that the FGIC could have a reasonable prospect of recouping the government's investment. This approach would be analogous to the capital requirements that banks must meet to avoid falling into receivership by the FDIC and being liquidated.²⁴⁰ Capital requirements would likely be much lower than in this case, as corporations do not face the same risks banks face of a run on the bank.²⁴¹ However, the underlying principle would be similar: to delineate between companies that could remain solvent with FGIC investments and those that are on the brink of insolvency. Given the expanded role for the FDIC in winding down systemically important financial institutions, these capital requirements would also serve as a dividing line between the FGIC's and FDIC's responsibilities. Capital requirements, coupled with a cap limiting the FGIC to no more than 50% of the capitalization of any given company, would be designed to limit the degree of the FGIC's risk exposure to any particular company.

D. Addressing Potential Objections to This Proposal

1. The Challenge of Sustaining FGIC Independence

Critics may recognize that sustaining FGIC independence is an admirable goal yet argue that bailouts historically have had political fingerprints and private opportunism written all over them.²⁴² Both Democrats and Republicans revel in directing funds to their corporate supporters to save jobs or bolster their district's economy,²⁴³ and private companies are always eager to outsource their liabilities to the federal

239. See Painter, *supra* note 13, at 159 (discussing the problem of government trying to "bail" itself out of poor bailout decisions).

240. See Jon Hilsenrath, Damian Paletta & Aaron Lucchetti, *Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis*, WALL ST. J., Sept. 22, 2008, at A1.

241. See, e.g., Adam Wasch, *FDIC Board Adopts Final Rule on Investments in Nonfinancial Firms*, 77 BNA'S BANKING REP. 959 (2001) (discussing the FDIC's lower capital requirements for banks' equity investments in nonfinancial companies).

242. For an overview of the challenges facing agency independence, see Rachel E. Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15, 19–41 (2010).

243. Democrats' campaigns have emphasized the impact of stimulus money on their districts in an attempt to localize political campaigns during a politically challenging year. Republicans have displayed hypocrisy in decrying bailout measures, yet lauding the impact of bailout and stimulus money in their own districts. See, e.g., Jeff Zeleny, *State in Play: Rougher Road for Democrats Without Obama Atop Ticket*, N.Y. TIMES, July 4, 2010, at A01 (discussing Democrats' efforts to localize campaigns by emphasizing positive impact of stimulus initiatives).

government. Given those incentives, skeptics might question whether a truly independent FGIC can exist or whether the temptation and opportunity for political and private actors to capture, politicize, and distort the FGIC's agenda will prove too overwhelming.²⁴⁴

A similar concern exists concerning the revolving door between the FGIC and Wall Street firms (and their legal and accounting service providers).²⁴⁵ Many of the crucial political appointees who were asleep at the wheel during the recent crisis were from Wall Street or soon headed in that direction once their term in government service ended.²⁴⁶ For the FGIC to work, it would need this financial acumen, but there is also a genuine dilemma about which master to whom these actors would be beholden (either *ex ante* in terms of their connections or *ex post* when they are looking to cash in from their experience at the FGIC). The FGIC may need this talent to understand the complexities of its investment targets, but this expertise may come at a high price if FGIC employees engage in favoritism towards beneficiaries.

There is not an easy solution to the private capture problem or to the overall challenges to the FGIC's independence.²⁴⁷ One way to temper politicization pressures is to impose limits on the nature and scope of the FGIC's investments, limits which have been discussed earlier in this Article. These limits may give the FGIC the ability to push back at politicians who are clamoring for their states' prospective beneficiaries to receive aid by pointing at the constraints the FGIC faces. For example, the FGIC could potentially point to its capital requirement guidelines to justify not investing in a company whose balance sheets are underwater.

Another way to preserve the FGIC's independence is to have self-financing of operations through existing investments.²⁴⁸ Politicians have

244. See, e.g., Neal Devins & David E. Lewis, *Not-So Independent Agencies: Party Polarization and the Limits of Institutional Design*, 88 B.U. L. REV. 459, 479–88 (2008) (discussing the increase in political capture of ostensibly independent agencies over the last generation).

245. See Barkow, *supra* note 242, at 23.

246. See Zachary A. Goldfarb, *Regulators Are Finding Opportunities at Firms Looking for Government Experience*, WASH. POST, Dec. 30, 2010, at A11 (discussing the revolving door of White House, Justice Department, SEC, and banking regulators heading to Wall Street and law firms).

247. See Painter, *supra* note 13, at 149–50 (discussing how “the corrupting influence from private employment prospects is difficult to mitigate with regulation”).

248. The virtue of self-funding is that it would liberate the FGIC from political meddling or underfinancing that could compromise its ability to fulfill its mandate. See, e.g., Roberta S. Karmel, *Realizing The Dream Of William O. Douglas—The Securities and Exchange Commission Takes Charge Of Corporate Governance*, 30 DEL. J. CORP. L. 79, 98–100 (2005) (discussing how the absence of self-funding coupled with limited congressional funding compromised the SEC's ability to police fraud); Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 NOVA L. REV. 233, 253–58 (2004) (discussing how self-funding could free the SEC from political constraints and allow it to more adequately fulfill its mandate).

come up with any number of ways to spend the remainder of the \$700 billion in TARP money,²⁴⁹ but giving the FGIC the ability to draw on this money without additional legislative consent would be the most appropriate way to ensure that the bailout money serves its intended purpose. This approach would insulate the FGIC from the need for further congressional or executive branch grants of money (and the related political strings that may come with that funding), except in exceptional circumstances. These monies could be invested in treasuries or other short-term instruments during times when they are not invested in bailout beneficiaries.

The challenge of private capture is more difficult to overcome.²⁵⁰ Washington, D.C.'s culture of soft corruption centers on the revolving door between the public and private sector.²⁵¹ A significant part of low-paid regulators' compensation is often the expected value of the salary that they will receive when they defect to work for the companies they are regulating.²⁵² This incentive understandably leads to regulatory inaction or favoritism. This problem may even be sharper for the FGIC because of the fact that the agency would need workers with the technical skills to assess prospective investments (which would often come from private industry). One way to mitigate the concern of private capture would be to give FGIC employees higher salaries to woo and retain their expertise and also to impose a quid pro quo of more severe bars on joining firms that benefit from bailouts or their service providers (such as law and accounting firms).²⁵³ Most federal agencies currently have modest bars limiting their employees from dealing with their own former agency for one year.²⁵⁴ To justify the higher salaries and deter private capture, both the duration and nature of the ban on working for beneficiaries should be more expansive for FGIC employees.²⁵⁵

249. See, e.g., David Cho & Michael D. Shear, *TARP Funds in Play for Jobs Program; Obama Likely to Back Deal*, WASH. POST, Dec. 5, 2009, at A10 (discussing how the Obama Administration supports spending part of repaid TARP funds for a new job-creation program).

250. For an overview of public choice theory, see generally DANIEL A. FARBER & PHILIP P. FRICKEY, *LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION* (1991) and JERRY L. MASHAW, *GREED, CHAOS, AND GOVERNANCE: USING PUBLIC CHOICE TO IMPROVE PUBLIC LAW* (1997).

251. See Eric Lichtblau, *Ex-Regulators Set to Lobby on New Financial Rules*, N.Y. TIMES, July 27, 2010, at B01 (discussing the revolving door from financial regulators to the private sector).

252. See James S. Roberts, Jr., *The "Revolving Door": Issues Related to the Hiring of Former Federal Government Employees*, 43 ALA. L. REV. 343, 344 (1992).

253. See, e.g., Painter, *supra* note 13, at 155 (suggesting that government employees should face a one- to two-year bar on receiving compensation from bailout beneficiaries).

254. See 18 U.S.C. § 207 (2006) (delineating the limits that former executive and legislative branch officials face in dealing with their former agencies).

255. Very senior officials and elected representatives face greater restrictions on dealing with matters under their supervision, which restrictions form a precedent for imposing more onerous restrictions on former FGIC officials. See *id.* § 207(d)–(e).

2. Concern About Potential FGIC Overstretch and Federal Oversight

Many critics may point out that fiscal constraint has not been a virtue of federal spending and that the federal government has had a poor track record in overseeing public and quasi-public agencies. The extensive spending on the bailouts and, as importantly, the related stimulus efforts suggests that a government unable to exercise spending constraints may fare poorly in imposing limits on the FGIC. The government's track record in overseeing Fannie Mae and Freddie Mac, privately owned companies that served a public role as mortgage intermediaries, may raise similar concerns about the possibility of effective oversight of the FGIC.²⁵⁶

Part of the paradox of Fannie Mae and Freddie Mac was that they were traded as privately held companies, but were subject to a conflict of control, incentives, and purpose through their public role (and related political pressures).²⁵⁷ In other words, intrinsic challenges exist from wearing both a public and private hat. In contrast, the FGIC would clearly be a public agency, but having the FGIC embrace an investment-oriented paradigm raises some similar issues.

The challenge is how to oversee individual FGIC managers and the FGIC as a whole in order to avoid having the FGIC succumb to public pressure or become a government version of the speculators that they will be bailing out.²⁵⁸ One approach would be to have the President and Congress appoint a special Inspector General with a fixed term who would enjoy broad powers to review the FGIC's operations and investments and serve to publicize FGIC missteps to the elected branches and the public.²⁵⁹ For this reason, it is key that the FGIC face clear ex ante parameters to guide its investments and maintain transparency about the scope and nature of its investments, in order to facilitate oversight and accountability. This

256. See, e.g., STAFF OF H. COMM. ON OVERSIGHT & GOV'T REFORM, 111TH CONG., REP. ON THE ROLE OF GOVERNMENT AFFORDABLE HOUSING POLICY IN CREATING THE GLOBAL FINANCIAL CRISIS OF 2008, at 2 (2009), reprinted in *Role of the Lending Industry in the Home Foreclosure Crisis: Hearing Before the Subcomm. on Commercial and Administrative Law*, 111th Cong. 363 (2009) (discussing how poor oversight of Fannie Mae and Freddie Mac allowed them to "privatize[] their profits but socialize[] their risks, creating powerful incentives for them to act recklessly and exposing taxpayers to tremendous losses").

257. See Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 5, 2008, at A01 (discussing how Fannie acquiesced to political pressure to purchase subprime mortgage-backed securities).

258. This challenge would be especially pronounced over time, as FGIC officials would face similar temptations to those regulators face: the imposition of "stricter regulation after a crash, followed by gradual relaxation thereafter" in the face of industry pressure. See John C. Coffee, Jr., *supra* note 220, at 821.

259. Part of the TARP program entailed the appointment of a special Inspector General who served as a watchdog over the Treasury Department's operations. See *U.S. Office of the SIGTARP: Welcome*, OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, <http://www.sig tarp.gov> (last updated June 17, 2011). Extending this concept to the FGIC would be a straightforward way to ensure some degree of transparency.

approach is not a panacea, as questions would remain about how to deal with FGIC failures. However, independent oversight would be designed to avoid political meddling with the FGIC's mandate.

A related concern is that creating the FGIC and entrusting the agency with a bailout fund would create incentives for the FGIC to make investments simply to justify its own existence and payroll. Bureaucracies are always tempted to work to spend their budget to justify future allocations and to produce results for congressional overseers and the public.²⁶⁰ But the incentives to expand the mandate may be even higher for the FGIC, as its investor focus may mean that its internal and external benchmark for success will be its return on its investments. The irony is the FGIC's investments will be countercyclical because its moments of greatest passivity will likely be at the peak of the investment cycle when market actors are reaping the highest returns. The FGIC may therefore be tempted by the same herding effects that distort market investing in the effort to chase higher returns.²⁶¹

Overly aggressive investing by the FGIC may blur the line between investments in systemically significant companies facing liquidity problems and purely speculative investments. This concern is particularly important given the function of the FGIC. This approach would not only lock up investment funds that would be needed in an emergency, but also raise concerns about excessive entanglement between the private and public sector. The ability to turn on the bailout when needed and turn it off when it is not needed is a tricky challenge that does not have an easy answer.

The best way to temper FGIC overstretch may be to deter prospective beneficiaries from seeking and accepting bailout investments. Investments by the FGIC must have significant enough consequences for managers, shareholders, and creditors of beneficiaries to make the appeal of FGIC investments truly be a last resort. This approach would serve as a check not only on private sector companies, but also on the FGIC, by creating incentives to resist FGIC investment offers.

3. Dangers of Creating a (De Facto) Sovereign Wealth Fund

Policymakers may acknowledge the stabilizing potential of the FGIC, yet still be concerned about the distorting effects of a de facto sovereign wealth fund on the economy. Similar concerns about political motivations for investments have come up concerning sovereign wealth funds'

260. See WILLIAM A. NISKANEN, JR., *BUREAUCRACY AND REPRESENTATIVE GOVERNMENT* 38–42 (paperback ed. 2007) (discussing how bureaucracies try to spend annual budgets to secure equal or higher budgets in the future).

261. See Thomas J. Fitzpatrick, IV & Chris Sagers, *Faith-Based Financial Regulation: A Primer on Oversight of Credit Rating Organizations*, 61 *ADMIN. L. REV.* 557, 590 (2009) (discussing growing empirical evidence of herding effects in financial markets).

investments in the United States. Like the FGIC, sovereign wealth funds are “government investment vehicles . . . which manage those assets separately from official reserves.”²⁶² Their virtue is analogous to the FGIC as these “long-term investment vehicles look . . . beyond quarterly results and therefore [potentially] serve as stable funding sources during financial turbulence.”²⁶³ For example, during the recent crisis, a number of sovereign wealth funds demonstrated this role by injecting capital into struggling American banks.²⁶⁴

Nonetheless, critics are concerned about the potential for sovereign wealth funds to engage in “unfair competition, corruption, and politically—or strategically—motivated investments.”²⁶⁵ These fears may have some plausibility for foreign sovereign wealth funds, some of which are tools of governments with (potentially) adverse national interests.²⁶⁶ Foreign officials may use investments as an extension of economic and foreign policy,²⁶⁷ such as large-scale derivatives bets designed to weaken other countries’ corporations or industries or to disrupt national markets.²⁶⁸

262. *Do Sovereign Wealth Funds Make the U.S. Economy Stronger or Pose National Security Risks?: Hearing Before the J. Econ. Comm.*, 110th Cong. 33 (2008) (statement of David H. McCormick, Under-Secretary for International Affairs, U.S. Department of the Treasury), available at <http://www.gpo.gov/fdsys/pkg/CHRG-110shrg41292/pdf/CHRG-110shrg41292.pdf>.

263. MARTIN A. WEISS, CONG. RESEARCH SERV., SOVEREIGN WEALTH FUNDS: BACKGROUND AND POLICY ISSUES FOR CONGRESS (2008), available at <http://fpc.state.gov/documents/organization/110750.pdf>. Sovereign wealth funds’ access to substantial long-term funding makes them able to endure short-term fluctuations and “promote economic growth and job production . . . and economic stability.” Amy Keller, Note, *Sovereign Wealth Funds: Trustworthy Investors or Vehicles of Strategic Ambition? An Assessment of the Benefits, Risks and Possible Regulation of Sovereign Wealth Funds*, 7 GEO. J.L. & PUB. POL’Y 333, 334–35 (2009).

264. Abu Dhabi’s Investment Authority and its affiliates invested \$7.5 billion into Citigroup and \$600 million in Advanced Micro Devices. See Stanley Reed, *Abu Dhabi’s Citigroup Bargain*, BLOOMBERG BUSINESSWEEK (Nov. 27, 2007), http://www.businessweek.com/globalbiz/content/nov2007/gb20071127_878991.htm. Large capital flows from sovereign wealth funds like the Abu Dhabi investment can lead to “higher stock and asset prices and lower risk premia, especially of riskier, less liquid assets.” See Douglas Rediker & Heidi Crebo-Rediker, *Foreign Investment and Sovereign Wealth Funds 2* (New Am. Found., Working Paper No. 1, 2007).

265. Keller, *supra* note 263, at 335.

266. See Bryan J. Balin, *Sovereign Wealth Funds: A Critical Analysis 4–5* (Working Paper Series, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1477725.

267. See Christopher Cox, Former Chairman, U.S. Secs. and Exch. Comm’n, Remarks at the Gauer Distinguished Lecture in Law and Policy at the American Enterprise Institute Legal Center for the Public Interest: The Rise of Sovereign Business (Dec. 5, 2007) (transcript available at <http://sec.gov/news/speech/2007/spch120507cc.htm>).

268. To date, no sovereign wealth fund has visibly used its funds in this underhanded way. See Balin, *supra* note 266, at 5. To alleviate some of these concerns, many sovereign wealth funds have taken proactive steps to demonstrate that their investment intentions are to generate returns and not to acquire stakes in sensitive or strategic industries. *Id.* For example, Chinese and Russian sovereign wealth funds informed the U.S. Treasury that they do not intend to invest in strategic industries, and China declared that it waived its voting rights from its \$3 billion investment in the Blackstone Group. *Id.* (noting that no one has shown that any “[sovereign wealth fund] to date has invested in a

While the FGIC would not raise the concerns of subversion, skeptics may be concerned about the distorting effects of government investment. For example, bailouts for failing automakers and their suppliers may redirect scarce capital away from other sectors that are more competitive. Similarly, FGIC investment decisions may be interpreted as a signal by the marketplace of which sectors or firms are “safe,” and therefore give them unfair advantages over competitors who have not received FGIC funds. Distortion concerns may become especially significant if politicians successfully pressure the FGIC to invest in politically influential sectors of the economy in order to bolster their campaign supporters.

Part of the solution to this problem is maintaining the independence of the FGIC. Investors may still interpret FGIC investments as a green light for private sector loans to industries and companies in which the FGIC invests. But concerns about politically driven decisions or corruption may be best safeguarded against by firmly entrenching the FGIC’s independence from the political process.

One other concern about the FGIC is one that many sovereign wealth funds experienced during the crisis. Creating a hedge fund or sovereign wealth fund is no sure-fire recipe for success. Professionalization and institutionalization may not be a cure-all. The backing of the state (or of a large pool of state funds) may empower FGIC managers to make poor investment decisions. For example, most of the major sovereign wealth funds made substantial investments in the American financial sector during the early stages of the crisis, including funds based in China, Singapore, and Dubai.²⁶⁹ But these sovereign wealth funds timed their investments quite poorly, and ironically, they were only bailed out from even worse losses because of the federal government’s intervention to prop up the financial sector. FGIC managers may be similarly tempted to make poor investment decisions, which underscores the importance of delineating guidelines for FGIC investments and effective oversight.

4. Ex Ante Versus Ex Post Approach to Conditioning Bailouts

Skeptics may argue that what matters in a crisis is filling liquidity gaps as quickly as possible and that policymakers have enough leverage to impose whatever conditions are necessary after the fact. This ex post logic

company for reasons of political ‘blackmail’ or espionage”). However, this concern is not theoretical, as derivative traders such as George Soros demonstrated how large-scale speculation could drag countries to their knees, such as his successful betting against the Malaysian currency which provided the immediate spark to the 1997 Asian Crisis. *See* HAL S. SCOTT, *INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION* 745 (14th ed. 2007).

269. For example, the Abu Dhabi Investment Authority infused capital into Citigroup; the China Investment Corporation made capital infusions into Morgan Stanley; and Singapore sovereign wealth fund Temasek invested in Merrill Lynch. *See* Edward D. Herlihy, *Takeover Law and Practice 2009*, in *CONTESTS FOR CORPORATE CONTROL 2010: CURRENT OFFENSIVE & DEFENSIVE STRATEGIES IN M&A TRANSACTIONS* 352 (2010).

drove the federal government's ad hoc response to the financial crisis and lives on in Congress' failure to develop a framework for dealing with future bailouts.²⁷⁰ But because of this failure, government responses to financial crises inevitably become a form of containment strategy designed to plug the widening holes in the dikes.²⁷¹ The containment strategy has two perverse effects. First, it emboldens financial institutions to take on greater risks based on the assumption that so long as they act in concert they will reap positive returns while the government will mitigate catastrophic losses. Second, containment strategies are easily gamed by prospective beneficiaries who may leverage the threat of financial dikes bursting to their advantage. Ironically, by not having a clear framework in place for bailouts, companies may have every incentive to *magnify* risks because the government is unlikely to impose meaningful conditions on aid if the government is desperate to avoid economic catastrophe.

The Treasury Department's experience with the TARP underscored the challenges of imposing conditions after the fact. Not only did the Treasury Department fail to impose any significant conditions after loans were made, but also the Treasury Department did not even exercise powers that were ostensibly linked to bailout aid after banks recovered.²⁷²

The best illustration of this point is the failure of executive pay limitations. The Bush and Obama Administrations both emphasized the fact that TARP beneficiaries would face limitations, including caps on top executive pay and potential clawbacks if beneficiaries provided excessive compensation to executives.²⁷³ The irony is that TARP conditions on executive pay encouraged beneficiaries to increase executive stock options as the primary form of compensation, which meant that the government bailout dollars ultimately translated into higher executive pay as stock prices recovered.²⁷⁴ While the Treasury Department belatedly recognized that TARP beneficiaries overpaid executives by billions of dollars, the Treasury Department lacked the political will to exercise its clawback

270. For an overview of the virtues of ex ante versus ex post approaches, see LOUIS KAPLOW & STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* 437–39 (2002) (arguing that welfare, which generally is based on an ex ante approach, is preferable to fairness, which generally is based on an ex post approach); Lawrence B. Solum, *Procedural Justice*, 78 S. CAL. L. REV. 181, 185–88 (2004) (discussing the virtues of ex ante over ex post approaches).

271. Anna Gelpern, *Financial Crisis Containment*, 41 CONN. L. REV. 1051, 1064 (2009) (“Regulation first seeks to change incentives to reduce the risk of failure and crisis For containment, the priorities are reversed: changing long-term incentives is relevant only if the financial system survives the present calamity.”).

272. See *supra* Subsection II.B.I.

273. See Verret, *supra* note 91, at 303.

274. See *id.*

powers.²⁷⁵ The unmistakable conclusion is that by failing to lay out clear conditions up front, the TARP program played right into the hands of beneficiaries who were able to neutralize the Treasury Department's potential power once beneficiaries regained their strength. In American democracy, money talks more than power, and the \$251 million that banks spent on lobbying to thwart financial reform went far towards eviscerating ex post attempts to address the financial crisis.²⁷⁶

The virtue of ex ante regulation is that establishing clear, settled expectations can provide guidance to both industry and regulators.²⁷⁷ Every rule and regulation triggers loophole seeking and tests of its limits, but credible commitments can put all parties on notice of what the likely responses will be and make it harder for politicians to deviate from existing frameworks for aid. The seventy-year experience with the FDIC highlights this point. While some significant deviations for large banks took place during the current crisis,²⁷⁸ the existence and success of the FDIC in winding up ailing institutions has made it much more difficult for politicians to depart from the settled framework for wind-ups.

The primary limitation of ex ante approaches, such as this Article's proposal, is that although ex ante reforms are shaped in anticipation of a future crisis, they can only be made through reflection on what has already occurred.²⁷⁹ Any comparative advantage that ex ante regulation may have may be mitigated by limits in the ability to anticipate the nature of future crises.²⁸⁰ For this reason, policymakers need not only to create rules to anticipate and address future crises, but also to create institutions equipped with the skills and authority to adapt to the particular wrinkles of future crises. The hope is that a well-designed FGIC would be well-positioned to anticipate and react to future cataclysms.

CONCLUSION

The greatest challenge facing this proposal is mitigating the moral hazard inherent in any bailout contingency planning. Investors will undoubtedly attempt to analyze how deep the pockets of the Federal

275. See Puzzanghera & Popper, *supra* note 172.

276. See Joshua M. Brown, *How Wall Street Uses Your Money to Lobby Against You*, CHRISTIAN SCI. MONITOR (Aug. 3, 2010, 4:09 PM), <http://www.csmonitor.com/Business/The-Reformed-Broker/2010/0803/How-Wall-Street-uses-your-money-to-lobby-against-you>.

277. See, e.g., Donald T. Hornstein, *Resiliency, Adaptation, and the Upsides of Ex Post Lawmaking*, 89 N.C. L. REV. 1549, 1560 (2011) (observing that the virtue of rules is that they "are typically viewed as specifying how law applies ahead of time").

278. See *supra* Part III.

279. See Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 1010 (2001).

280. Richard J. Herring, *The Known, the Unknown, and the Unknowable in Financial Policy: An Application to the Subprime Crisis*, 26 YALE J. ON REG. 391, 394–95 (2009).

Government Investment Corporation are and the likelihood of intervention and factor that into their investment decisions. Skeptics may fear that “if you build it, they will come,” in a perverse way. Firms may seek to maximize risk and returns, while pushing off as much of the downside risk as they can onto the federal government.

In spite of this concern, this Article has shown how institutionalizing an investor role for the FGIC and establishing clear contours and conditions for bailouts would temper corporate risk-taking and protect taxpayers. Preserving the status quo of uncertainty for future bailouts would only embolden reckless risk-taking. Companies will count on the fact that desperate politicians will do anything to spur the economy in the face of another crisis. In contrast, establishing an independent agency with clear parameters for bailout aid would create a depoliticized, settled way of addressing future financial instability that would complement the long-established FDIC framework for winding up insolvent financial firms. The prospect of investments by the FGIC would stabilize markets by establishing the terms for government investments in ailing firms. At the same time, FGIC conditions of having managers, shareholders, and creditors face cuts to their stakes, proportional sharing of returns with the FGIC over a multiyear time horizon, and imposing corporate governance reforms would provide disincentives for corporations to receive or rely excessively on FGIC funds. While creating an independent FGIC would face political hurdles, this proposal offers a practical pathway for addressing and defusing future financial crises and protecting taxpayers in the process.