THE GOVERNMENT SHAREHOLDER: REGULATING PUBLIC OWNERSHIP OF PRIVATE ENTERPRISE

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INTRODUCTION

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

1. Throughout this Article, the term "financial crisis" refers to the credit crisis that is generally acknowledged to have started in early 2007 as subprime lenders began to fail and which started to stabilize by the end of 2009. *See* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 471 (2009). At publication, it is far from clear that the economic problems spawned by the financial crisis are fully resolved, given continued high unemployment rates and market volatility.

2. *See id.* at 470 (describing an environment where governments "increasingly participate[] as market actors").

3. FIN. MGMT. SERV., U.S. DEP'T OF THE TREASURY, 2009 FINANCIAL REPORT OF

alone were valued at $512.3 billion.[4] Some political pundits condemned the investments as socialism.[5] Yet, the mere ownership of stock in a private enterprise by the U.S. government does not indicate a socialist political economy; nor is it the first time that the United States had an ownership interest in a financial institution.[6] Historically, the U.S. government has taken an ownership interest in national banks in order to further the country's economic interests.[7]

The sudden increase in the government portfolio is better understood as a Keynesian response to market failure rather than a radical change in the political economy. The growth in government ownership was driven by the government's deal-making approach to the financial crisis that started with a series of forced sales of financial institutions supported by government loans and evolved into direct equity investments by the U.S. Department of Treasury (Treasury).[8] However, given the pace at which the government operated in response to the evolving crisis, the dramatic increase in the government portfolio strained the capacity of the U.S. political and bureaucratic establishments to effectively and efficiently make and manage the investments.[9]

While these federal investments are credited in part with restoring confidence in the financial markets,[10] the government ownership of large

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THE U.S. GOVERNMENT 49 (2009), *available at* http://www.fms.treas.gov/fr/09frusg/09frusg.pdf. This figure takes into account assets on the government's balance sheet that consist of loans receivable and mortgage-backed securities ($538.9 billion), Troubled Asset Relief Program (TARP) direct loans and equity investments ($239.7 billion), beneficial interest in trust ($23.5 billion), securities and investments ($93.1 billion), and investments in government-sponsored enterprises (GSEs) ($64.7 billion). *Id.*

4. *Id.* This figure consists of the following assets: GSE mortgage-backed securities ($184.4 billion), net TARP direct loans and equity investments ($239.7 billion), beneficial interest in trust ($23.5 billion), and investments in government-sponsored enterprises ($64.7 billion). *Id.* at 49, 65.

5. Lanny J. Davis, *The GOP Leads A 'Socialist' Bailout*, WALL ST. J., Sept. 22, 2008, at A21, *available at* http://online.wsj.com/article/SB122204285661261373.html.

6. Andrew M. Shocket, *The Bailout: A Far Cry from Socialism*, HIST. NEWS NETWORK, Nov. 3, 2008, http://hnn.us/articles/55762.html.

7. *See* A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543, 551–52 (1995) (discussing the U.S. government's 1/5th ownership interest in the Second Bank of the United States).

8. Davidoff & Zaring, *supra* note 1, at 464–65.

9. *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, 545–49 (2010) (describing the response of policymakers to the crisis).

10. OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, SIGTARP: APR. 20, 2010 QUARTERLY REPORT TO CONGRESS 5 (2010), http://www.sigtarp.gov/reports/congress/2010/April2010_Quarterly_Report_to_Congress.pdf. Although stability in the financial markets was attained by 2010, there were still

stakes in private enterprise raises numerous legal, ethical, and policy issues.[11] Can the government effectively and ethically manage a portfolio of investments in companies as a shareholder when it is also charged with regulating those same companies? To what extent does the government mandate to pursue the public interest (e.g., reducing unemployment) conflict with corporate duties to maximize shareholder value? Have the bailouts created an implicit government guarantee that creates a new set of moral hazards? Has a political economy in which entrepreneurial capitalism plays a central role been irrevocably harmed by government bailouts of inefficient firms?

The Obama Administration promises a swift exit from the government investments,[12] but some commentators suggest that Treasury will hold some stock bought through the Housing and Economic Recovery Act of 2008 (HERA),[13] the Emergency Economic Stabilization Act of 2008 (EESA),[14] and the American Recovery and Reinvestment Act of 2009 (ARRA)[15] for the next decade, if not longer.[16] Prior to the government response to the financial crisis, a need existed to address problems posed by government investment. Over the last thirty years, the U.S. government, on both a state and federal level, has significantly increased public investment in private firms in order to advance policy goals in economic and technology

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concerns about the long-term viability of the recovery given high unemployment, continuing problems at regional banks and a struggling real estate market. *See id.*

11. *See* CONG. OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT: THE USE OF TARP FUNDS IN THE SUPPORT AND REORGANIZATION OF THE DOMESTIC AUTOMOTIVE INDUSTRY 3–4 (2009), http://cop.senate.gov/documents/cop-090909-report.pdf (raising questions over the conflict of interest apparent when the government owns shares in two competitors—i.e., Chrysler and General Motors).

12. *See* CONG. OVERSIGHT PANEL, *supra* note 11, at 163; Press Release, U.S. Dep't of the Treasury, Treasury Department Releases Text of Letter from Secretary Geithner to Hill Leadership on Administration's Exit Strategy for TARP (Dec. 9, 2009), *available at* http://www.financialstability.gov/latest/pr_12092009.html (explaining that the funds given to banks during the bailout will be repaid to the government in the near future).

13. Pub. L. No. 110-289, 122 Stat. 2654 (2008).

14. Pub. L. No. 110-343, 122 Stat. 3765 (2008).

15. Pub. L. No. 111-5, 123 Stat. 115 (2009).

16. Surojit Chatterjee, *AIG Offers Risky Bailout Repayment Plan, Will Use TARP Fund to Make Fed Exit*, INT'L BUS. TIMES, Oct. 1, 2010, http://www.ibtimes.com/articles/67392/20100930/aig-offers-risky-bailout-repayment-plan-will-use-tarp-fund-to-make-fed-exit.htm (recounting that former AIG CEO Maurice Greenberg speculates that it may be over a decade before the government is able is divest itself of shares in AIG); Edward L. Glaeser, *The Future of Freddie and Fannie*, NYTIMES.COM, (Oct. 5, 2010, 6:00 AM), http://economix.blogs.nytimes.com/2010/10/05/the-future-of-freddie-and-fannie/ (arguing that Fannie Mae and Freddie Mac should be converted into a public entity that is entirely owned by the government).

development.[17]

As a prescriptive goal, this Article attempts to define institutional norms and rules of the game that allow and encourage government investment while preserving the free market economic principles that drive growth and foster innovation. The Article attempts to reconcile the reality of massive government investment with the liberal market economy that provides for private incentive and entrepreneurial innovation. In this proposed model, the state would participate as a market actor according to the rules of a liberal market economy. This Article uses the term "state entrepreneurism"[18] to differentiate such a model from one of state capitalism or coordinated market economies.[19] At the core of the prescriptive regulatory proposal are three principles: (1) there must be political insulation of the investment decision and management of assets by creating an independent investment authority; (2) ethical walls should be created between the investment authority and the regulatory agencies overseeing private enterprise; and (3) the investment authority should be required to act as a prudent investor with the goal of maximizing the return on investment (ROI). In applying these principles, this Article defines a typology of government investments that includes five categories: (1) infrastructure investments; (2) social investments; (3) political investments; (4) economic investments; and (5) financial investments. The typology helps define the measures of success of a particular investment. The ROI of a financial investment should be measured by the amount of wealth created; whereas the ROI of a social investment should be measured by the degree to which the social goal is achieved. This does not mean that social investments are those where the government can squander taxpayer dollars without regard to cost. Regardless of the investment type, the government should be constrained to act as a prudent investor according to the context.

Any discussion of a regulatory regime for government investment necessarily requires a discussion of the nature and evolution of the political economy. Section I of this Article discusses the political economy of

17. Fred Block, *Swimming Against the Current: The Rise of a Hidden Developmental State in the United States*, 36 POL. & SOC'Y 169, 191 (2008).

18. Peter K. Eisinger was perhaps the first to identify the state's emergence as an entrepreneurial market participant in an influential study of government investment. *See generally* PETER K. EISINGER, THE RISE OF THE ENTREPRENEURIAL STATE 257 (1988).

19. This Article does not attempt to define an entirely new typology of capitalism; rather, the attempt here is to describe institutional norms surrounding government investment, how those institutions are undergoing a redefinition, and how new norms might be put into place that would comport with well-accepted models of capitalism in order to achieve agreed upon social goals of funding social welfare programs without adversely affecting innovation and growth.

government investment by drawing upon the theories of comparative capitalism put forward by the new institutionalism school. New institutionalism provides the theoretical framework for discussing the formal and informal norms that constrain a particular type of economy and how those norms are subject to change. Given the analytic tools provided by new institutionalism, Section II assesses U.S. government investment normatively—evaluating the successes and failures and establishing the institutional norms by which the U.S. government manages its investments. Section III offers a prescriptive solution to the problems posed by government investments in the form of a set of institutional rules meant to maximize the efficiency of government investments within liberal market economies while reducing the risks of ethical misconduct.

I. CAPITALISM AND THE POLITICAL ECONOMY OF GOVERNMENT INVESTMENT

In recent years, there has been much research in the area of comparative capitalism. Since the end of the Cold War, many economists have focused on the differing forms of capitalism that emerged in Eastern Europe and Asia in comparison to those that exist among developed countries.[20] Attempts have been made to understand why different forms of political economy flourish in different cultures. The role and degree of government investment has been an important factor in comparative capitalism studies. Some form of government investment exists in every type of political economy, though differences occur in the scope, type, and manner of investment.

As a preliminary matter, the field of comparative capitalism attempts to describe the makeup of the different types of capitalism. While numerous typologies surfaced,[21] there has been little agreement among scholars as to how to label capitalist systems or how many different varieties exist.[22] A number of monikers emerged to describe various forms including: "blue-

20. *See* PETER A. HALL & DAVID SOSKICE, VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE 1–3 (2001) (describing the various focuses of economic thought in the mid-to-late twentieth century).

21. *See generally* GLENN MORGAN ET AL., CHANGING CAPITALISMS? INTERNATIONALIZATION, INSTITUTIONAL CHANGE, AND SYSTEMS OF ECONOMIC ORGANIZATION 1 (Glenn Morgan et. al. eds., 2005) (discussing the differences between market economies and their roots in contrasting institutional arrangements); 24 COMPARATIVE SOCIAL RESEARCH: CAPITALISM COMPARED (Lars Mjøset & Tommy H. Clausen eds., 2007) (discussing capitalism from a compilation of comparative economics perspectives).

22. Mary Nolan, *Anti-Americanism and Americanization in Germany*, 33 POL. & SOC'Y 88, 103 (2005).

collar-capitalism,"[23] "casino capitalism,"[24] "crony capitalism,"[25] "disaster capitalism,"[26] "dynamic capitalism,"[27] "family capitalism,"[28] "gangster capitalism,"[29] "money manager capitalism,"[30] "monopoly capitalism,"[31] "oligarchic capitalism,"[32] "paternalistic capitalism,"[33] "regulatory capitalism,"[34] and "welfare capitalism"[35]—to name just a few.

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

One important development in comparative capitalism studies was Hall and Soskice's "varieties of capitalism" school. In this model, political economies tend to gravitate to one of two types—either a liberal market economy (LME) or a coordinated market economy (CME).[36] Neither type

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23. David Segal, *Enter the Recession's Waiting Room*, N.Y. TIMES, Sept. 27, 2009, at BU1.

24. Rebecca Cassidy, *'Casino Capitalism' and the Financial Crisis*, 25 ANTHROPOLOGY TODAY 10, 10–11 (2009).

25. Joseph H. Haslag & Rowena Pecchenino, *Crony Capitalism and Financial System Stability*, 43 ECON. INQUIRY 24 (2005).

26. NAOMI KLEIN, THE SHOCK DOCTRINE: THE RISE OF DISASTER CAPITALISM (2007).

27. Edmund S. Phelps, *Dynamic Capitalism*, WALL ST. J., Oct. 10, 2006, at A14.

28. HAROLD JAMES, FAMILY CAPITALISM: WENDELS, HANIELS, FALCKS, AND THE CONTINENTAL EUROPEAN MODEL (2006).

29. COLIN CROUCH, CAPITALIST DIVERSITY AND CHANGE: RECOMBINANT GOVERNANCE AND INSTITUTIONAL ENTREPRENEURS 6 (2005).

30. L. Randall Wray, *The Rise and Fall of Money Manager Capitalism: A Minskian Approach*, 33 CAMBRIDGE J. ECON. 807, 807 (2009).

31. BARRY C. LYNN, CORNERED: THE NEW MONOPOLY CAPITALISM AND THE ECONOMICS OF DESTRUCTION (2010).

32. Serguey Braguinsky, *Postcommunist Oligarchs in Russia: Quantitative Analysis*, 52 J.L. & ECON. 307, 307 (2009).

33. ANDREAS G. PAPANDREOU, PATERNALISTIC CAPITALISM (1972).

34. David Levi-Faur & Jacint Jordana, *The Rise of Regulatory Capitalism: The Global Diffusion of a New Order*, 598 THE ANNALS OF THE AM. ACAD. OF POL. & SOC. SCI. 200 (2005).

35. GØSTA ESPING-ANDERSEN, THE THREE WORLDS OF WELFARE CAPITALISM 2 (1990).

36. HALL & SOSKICE, *supra* note 20, at 8.

is normatively superior;[37] rather, the existence of one type depends on cultural and historical forces.[38] Moreover, the varieties of capitalism school suggests that path dependence makes it inefficient for a political economy to shift significantly from one form to another. Recently, the dualist notion of two polar opposites has been challenged, and a more nuanced model has emerged that blends different attributes and recognizes that political economies are neither static nor path dependent.[39] This Section first discusses comparative capitalism literature in order to give a theoretical foundation to understanding how government investment changed in the United States. The Article then considers the economic policies of the United States and the political debate between monetarism and Keynesianism.

A. *The Varieties of Capitalism Approach and New Institutionalism*

Hall and Soskice's varieties of capitalism model is considered the dominant paradigm for comparative capitalism studies.[40] The varieties of capitalism approach draws deeply upon the new institutionalism school of thought, where political economies are thought to be comprised of a series of institutions or rules that govern market actors.[41] New institutionalism attempts to explain the development of rules of the game—both formal and informal—that constrain the behavior of people and firms. New institutionalism theory has found support among socioeconomists, sociologists, and political scientists, as well as law and economics scholars, though differences exist between the disciplines.[42]

Economists also differ on how they define "institution" though certain themes have emerged. Hall and Soskice rely on Douglass North's seminal definition of an institution "as a set of rules, formal or informal, that actors generally follow, whether for normative, cognitive, or material reasons."[43] Organizations are distinguished from institutions and are defined as "durable entities with formally recognized members, whose rules also

37. *Id.* at 21.

38. *Id.* at 12–14.

39. CROUCH, *supra* note 29, at 23.

40. Peer Zumbansen, *The Parallel Worlds of Corporate Governance and Labor Law*, 13 IND. J. GLOBAL LEGAL STUD. 261, 304 (2006).

41. CROUCH, *supra* note 29, at 2.

42. New institutionalism in the study of economics differs from new institutional theories in sociology, political science, etc. *Id.* at 5–6. This Article is limited to a discussion of new institutionalism in the socioeconomics literature surrounding comparative capitalism studies and does not consider the law and economics approach to new institutionalism.

43. HALL & SOSKICE, *supra* note 20, at 9.

contribute to the institutions of the political economy."[44] Aoki broadly defines institution as a "rule of the game" that includes both exogenously- and endogenously-generated codified laws and social norms, but he adds an insight that the rules consist of "shared beliefs about how the game is played and to be played."[45] Crouch defines institutions as "patterns of human action and relationships that persist and reproduce themselves over time, independently of the identity of the biological individuals performing within them."[46]

Despite different definitions, economists generally agree that institutions include both formal rules (constitutions, codified laws, regulations, judicial decisions, etc. regarding both public and private law) that actors must follow or risk legal penalties (both civil and criminal) and informal rules (norms, customs, etc.) that actors are not legally bound to follow but which they comply with because to do otherwise could result in a nonofficial penalty. Institutions constrain behavior in that firms are bound to act according to the dictates of the institution. Much of the new institutional literature focuses on institutional change in order to understand how a society might modify the rules of the game that govern the political economy.[47]

1. *Liberal Market Economies Versus Coordinated Market Economies*

Hall and Soskice use new institutionalism to explain the mechanisms by which different political economies operate. Through a rigorous analysis of political economies, Hall and Soskice divided developed capitalist systems into two primary types—*liberal market economies* (LMEs), such as the United States and the United Kingdom, and *coordinated market economies* (CMEs), such as those found in Germany and Japan.[48] The emergence of a particular type of capitalism in a country depends on its culture, informal rules, and history.[49] While the dualist analysis to comparative capitalism

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44. *Id.*

45. Masahiko Aoki, *Endogenizing Institutions and Institutional Changes*, 3 J. OF INST. ECON. 1, 6 (2007) (emphasis omitted).

46. CROUCH, *supra* note 29, at 10 (emphasis omitted).

47. *See generally* CROUCH, *supra* note 29; HALL & SOSKICE, *supra* note 20; Aoki, *supra* note 45.

48. *See* HALL & SOSKICE, *supra* note 20, at 1–8. Hall and Soskice sought to explain the differences in political economies by studying how the firm, as the primary actor in any given economy, develops relationships in five spheres—industrial relations, education, corporate governance, interfirm relationships, and employee relations. *Id.* at 1–7. By linking microeconomic game theory analysis of the firm into macroeconomics, Hall and Soskice merged business studies with the study of comparative political economies. *Id.* at 5.

49. *See id.* at 12–13 (noting that many people learn informal rules through shared

preceded their approach, Hall and Soskice conclude that neither type of capitalism is normatively superior to the other in terms of producing lower inflation and higher rates of growth and employment.[50] Rather, each type of capitalism displays a comparative institutional advantage as to developing certain types of industries and products. According to Hall and Soskice, the institutional makeup of each type allows firms within a particular economy "to produce some kinds of goods, more efficiently than others because of the institutional support they receive for those activities in the political economy."[51]

LMEs are characterized by a neoclassical economic model where transactions occur in a competitive market. The institutions that characterize an LME include open competition, arm's-length negotiations between actors, and formal contracting.[52] In an LME, labor markets are fluid, and labor unions are generally not as strong as in CMEs.[53] Corporate governance in an LME is considered an "outsider" system where there is dispersed ownership of a firm and a liquid securities market contributing to diversified portfolios.[54] Since shareholders can diversify their risk, outsider systems are more conducive to financing companies that engage in entrepreneurial risk-taking ventures. This results in a higher degree of radical innovation in areas such as financial services and technology.[55] Under this model, the role of government investment in an LME would be minimal—occurring when there is market failure rather than as a regular course of business.

CMEs differ from LMEs in that "firms depend more heavily on non-market relationships" to shape economic relationships.[56] In CMEs, the various actors work collaboratively rather than competitively.[57] CMEs are

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experiences and stating that the expectations that emerge from this experience allow individuals to share a "common culture").

50. *See id.* at 20–21. Hall and Soskice note that the two forms also display differences in the distribution of incomes and employment. Liberal market economies (LMEs) have a high income disparity, and coordinated market economies (CMEs) usually have a shorter working week. *Id.*

51. *Id.* at 37. This insight provided a scholarly basis for challenging the assumptions of globalization—by opening markets, the world's economies would converge and evolve to neoliberal political economies. CROUCH, *supra* note 29, at 25–26.

52. HALL & SOSKICE, *supra* note 20, at 8.

53. *See id.* at 29–30 (stating that in LMEs trade unions are "less cohesive and encompassing," which makes wage coordination challenging).

54. Beth Ahlering & Simon Deakin, *Labor Regulation, Corporate Governance, and Legal Origin: A Case of Institutional Complementarity?*, 41 LAW & SOC'Y REV. 865, 872–73 (2007).

55. Alan Dignam & Michael Galanis, *Corporate Governance and the Importance of Macroeconomic Context*, 28 OXFORD J. LEGAL STUD. 201, 215 (2008).

56. HALL & SOSKICE, *supra* note 20, at 8.

57. *Id.*

typically considered "insider" systems as to corporate governance. Ownership is concentrated so there is not as much separation of ownership and control as in LMEs. Maximization of profit is less important in CMEs than in LMEs. CMEs adopt a stakeholder theory of the firm, where labor unions coordinate with both government and managers.[58] The economy of a CME gravitates toward capital-intensive industries where innovation is incremental.[59] Government investment is more likely to thrive in a CME, given that the state is seen as a partner with firms. CMEs occur in political systems characterized as social democracies where Keynesian economic policies predominate, whereas LMEs are associated with neoliberalism[60] and the neoclassical, free market approach.[61]

One of the most intriguing questions to surface in comparative capitalism studies is the degree to which a particular form of capitalism can thrive by adopting the institutional rules of the game normally found in other types of capitalism. In other words, is there an adverse effect on the long-term economic output as well as the integrity of the political economy if an LME adopts an institution normally found in a CME? This question is central to this Article's analysis given that the United States—although considered an LME—used the rules of the game of a CME in response to the financial crisis by coordinating with various actors to determine the winners and losers in the marketplace.

Hall and Soskice conclude that political economies suffer when states adopt institutions not normally found within their political economy. This is because of the theory of institutional complementarities. Institutions are "complementary if the presence (or efficiency) of one increases the returns from (or efficiency of) the other."[62] Hall and Soskice argue that LMEs will likely have market-driven rules of the games in all spheres of the economy, and that CMEs will have coordinated rules of the games across the economy.[63] For example, a labor force subject to market governance will more likely thrive if there is also a financial system governed by the market since the fluidity of capital creates new jobs, keeping demand for workers high.[64] Thus, Hall and Soskice argue that political economies tend to

58. *See* Ahlering & Deakin, *supra* note 54, at 872–73 (noting that this contributes to the feeling that employees are helping maintain "the sustainability of the enterprise").

59. Dignam & Galanis, *supra* note 55, at 215.

60. *See generally* CROUCH, *supra* note 29, at 27–29 (explaining the shortcomings of the modern characterizations of economic types).

61. Nolan, *supra* note 22, at 103 (describing various views of the liberal and nonliberal dynamic between American and German capitalism).

62. HALL & SOSKICE, *supra* note 20, at 17–21.

63. *Id.* at 18.

64. *Id.*

develop either as an LME or CME. A more mixed economy would underperform, given that the institutions of a CME would not complement (or make more efficient) the institutions of an LME. Critics of the Obama Administration's investment in Chrysler and General Motors (GM) might have used the theory of complementarities to argue that such a coordinated approach has and will continue to damage the efficiency of the neoliberal financial markets. Under this analysis, the government's attempted bailout and subsequent ownership of a large stake in GM preempted the bondholders from seeing a return on their investment, given the inevitable bankruptcy of the firm. This situation will likely make money managers less willing to invest in a company's bonds if they think the government may seek to take away their right to ownership in case of a bankruptcy. With less fluid financial markets, businesses cannot access capital, thus affecting job growth and the labor markets.

2. Path Dependence and Institutional Change

Economists differ on how an institution develops.[65] Some new institutionalists use path dependence theory to describe how an institution gains dominance. Path dependence theory suggests that actors in an economy adopt certain rules of the game that become ingrained in their behavior. Actors might initially be presented with two equally viable rules, but the adoption of one rule increases the probability of the actor choosing the same rule when presented with the choice again.[66] Formal institutions—whether constitutional, legislative, administrative, or judicial—are influenced by the political process "with its conflicts of interest, mobilizations of coalitions, and arbitrary trade-offs."[67] Likewise, informal social institutions may gain dominance through a power dynamic as well. A certain group of actors benefits by the adoption of a particular rule of the game.[68] Through a self-reinforcement mechanism, the group that benefits will seek to make the adoption of the rule permanent in order to continue reaping the rewards of the rule.[69] An institution may also gain dominance because the "learning curve" to take an alternate route

65. *See* CROUCH, *supra* note 29, at 10 (suggesting that unintended development is one possibility).

66. *See id.* at 75–76 (explaining that this can be understood as the first-mover advantage, as an actor is more likely to use rules that he is already familiar with).

67. *Id.* at 7.

68. *See id.* at 80–81 (describing the process through which actors can dominate the decisionmaking process and establish path dependency).

69. *See id.* at 81 (noting that a path may continue to be followed even if it no longer produces positive results because it will still produce "insider rewards").

reinforces prior behavior.[70] When presented with two equally viable paths—both of which require that an actor learn a procedure—it is more efficient for actors to choose the path with which they are already familiar since they do not have to learn a new procedure.[71] After repeated iterations, an actor may continue with the known path even if it begins to fail because "all competence at the discarded approach has been lost."[72] Because of path dependence, some new institutionalists contend that a particular form of capitalism will not transmute or evolve into another form once it gains dominance.[73]

The rule of the game that comprises a particular institution is distinguished from its governance. Governance of an institution consists of enforcement mechanisms used to constrain actors to follow the rule.[74] The constraint on behavior that characterizes a rule as an institution may be enforced externally through formal laws and through informal "normative pressures and expectations" put upon each actor to follow the rules of the game.[75] Governance might include "the state, the market, corporate hierarchies, associations, communities, clans, networks, and formal law . . . ."[76] Thus, "government is a subset . . . of governance" and both public and private enforcement may constrain an actor's choice.[77] Yet it is the constraining nature of an institution coupled with external enforcement mechanisms—both formal and informal—that leads to an underlying tension and "pressure for change" to rules of the game given that "there is always friction between a general rule and its application to individual cases."[78] In other words, an actor who wishes to maximize his economic benefit may be unable to do so because of the constraints imposed by an institution through governance—laws and expectations fostered through belief systems and other mechanisms.[79] Such an actor would seek to change the governance in order to change the institution.

How does an institution change? Although the focus here is on the constraint that an institution places on actors, institutions also facilitate

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70. *See id.* at 78–80 (explaining the inherent assumptions of the institutional learning curve theory).

71. *See id.* at 78 (postulating that the actor will also be an expert at this action).

72. *Id.* at 79.

73. *See id.* at 74 (noting that this is a less sophisticated approach to the problem than is warranted).

74. *See id.* at 12 (noting that the law is one example of a formal enforcement mechanism).

75. *Id.*

76. *Id.* at 21.

77. *See id.* at 20–21 (defining and exploring the concept of governance).

78. *Id.* at 13.

79. *Id.* at 18.

actors and "can often be adjusted."[80] However, such adjustment is not a matter that is "fully subject to human will."[81] For some new institutionalists, no change can occur once a path is set, even if it is economically rational for an actor to adopt different rules.[82] Over time, a particular institution can become so dominant that the path an actor takes becomes predetermined, and any attempt to change the behavior meets great resistance.[83] For example, if strict path dependence theory is correct, then it would be very difficult for an LME to adopt a rule that is characteristic of a CME, and vice versa, even if such a change were "in all actors' long-term best interests."[84] Thus, the strict path dependence theorist stands in sharp contrast to a rational choice theory, which contends that "an institution always needs to be useful to the specific actors who choose to have it, otherwise they would reject it."[85]

A more sophisticated analysis suggests that radical shifts in institutions only occur when there is a profound crisis.[86] Institutional innovation occurs when there is a conflict between periods of stability (times when there is "specialization and differentiation") and periods of change (where institutions recombine and barriers are overcome).[87] Clearly, the financial crisis was a period where the rules of the game suddenly changed. Faced with a collapse of the credit markets, the government adopted the rules and techniques of a CME, which would have likely met considerable resistance in the presence of a healthy economy.

Other theorists contend that major change can occur incrementally over longer periods of time.[88] The degree to which an institution may be susceptible to change depends upon how deeply an institution is embedded within the "cognitive, cultural, social, structural, [and] political" contexts of a society.[89] Some institutions may be strongly embedded (i.e., resistant to change even though the rule has outlived its usefulness) or weakly

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80. *Id.*

81. *Id.*

82. *See id.* at 74 (arguing that there will be no possibility of change or exit).

83. *See id.* at 1–2 (indicating that this predetermined path concept applies to countries as well).

84. *Id.* at 74.

85. *Id.* at 13.

86. *Id.* at 3. Significant changes that occur in short periods of time are typically followed by long periods where subsequent change is limited to a "closely bounded" range. *Id.* at 74–75.

87. *Id.* at 4.

88. *See id.* at 75 (describing an example of the theory of "cumulative change by gradual accretion").

89. *Id.* at 14.

embedded and thus easy to change.[90] The key to changing an institution is changing its governance.[91] A rule of the game no longer enforced by the state, stakeholders, or the community will no longer be considered an institution.[92] An institutional entrepreneur who wishes to foster change will seek to change the governing mechanisms that enforce the rules of the game.

An example of attempted institutional entrepreneurism occurred during the Clinton Administration with the debate over Social Security reform. In 1999, there was serious discussion that some portion of the Social Security Trust Fund should be moved into a more diversified portfolio that included stocks.[93] The move would have been the rational choice since stocks outperform a bond-only portfolio over the long term,[94] and there was support from various politicians, think tanks, and committees.[95] The change would have required alterations to both the formal law[96] and the informal institutional constraint proscribing government investment in anything but government bonds. The governance of this institutional constraint included two strongly held beliefs: (1) that if the government becomes an investor in private enterprise, then it will interfere in corporate governance, and (2) that fluctuations in the stock market would affect the ability of the government to pay out benefits.[97] President Clinton attempted to change the institution by changing its governance. He and others introduced the idea of addressing Social Security funding through investment in index funds so that the government would not exercise any shareholder vote, thus removing the fear of state meddling in corporate

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90. *Id.* at 16.

91. *Id.* at 24.

92. *Id.* at 22 (stating that "[i]f the governance mechanisms of an institution collapses, the institution will collapse").

93. *See* Lewis D. Solomon & Bryan L. Berson, *Private Market Reforms for Social Security: A Comprehensive Guide for Composing Reform Legislation*, 11 S. CAL. INTERDISC. L.J. 117, 124 (2001) (chronicling the recent history of congressional and presidential support for private market reform).

94. JEREMY J. SIEGEL, STOCKS FOR THE LONG RUN: THE DEFINITIVE GUIDE TO FINANCIAL MARKET RETURNS AND LONG-TERM INVESTMENT STRATEGIES 26–28, 27 fig.2.1, 28 tbl.2-1 (2d ed. 1998).

95. This loose coalition of politicians, analysts, and citizens is designated as a collective actor, as opposed to an individual actor. The constraint that an institution imposes applies whether the actor is collective or individual. CROUCH, *supra* note 29, at 18.

96. *See, e.g.*, 42 U.S.C. § 401 (2006) (laying out the existing rules on the management of the Federal Old-Age and Survivors Insurance Trust Fund).

97. *See* Benjamin A. Templin, *Full Funding: The Future of Social Security*, 22 J.L. & POL. 395, 432–33, 443 (2006) (detailing the government's past objections to the Social Security Trust Fund and arguing that the trust fund model insulates individuals from the risk of a market downturn).

governance.[98] Given the bull market during the late 1990s, there was likely never a better a time to overcome fears of systemic risk. Yet President Clinton's attempt failed. Why?

A new institutionalism and path dependence theorist might explain that government investment is not complementary with the neoliberal political economy of the United States. If path dependence theory is correct and government investment is an institution that aligns with a coordinated market economy, then, barring some cataclysmic event, the implementation of government investment in an LME is unlikely to be successful given the entrenched values and beliefs concerning the practice in the United States. President Clinton could not create the political will to effect the change, given the embedded nature of the institutions constraining government investment. An alternative explanation is that President Clinton lost political capital to move his policy agenda forward once the Monica Lewinsky scandal broke.[99]

B. *Beyond Dualism: Blended Forms of Capitalism*

Not surprisingly, the varieties of capitalism approach has its critics. Crouch contends that the varieties of capitalism school is overly simplistic and deterministic.[100] He sets forth a methodology to move new institutional analysis away from "gloomy determinism and inflexibility"[101] and toward a heterogeneous view of rules that allows institutional entrepreneurs to foster innovation. Crouch argues that breaking the typologies into two dominant forms of capitalism overly simplifies the complexity of political economies and the numerous forms of institutions.[102]

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98. In his 1999 State of the Union Address, President Clinton proposed that 60% of the Social Security Trust Fund be invested in the private sector. William J. Clinton, President, United States of America, State of the Union Address (Jan. 19, 1999), *available at* http://www.cnn.com/ALLPOLITICS/stories/1999/01/19/sotu.transcript/. A bill was introduced in Congress to use index funds as an investment vehicle, Retirement Security Act of 1998, H.R. 4076, 105th Cong. § 2 (1998), but the bill never passed. See Deborah M. Weiss, *The Regulation of Funded Social Security*, 64 BROOK. L. REV. 993, 1016 n.61 (1998) and H.R. 4076, 105th Cong. § 2 (1998) for a description of how § 2 was designed to amend Title II of the Social Security Act to provide a centralized fund invested in a series of index funds.

99. *See* Michael D. Tanner, *Clinton Wanted Social Security Privatized*, CATO INST. (July 13, 2001), http://www.cato.org/dailys/07-13-01.html (concluding that privatizing Social Security is a nonpartisan issue, as evidenced by the Clinton Administration's attempted reforms).

100. CROUCH, *supra* note 29, at 22–23, (arguing that oversimplification results from bundling characteristics of economies into "coherent wholes" without paying attention to the forces which produce those characteristics).

101. *Id.* at 1.

102. *See id.* at 23 (stating that the confusion between the "ideal types and cases" of

Crouch poses the question of whether models can be developed that allow particular types of capitalism to use and benefit from the institutions and rules used in other types of capitalism.[103] In other words, could an LME benefit from and use the tools characteristics of a CME? To put it in terms of this Article, can a model be developed for the United States to adopt a vibrant program of government investment without destroying the traits and innovation characteristic of its liberal market economy? Crouch is optimistic and has lofty goals. He writes, "in all such work we are ourselves engaging in the construction of paradigms that might (if we are very fortunate) start to influence some actors in the real world."[104]

Crouch lays out his argument empirically and theoretically. From an empirical point of view, Crouch challenges path dependence by documenting institutional innovation in California's high tech industry[105] and the United Kingdom's transformation "from neocorporatism and Keynesianism towards monetarism and neoliberalism."[106] Crouch attacks the characterization that LMEs produce radical innovation in future-oriented industries and CMEs only produce incremental innovation in traditional industries by pointing to the leadership of Finland and Sweden (both CMEs) in telecommunications "and the Nordic countries generally in medical technologies."[107]

As a theoretical matter, Crouch proposes an alternative to path dependence by advancing a theory of recombinant governance, whereby institutional entrepreneurs can recombine elements of different institutions in order to address economic issues.[108] Crouch demonstrates that "institutional heterogeneity may facilitate innovation, both by presenting actors with alternative strategies when existing paths seem blocked and by making it possible for them to make new combinations among elements of

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capitalism oversimplifies economic systems).

103. *See id.* at 3 (describing "institutional entrepreneurs" who recombine elements of institutions in a novel way to produce change).

104. *Id.* at 157.

105. *See id.* at 129–30, 141 (explaining that California's high tech economy has flourished because of a close link between scientists in the region's universities and firms). Much of the innovation in the U.S. economy comes from funding by a "scientifically oriented military sector, tying a number of contracting firms into close and necessarily secretive relations with central government departments . . . ." *Id.* at 28. Such relationships are more characteristic of a CME and inapposite to the neoliberal model. *Id.*

106. *Id.* at 149.

107. *Id.* at 31.

108. *See id.* at 3 (analogizing institutional entrepreneurs who recombine elements of institutions to geneticists who work on recombinant DNA, combining genetic components from two or more sources to form a new molecule).

various paths."[109] Institutional entrepreneurs who want to introduce an alternative rule can improve their probability of success by being mindful of the degree of embeddedness of an institution and by having a belief in an alternative rule as creating better results despite imperfect knowledge about the result.[110] Given that governance schemes are fragmented between state regulation, the market, and society, it becomes easier for institutional entrepreneurs to break down the governance mechanisms and recombine existing elements of an institution to form a new and innovative approach.[111] Crouch is realistic about the ability of institutional entrepreneurs to foster change given that "power asymmetries" may exist to enforce an institution.[112] The existence of functional equivalents—the availability of many different solutions—can also hamper the introduction of an innovation.[113]

Within the legal academy, there have been similar attempts to synthesize a theory of governance that embraces the market-based concepts prevalent in law and economics with the top-down regulatory approach advocated by critical legal scholars.[114] Lobel envisions a "Renew Deal" governance that promotes collaboration among state and nonstate actors and leverages new institutional norms to address what she sees as a new form—or at least the new realities—of political economy.[115] Lobel and Crouch share a vision, in that both scholars advocate and value a heterogeneous view toward institutions and believe that greater participation of nonstate and state actors in governance will yield a more diverse set of tools with which to address economic and social problems.[116]

Another important alternative to the dualist approach in comparative

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109. *Id.* at 73.

110. *See id.* at 99–100 (stating that the model entrepreneur purposefully departs from the conventional ways that institutions have been run in the past to create change).

111. *See id.* at 110–26 (explaining how institutional entrepreneurs are able to choose and combine governance elements by their desired results).

112. *See id.* at 127–28 (concluding that power asymmetries within an existing governance model will not prevent institutional entrepreneurs from recombining elements of governance systems).

113. *See id.* at 128 (discussing the concept of alternative strategies when existing paths seem blocked).

114. *See, e.g.*, Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342, 344 (2004) (introducing a new governance model combining law and economics and critical legal scholarship to promote a renewed dialogue in the academic community).

115. *Id.* at 344–49.

116. *See* CROUCH, *supra* note 29, at 126 (explaining that institutional heterogeneity will facilitate innovation by presenting actors with tools to overcome barriers and foster new solutions); Lobel, *supra* note 114, at 344–49 (describing how combining dispersed law reform efforts will promote coordination of problems and facilitate government innovation).

capitalism studies is the expanded set of typologies adopted by Baumol, Litan, and Schramm. The authors posit that four distinct archetypes of capitalism emerged after the fall of the Berlin Wall in 1989: (1) entrepreneurial capitalism, (2) big-firm capitalism, (3) state-directed capitalism, and (4) oligarchic capitalism.[117] Rather than being constrained to just one typology, Baumol, Litan, and Schramm argue that in different stages of development, a state might be classified as leaning towards one of the four, but the classification is not static.[118]

Of the four archetypes, Baumol, Litan, and Schramm consider entrepreneurial capitalism as having the best chance of exhibiting strong economic growth and fostering innovation.[119] Increasingly, some economists have challenged the premise that unrestrained economic growth is desirable or even attainable.[120] Sometimes, unrestrained economic growth results in displacements in the labor workforce, bankruptcies of inefficient firms, harm to the environment, and, of course, the tumultuous markets experienced during the financial crisis as the market corrects itself. However, the dominant metric is still gross domestic product.

To achieve economic growth and innovation, Baumol, Litan, and Schramm set out four institutional norms of a successful entrepreneurial economy: (1) The creation and dissolution of a business must be simple, efficient, and without too much cost or "time-consuming bureaucratic red tape."[121] In addition, there must be a "well-functioning financial system" providing capital to entrepreneurs and "flexible labor markets" which allow firms to "fire nonperforming workers or shed workers they no longer need."[122] (2) The institutional rules within the political economy must

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117. WILLIAM J. BAUMOL, ROBERT LITAN & CARL J. SCHRAMM, GOOD CAPITALISM, BAD CAPITALISM, AND THE ECONOMICS OF GROWTH AND PROSPERITY 10–11 (1st ed. 2007).

118. *Id.* at 11.

119. *See id.* at 85–86 (stating that entrepreneurial capitalism has produced innovations that radically improved the standard of living).

120. *See, e.g.*, Bill MCKIBBEN, DEEP ECONOMY: THE WEALTH OF COMMUNITIES AND THE DURABLE FUTURE 1–2 (2007) (arguing that economic growth is not sustainable given the limits of natural resources and environmental concerns over pollution). Recently, much work has been done by policy analysts, government statisticians and economics scholars to develop measures other than gross domestic product (GDP) to gauge a society's social advancement. *See, e.g.*, Mark A. Cohen & Michael P. Vandenbergh, *Consumption, Happiness, and Climate Change*, 38 ENVTL. L. REP. 10,834, 10,834–37 (2008) (exploring happiness measures as a replacement for GDP); Jon Gertner, *The Rise and Fall of the G.D.P.*, THE N.Y. TIMES MAGAZINE, May 16, 2010, at MM60, *available at* http://www.nytimes.com/2010/05/16/magazine/16GDP-t.html (noting that some developed nations have worked on measures other than GDP to indicate a nation's prosperity by gauging overall human development rather than just economic output).

121. BAUMOL ET AL., *supra* note 117, at 7.

122. *Id.*

support property and contract rights so that entrepreneurs are confident that nationalization of their efforts does not occur. Without those assurances, entrepreneurs are unlikely to take on the risk of a new venture.[123] (3) The government must adopt institutional norms that promote Pareto improvement rather than rent-seeking behavior, such as "political lobbying or the filing of frivolous lawsuits designed to transfer wealth from one pocket to another."[124] (4) The economy should incentivize both entrepreneurs and large firms to "innovate and grow, or else economies will sink into stagnation" by adopting "effective antitrust laws" and promoting free trade.[125]

Baumol, Litan, and Schramm describe the U.S. economy as having a blend of big firm and entrepreneurial capitalism thereby blending innovation in business with a strong presence in international trade.[126] The institutions that make up the economy include fluid labor and capital markets, strong contract and property rights, and a regulatory system that favors the market rather than coordination by the government.[127] In such an economy, government investment is typically minimal. Rather than choosing winners and losers, the government's primary role is as a regulator and not as an owner.[128] However, the recent financial crisis and resurgence of Keynesian interventionism shifted the institutional balance to include aspects of state-directed capitalism.

In the Baumol, Litan, and Schramm model, state-directed capitalism, or state capitalism, consists of a centrally controlled economy where the government, rather than private investors and entrepreneurs, determines which industries will be pursued within the country and which firms will get the capital to build those industries.[129] Baumol, Litan, and Schramm dismiss communism and socialism as viable economic models and maintain that those political economies disappeared by the end of the Cold War.[130] Everything remaining, in their view, is a form of capitalism. Although the government may choose the winners, such support does not necessarily mean those industries and firms will be economically successful or efficient

123. *Id.*

124. *See id.* at 7–8 (describing how activities that "divide up the economic pie rather than increase its size" are unproductive and should be discouraged).

125. *Id.* at 8.

126. *See id.* at 228–29 (accrediting the United States' role as leading economic power in the world to its unique blend of "big-firm and entrepreneurial capitalism").

127. *See* BAUMOL ET AL., *supra* note 117 at 7–8.

128. *See id.* at 8 (explaining that the government should set in place a system of enforcement whereby market forces encourage competition and trade).

129. *Id.* at 62.

130. *See id.* at 7 (stating that "central planning" systems fail to produce high standards of living).

without further government support.[131]

In the case of China, state-guided capitalism has worked well to propel what was once a third world country into the world's second largest economy.[132] Yet, state-guided capitalism that owns the means of production may stifle innovation. In addition, state capitalism is marred by insider dealings and corruption, thus setting the stage for rent-seeking behavior.[133] While China has been successful in producing products with cheap labor, the growth has not come without corruption, and technological innovation is still elusive in the People's Republic.[134] Sometimes, state capitalism is coercive, as when Venezuela nationalized private assets and compensated the owners with less than the fair market value. Venezuelan President Hugo Chavez justified his nationalization of foreign-owned oil companies in the country by contending that oil was "strategic" for the country's development and that leaving these to foreign investors alone is not sufficient to assure the country's economic growth."[135]

Although the U.S. political economy is far from a state-guided capitalist model, the actions of the government during the financial crisis had characteristics normally found in more centralized systems. Furthermore, the massive increase in the government portfolio of private investments created dissonance between the actions of the government and the U.S. political and economic philosophy of an LME. Although the United States did not nationalize the banks during the financial crisis, some of the initial EESA investments made under the Troubled Asset Relief Program (TARP) were coercive in that the preferred stock sales were forced on healthy banks.[136] Moreover, the pre-bankruptcy loans to GM and Chrysler were likely politically driven, and subsequent management of the investment amounted to the centralized planning inherent in a state capitalist model.

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131. *See id.* at 70 (describing how state-guided capitalism economies have difficulty "pulling the plug" on overly regulated industries).

132. Yoree Koh, *China Overtakes Japan. Do Japanese Care?* WALL ST. J. CHINA REALTIME REP. (Aug. 17, 2010, 10:04 AM), http://blogs.wsj.com/chinarealtime/2010/08/17/china-overtakes-japan-do-japanese-care/.

133. *See* BAUMOL ET AL., *supra* note 117, at 62–71 (discussing state guided capitalism and susceptibility to corruption).

134. *See id.* at 63–70 (discussing the pitfalls of state-guided capitalism in relation to corruption).

135. Gregory Wilpert, *Venezuela Decrees Nationalization of Last Foreign Controlled Oil Fields*, VENEZUELANALYSIS.COM (Feb. 27, 2007), http://venezuelanalysis.com/news/2245.

136. *See* Sara Lepro, *Documents: Paulson Forced 9 Bank CEOs to Take TARP*, SEATTLE TIMES (May 14, 2009, 12:09 PM), http://seattletimes.nwsource.com/html/businesstechnology/2009219260_apustreasurydocuments.html (describing how the government pressured banks to participate in the TARP program and wanted "healthy institutions" to participate to remove any stigma associated with institutional participation).

At least one commentator suggests the dissonance has been present well before the subprime financial crisis. Block contends that a "hidden development state" funding technology research and development existed since the 1980s, and the state's political rhetoric committing to the free market merely hid that form of state guided capitalism from the public.[137]

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

C. U.S. Economic Policy Swings: Monetarism Versus Keynesianism

Although U.S. economic policy is classified as neoliberal, it swings on a continuum where the dominant policy sometimes favors Keynesian state interventionism, such as that found in CMEs, and at other times monetarism, which embodies the neoclassical economic theories found in LMEs.[138] Monetarists support small government and minimal regulation under the theory that a market which is allowed "to flourish unhindered will grow and prosper."[139] To stimulate growth, monetarists contend that a strong monetary policy is the most effective tool against inflation and a key to spur economic growth.[140] Monetarists think that state intervention results in inefficiencies.[141] Keynesians, however, dispute the efficiency of the markets, and advocate government intervention in the economy through a strong economic policy in order to maximize the utility of capital and labor.[142]

Another major dispute between monetarists and Keynesians is the degree to which the market self-corrects. Neoclassical economists believe

137. Block, *supra* note 17, at 169–70.

138. *See* Steven Pressman, *The Role of the State and the State Budget*, *in* A NEW GUIDE TO POST-KEYNESIAN ECONOMICS 102, 103 (Richard P. F. Holt & Steven Pressman eds., 2001). The U.S. policy debate finds its roots in a more complex centuries-long debate among economists over the nature of capitalism, with some promoting its virtues and others lamenting its faults. *See* Alberto Cassone, *The Reconstruction of Keynesian Economics: Works in Progress*, *in* KEYNES AND THE ECONOMIC POLICIES OF THE 1980S 21, 21 (Mario Baldassarri ed., 1992).

139. Pressman, *supra* note 138, at 103.

140. *See* MILTON FRIEDMAN, MONETARIST ECONOMICS 11 (1991) (describing monetarists' belief that fiscal policy alone is ineffective).

141. *Id.*

142. *See generally* JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY (Palgrave MacMillan 2007) (1936). Government intervention "is only one aspect of Keynes' overall contribution, but to the outside world it is essentially what a Keynesian approach to economic management means." Walter Eltis, *Has the Reaction Against Keynesian Policy Gone Too Far?*, *in* KEYNES AND THE ECONOMIC POLICIES OF THE 1980S, *supra* note 138, at 51.

that wages and prices in the market self-correct such that the GDP will find its natural level.[143] Under neoclassical economic theory, a decrease in aggregate demand[144] results in a drop in real GDP that is below the natural level. In other words, there are workers who want to be employed and resources that may be exploited, but prices are too high. Neoclassical theorists argue that wages will drop naturally because the workforce will accept a lower wage in order to remain employed. Since wages are lower, the cost of producing goods also drops, thus driving down prices. Therefore, as aggregate demand decreases, the market self-regulates and corrects with a decrease in price. Real GDP remains the same even though prices have dropped.

Keynes challenged the neoclassical theory that wages and prices adjust such that "Supply creates its own Demand."[145] Keynes reasoned that prices and wages are "sticky"[146]—i.e., react too slowly—and are not reliable in readjusting imbalances in equilibrium.[147] Prices are slow to adjust because of "rigidities introduced into markets by producer organizations, the variability of business confidence, and a variety of other common phenomena . . . ."[148] As to wages, Keynes maintained that workers would not be willing to accept lower wages; therefore, prices would not reduce in response to lower demand.[149] Since unemployed workers have no income and are not purchasing goods and services, aggregate demand remains stagnant at a decreased level without a correlated adjustment in supply. Since prices and wages are slow to adjust, the decreased demand results in "unnecessarily low levels of employment" and longer than necessary recession.[150] As a policy matter, Keynes argued that governments should intervene by increasing government spending in order to maintain

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143. Real GDP is at its natural level when all of the economy's resources are employed.

144. This Article uses the well-accepted definition of aggregate demand as consisting of consumption, investment, government spending, and net exports. *See* ANSEL M. SHARP, CHARLES A. REGISTER & RICHARD H. LEFTWICH, ECONOMICS OF SOCIAL ISSUES 327 (1994) (defining the components of aggregate demand).

145. KEYNES, *supra* note 142, at 25–26 (describing the classical doctrine that supply creates demand).

146. *Id.* at 237–38.

147. James Tobin, *Keynesian Theory: Is it Still a Useful Tool in the Economic Reality of Today?*, *in* KEYNES AND THE ECONOMIC POLICIES OF THE 1980S, *supra* note 138, at 3 (positing the Keynesian principle that market economies automatically stabilize and adjust imbalances but the mechanisms are unreliable and slow).

148. PETER HALL, THE POLITICAL POWER OF ECONOMIC IDEAS: KEYNESIANISM ACROSS NATIONS 6 (1989).

149. KEYNES, *supra* note 142, at 237–38.

150. HALL, *supra* note 148, at 6.

aggregate demand.[151] Keynes suggested that it does not matter how government spends the funds so long as the spending balances the decrease in consumption.[152] However, Keynes thought the "agenda" for the state should not include "activities which private individuals are already fulfilling, but to those functions which fall outside the sphere of the individual, to those decisions which are made by *no one* if the State does not make them."[153] In that respect, Keynes preferred that government spend on areas where there was a need, which in the 1930s was "more houses, hospitals, schools, and roads."[154] Keynes sought to improve "the technique of modern Capitalism by the agency of collective action,"[155] but he did not think the collectivist nature of his theories was "seriously incompatible" with the profit motive of capitalism.[156] Indeed, Keynes was a critic of some forms of socialism[157] and thought capitalism, although imperfect, could achieve better economic gains than "any alternative system" provided that it was "wisely managed."[158] That said, Keynes hoped that through thought, rather than revolution, an economic system without the ills of capitalism could eventually be developed.[159]

Keynesian economics dominated U.S. economic policy from the 1930s until the early 1980s when monetarism and neoclassical economics took hold.[160] Milton Friedman's theories epitomize the monetarist approach and were embraced by the Reagan Administration as well as other countries during the early 1980s.[161] Friedman contended that monetary policy, rather than fiscal policy, was the most effective tool in maintaining economic growth in a low inflationary environment.[162] Friedman

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151. KEYNES, *supra* note 142, at 374–81.

152. *Id.* at 218–20.

153. JOHN MAYNARD KEYNES, THE END OF LAISSEZ-FAIRE: THE ECONOMIC CONSEQUENCES OF PEACE 40 (2004).

154. Pressman, *supra* note 138, at 104.

155. KEYNES, *supra* note 153, at 43.

156. *Id.*

157. *See id.* at 39–40 (critiquing state socialism as an antiquated theory that does not react to present conditions).

158. *Id.* at 44.

159. *See id.* at 44–45 ("The next step forward must come, not from political agitation . . . but from thought.").

160. Pressman, *supra* note 138, at 102. The shift away from Keynesian policies in the 1980s was largely because the application of the policy proved to be inflationary during the 1970s—a time when GDP was falling, government budget deficits were growing, and the price of oil spiked. *Id.* Stagflation coupled with large budget deficits suggested that the Keynesian model was ineffective at managing the economy. *Id.*

161. *See* FRIEDMAN, *supra* note 140, at 11–13 (introducing the concepts of monetary and fiscal policy).

162. *See id.* (describing the example of the United States in the 1960s as proving that

maintained that there is a positive relationship "between the rate of growth of the quantity of money and the rate of growth of nominal income."[163] Changes in nominal income affect output in the short-term and prices in the long-term.[164] Inflation occurs when there is "a more rapid increase in the quantity of money than in output."[165] Friedman argues that monetary policy that provides for a steady, automatic growth in the money supply will result in a "stable monetary framework for economic growth without itself being a source of instability and disturbance."[166]

Keynesians squared off with monetarists over the importance of monetary policy versus fiscal policy.[167] Keynesians view monetary policy as a tool that can be useful—especially negatively—to lower investment in times of an over-heated economy.[168] However, Keynesians think fiscal policy, rather than monetary policy, is more effective at controlling inflation.[169]

By the mid-1990s, monetarism dominated U.S. economic policy and was thought to have eclipsed Keynesian economics.[170] Debates will likely continue over which is the better approach—Keynesian economics or monetarism. The shifts in economic policy are aligned with political ideology; consequently, policy is likely to shift as the political cycle changes. The "social democratic Left" uses Keynes's theories to defend "government intervention in the economy,"[171] whereas the "conservative Right" vilifies Keynes for "undermin[ing] the traditional belief in *laissez-faire* during the Great Depression."[172] The Obama Administration's ARRA stimulus package was classic Keynesian economics, in that it authorized $787 billion in spending for jobs, infrastructure investments, research, and other

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monetary policy is more effective in stimulating growth).

163. *Id.* at 14.

164. *See id.* at 15–16 (noting that nominal income appears in output but hardly at all in prices).

165. *Id.* at 16.

166. *Id.* at 18.

167. *See generally* J.E. KING, A HISTORY OF POST KEYNESIAN ECONOMICS SINCE 1936 161–80 (2002) (describing monetarist and Keynesian dynamics and conflicts).

168. *See id.* at 163–64 (detailing how monetary policy can have negative effects on the level of investment).

169. *See id.* (cautioning that monetary policy should not be used to control inflation).

170. *See id.* at 179 ("[M]onetarists had won the war, but also . . . lost some important battles in the process.").

171. *See* Bradley W. Bateman, *The End of Keynes and Philosophy?*, *in* THE PHILOSOPHY OF KEYNES'S ECONOMICS: PROBABILITY, UNCERTAINTY, AND CONVENTION 71, 71 (Jochen Runde & Sohei Mizuhara eds., 2003) (describing how Keynes is viewed by both sides of the political spectrum).

172. *Id.*

projects to restart economic growth.[173] However, the EESA that authorized TARP investments was not so easily categorized as Keynesian. In some respects, a government purchase of equity in a company is similar to a government purchase of goods, in that the government steps in and makes purchases when the market cannot. However, some TARP investments were conducted in a fashion where the government seemed to use the institutional norms of a CME. The intervention of the state into the management of American companies led to widespread concern about the nature of American capitalism. The February 16, 2009 cover of Newsweek declared, "We Are All Socialists Now," lamenting the move from free market capitalism to more of a "modern European state."[174]

II. U.S. GOVERNMENT INVESTMENTS: AN INSTITUTIONAL ANALYSIS

From 2008 to 2009, the U.S. investment portfolio nearly tripled. For purposes of this Article, the government investment portfolio will be considered those financial assets reported on the U.S. government's consolidated balance sheet. From 2008 to 2009, the government portfolio increased 282% from $340.4 billion to $959.9 billion.[175] The investments made in an effort to ease the financial crisis alone were valued on the government's 2009 balance sheet at $512.3 billion.[176] The remainder of the portfolio consisted of $354.5 billion in direct loans other than those made in response to the crisis, and $93.1 billion in securities held in a mix of special purpose funds.[177] The valuation does not reflect the total amount

173. *See generally* American Recovery and Reinvestment Act of 2009, Pub.L. No. 111-5, 123 Stat. 115 (codified as amended in scattered sections of 26 U.S.C.).

174. John Meacham & Evan Thomas, *We Are All Socialists Now*, NEWSWEEK, Feb. 7, 2009, at cover, 23.

175. *See* 2009 FIN. MGMT. SERV., *supra* note 3, at 49. This figure takes into account assets on the government's balance sheet that consist of loans receivable and mortgage-backed securities ($253.8 billion at the end of 2008 fiscal year and $538.9 billion at the end of the 2009 fiscal year), TARP direct loans and equity investments ($0 at the end of 2008 fiscal year and $239.7 billion at the end of the 2009 fiscal year), beneficial interest in trust ($0 at the end of 2008 fiscal year and $23.5 billion), securities and investments ($79.6 billion at the end of 2008 fiscal year and $93.1 billion at the end of the 2009 fiscal year), and investments in government-sponsored enterprises ($7 billion at the end of 2008 fiscal year and $64.7 billion at the end of the 2009 fiscal year). *Id.*

176. This figure consists of the following assets: GSE mortgage-backed securities ($184.4 billion), TARP direct loans and equity investments ($239.7 billion), beneficial interest in trust ($23.5 billion), and investments in government-sponsored enterprises ($64.7 billion). *Id.* at 49, 65.

177. Historically, the government has been the lender of last resort to certain populations when private institutions fail to provide credit. *Id.* at 66. For example, the government portfolio for Federal Direct Student Loans for education, the largest of these programs, held a face value of $153.3 billion at the end of the 2009 fiscal year—taking into

the government invested during the financial crisis given that some investments have been paid back, some were already written down in value by the end of the 2009 fiscal year, and other investments were made after the close of the 2009 fiscal year. Additionally, the figure does not take into account securities held by the Federal Reserve and its member banks because the Federal Reserve reports financial results separately as an independent entity.[178] Some analysts combine the Federal Reserve's portfolio with the portfolios of Treasury and the Federal Deposit Insurance Corporation (FDIC) to reflect a portfolio of financial crisis investments valued at $1.93 trillion.[179]

Even though the government's 2009 balance sheet only gives a snapshot in time of its portfolio, the increase in government holdings from 2008 to 2009 was dramatic. In a little over one year, the U.S. government transformed itself into one of the largest shareholders in the world. By way of comparison, the world's largest sovereign wealth fund, the Abu Dhabi Investment Authority, held an estimated $627 billion in assets.[180] The sudden increase in the government's portfolio highlighted its portfolio management practices. Much criticism arose not only over the rapid increase in the government portfolio, but also the way in which taxpayer dollars were invested and managed. While it is dangerous to generalize about management practices that span many agencies and different types of investments, some consistent themes emerge not only from the practices highlighted during the financial crisis but also in the management of the government portfolio before the crisis. This Section will address the current general institutional constraints on government investments.

As a preliminary matter, and for purposes of this Article, the term

account the value of defaulted loans. *Id.* at 65–66.

178. *See id.* at vii n.2 ("The Federal Reserve is an independent organization and not considered a part of the Federal reporting entity.").

179. *See Total Wall Street Bailout Cost*, SOURCEWATCH, http://www.sourcewatch.org/index.php?title=Total_Wall_Street_Bailout_Cost (last visited Nov. 7, 2010) (valuing the combined Treasury, Federal Deposit Insurance Corporation, and Federal Reserve portfolios to a sum of $1.93 trillion outstanding).

180. *Largest Funds by Assets Under Management*, SOVEREIGN WEALTH FUND INST., http://www.swfinstitute.org/fund-rankings (last updated Sept. 2010). Other analysts claim that the size of the Abu Dhabi fund is overstated and was merely $300 billion in 2009. Nadim Kawach, *Gulf Sovereign Wealth Funds See Further Fall*, EMIRATES BUS. 24/7 (Mar. 29, 2009), http://www.emirates247.com/2.266/investment/gulf-sovereign-wealth-funds-see-further-fall-2009-03-29-1.95439 (last visited Nov. 7, 2010). Comparing the U.S. total of investments to sovereign wealth funds is admittedly problematic since the U.S. figure presented here includes investments spread out over several agencies. If similar investments made by foreign governments were taken into account, a different picture of comparative government investment would emerge.

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

Government investment should be distinguished from government subsidies in that subsidies are considered the funding of programs where the government does not expect a tangible return on the investment. For example, subsidies to farmers are paid out in an attempt to affect the supply of a good. There is no expected return on investment to the government from such payouts.[181] Likewise, when the government gives a company a tax break if the company pursues a certain business plan, it is sometimes thought to be an "investment" in that the government forgoes its revenue (taxes) in favor of some other goal. This is better categorized as part of the larger fiscal policy rather than an investment.[182] Additionally, government guarantees on loans are not strictly an investment. The government guarantees loans for policy reasons, such as encouraging banks to make loans to underserved communities.[183] Although a default of the borrowers

181. The return on investment in a subsidy is indirect. In the case of government-subsidized research, the research is anticipated to create new jobs and products that would result in an increased tax revenue stream to the government. Such funding is outside the scope of this Article, though. It should be noted that there has been discussion that private companies that exploit government-subsidized technology research should be required to return some percentage of their stock into a "public sector trust fund" to develop future technology. *See, e.g.*, Block, *supra* note 17, at 195–96 (proposing that Google, which emerged out of research at Stanford University funded by the National Science Foundation, be required to pay 5% of their shares in a public sector trust fund). In this sense, subsidies would then generate a more direct return on investment for the government.

182. *See* Robert S. Chirinko, *Investment Tax Credits*, *in* ENCYCLOPEDIA OF TAXATION AND TAX POLICY 226 (Joseph J. Cordes et al. eds., 2d ed. 2005) (noting that investment tax credits have often been used as fiscal policy).

183. Government-guaranteed loans are granted by a number of different agencies, including the Department of Housing and Urban Development (HUD), the Export–Import

usually leads to government ownership of a security or an interest in some asset, guarantees only have an indirect benefit to the government as an advancement of some policy if the loan is successfully repaid. That said, government guarantees—both implicit and explicit—have been largely blamed for creating the moral hazards that led to the financial crisis.[184] While guarantees are not generally considered investments, the market-driven proposals in this Article could help regulate the issuance of high-risk government guarantees which are routinely made as a matter of policy.

Given the controversy over government investment during the subprime financial crisis, this Article emphasizes investments made under the TARP program; however, it will also consider investments made under other programs both prior to and after the financial crisis. Some of the government investments discussed here include loans and security purchases made by the Federal Reserve rather than Treasury. During the financial crisis, Treasury coordinated with the Federal Reserve in many government-brokered deals in order to stabilize the markets, such as the sale of Bear Stearns to J.P. Morgan. In that deal, the government acted more as "a dealmaking middleman, a traditional role for investment bankers," rather than as an investor,[185] though the Federal Reserve authorized the Federal Reserve Bank of New York (FRBNY) to make $30 billion in loans available to J.P. Morgan in order to facilitate the transaction.[186] FRBNY also loaned AIG funds during its liquidity crisis. Although the securities held by FRBNY are not strictly part of the government portfolio, loans from Federal Reserve Banks were done in the context of government deal making; FRBNY acted as an agent of the Federal Reserve Board, using funds that the government created and added to the money supply.[187] Given the close relationship and its quasi-public status, the FRBNY transactions help inform how the government operates as a market actor during a financial crisis and therefore will be discussed when relevant to the institutional analysis of government investment.

Both formal and informal institutions constrain the government in its

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Bank (Ex-Im Bank), and the Small Business Administration (SBA). *See* FIN. MGMT. SERV., *supra* note 3, at 66.

184. *See* Kevin Dowd, *Moral Hazard and the Financial Crisis*, 29 CATO J. 141, 142–55 (2009), *available at* http://www.cato.org/pubs/journal/cj29n1/cj29n1-12.pdf (asserting that moral hazard was a central cause of the events leading up to the financial crisis).

185. Davidoff & Zaring, *supra* note 1, at 538.

186. *Maiden Lane Transactions*, FED. RESERVE BANK OF N.Y. http://www.newyorkfed.org/markets/maidenlane.html (last visited Nov. 7, 2010).

187. CONG. OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT'S EXIT STRATEGY 183–84 (2010), *available at* http://cop.senate.gov/documents/cop-061010-report.pdf.

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

Government investment occurs with less frequency in an LME than in a CME; though investment occurs in LMEs in the presence of market failure. Given America's liberal market economy, U.S. government investment in private assets has long been disfavored—at least within the political discourse. In the early 1980s when the laissez-faire policies of Milton Friedman gained popularity, the Reagan administration started a trend towards deregulation, minimalist intervention in the market, and privatization. However, even prior to the Reagan era, government investment was discouraged. One of the best examples of the political divide over government investment is the debate over whether the Social Security Trust Fund should be invested in a diversified portfolio that includes stocks rather than just government bonds. Although President Bill Clinton supported the diversification in order to earn a higher rate of return on the portfolio,[188] President Bush was adamant that government not invest in private enterprise to fund social welfare programs.[189]

This Section groups the institutions surrounding U.S. government investment into two broad categories: (1) rules that constrain the investment decision, and (2) rules for the management of the investment, such as the role of the government in corporate governance. The first category relates to the investment decision—whether to purchase equity in a company—and the reasons behind that decision. The investment decision is broadly conceived here to include not only the initial decision to invest, but also the motivation behind investments, the terms of the investment, and the exit strategy. The institutions within the first category are characterized by the belief that government should only invest in private enterprise for policy reasons and not for the purpose of wealth creation.

The second category is equally broad and relates to the subsequent management of the investment and the relationship between the company and the government shareholder. The government's role as both a shareholder and as a regulator suggests inherent conflicts of interests for an

188. *See* Clinton, *supra* note 98.

189. President Bush appointed a commission to study Social Security reform which strongly opposed investment by the Social Security Trust Fund in private equities. *See* PRESIDENT'S COMM'N TO STRENGTHEN SOC. SEC., STRENGTHENING SOCIAL SECURITY AND CREATING PERSONAL WEALTH FOR ALL AMERICANS 13 (2001), *available at* http://govinfo.library.unt.edu/csss/reports/Final_report.pdf.

LME. The rules within this category are characterized by an institutional norm where politically driven activism in corporate governance is tolerated even if that activism runs counter to the principles that a prudent private investor would follow. The rules in the second category can be thought of as complimentary to those in the first category in that "the presence (or efficiency) of one increases the returns (or efficiency of) the other."[190] The political interference in corporate governance can be justified if the intent of the investment was not wealth maximization but was some policy that grew out of the political process. The existence of these norms does not suggest that they lead to an overall efficiency in the political economy. This Section merely attempts to describe the norms which surround government investment—investment in a liberal market economy generally occurs for policy reasons and political influence in managing the investment is tolerated if not encouraged.

A. *Institutional Norms Governing the Investment Decision*

Despite the political rhetoric against it, U.S. government investment in private enterprise occurred frequently even before the subprime crisis.[191] Unlike most private investors, the government generally invests for policy reasons rather than for the purpose of wealth-creation. This motivation can result in some inefficiency in the investment decision as well as consequences for the market as a whole. In general, the government's approach to investment is far different from that of a prudent private investor. For the purposes of this Article, this Section highlights those differences by emphasizing the way in which government action differs from that of the prudent investor. Consequently, many of the following rules are stated in the negative—what is lacking—rather than in the affirmative. The preference for policy driven investments generates a unique blend of characteristics and consequences that include the following: (1) valuation at market prices and terms is not required of an investment; (2) political influence in the investment decision is tolerated; (3) maximizing the economic return is not required; (4) preference for short holding periods; (5) preference in favor of public–private ventures and against nationalization; and (6) government willingness to bail out firms considered "too big to fail" leads to moral hazards. This Section will discuss each of these results and then offer some conclusions.

190. HALL & SOSKICE, *supra* note 20, at 17.

191. Block contends that a "hidden developmental state" funding technology research and development existed since the 1980s and that the state's political rhetoric committing to the free market merely hid that form of state guided capitalism from the public. Block, *supra* note 17, at 169.

1. Valuation at Market Prices and Terms Is Not Required of an Investment

The rules by which the government invests do not encourage a market-based valuation of securities. In other words, the government sometimes overpays for the value that it purchases. In addition, the government does not always insist on terms that a prudent investor would insist on given the circumstances of the investment. During the financial crisis, Treasury was criticized for its valuation methodology in pricing some of the securities it purchased.[192] Some of the mistakes were inevitable given that agencies were reacting to a crisis under time constraints.[193] However, some private investors making similar investments during the same time came away with much better deals. The overvaluation of investments by the government may be a result of a lack of expertise, lack of incentive, or the result of a reasoned process to abstain from optimal pricing for policy reasons. This Section will first describe the U.S. government investment programs during the 2008–2009 subprime financial crisis and then analyze the valuation criteria used by Treasury when making the investments.

The financial crisis spawned a number of government programs and a confusing set of acronyms. Between October 2008 and 2009, the purpose, funding, and terms of any given investment under the EESA were fluid. Both the Bush and Obama Administrations were reactive—tailoring and funding investments according to the art of the possible rather than by a strict sense of ordered criteria. Under the EESA, Treasury was initially authorized to purchase subprime mortgages and asset-backed securities under TARP. However, Treasury soon determined the assets sales could not proceed with enough speed to stem the financial crisis, and it used its authorization under TARP to create other programs. By July 2009, Treasury had started twelve different programs targeting different sectors of the economy or particular firms—e.g., financial institutions, the automobile industry, AIG, and home owners, to name a few.[194] Funding of some programs also came from the Federal Reserve under the Term Asset-Backed Securities Loan Facility (TALF). Leveraging the grace period often accorded a new president in the first 100 days in office, President Obama cajoled Congress to pass the ARRA. The ARRA was a classic Keynesian

192. CONG. OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: VALUING TREASURY'S ACQUISITIONS 2 (2009), *available at* http://cop.senate.gov/documents/cop-020609-report.pdf.

193. Davidoff & Zaring, *supra* note 1, at 469–70.

194. For a list of programs, see OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS: JULY 21, 2009 4, tbl.1 (2009), *available at* http://www.sigtarp.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf.

economic stimulus plan that principally authorized spending $787 billion on infrastructure and other government projects in order to restart growth in the GDP, but the legislation also modified the terms under which the previously approved TARP investments would operate.

The TARP investments were justified, in part, as an investment in which the taxpayer might make a profit. Treasury Secretary Henry Paulson reassured Congress during hearings prior to the passage of the EESA that the TARP money would be "an investment, not an expenditure."[195] Secretary Paulson went on to say that "there is no reason to expect this program will cost taxpayers anything."[196] Treasury acted quickly and during October and November 2008 invested $254.2 billion in hundreds of transactions.[197] In December 2008, Secretary Paulson reiterated that the valuations on the initial preferred stock purchases were made at par.[198] However, not everyone agreed that the prices paid were at market value. The Congressional Oversight Panel (COP) set up to monitor deployment of the TARP for Congress concluded that "Treasury paid substantially more for the assets it purchased under the TARP than their then-current market value."[199] Additionally, Treasury did not include contractual restrictions that a private investor would have likely negotiated given the investment environment in October 2008.

Incongruously, some of Treasury's investments were made at a valuation well below the fair value of the assets. The legal and accounting definition of fair value is the price at which a willing buyer and seller would agree on in the sale of an asset in an active market.[200] The COP analyzed the ten largest TARP investments to determine if Treasury paid fair value at the time of the investment. Although preferred stock is technically equity in a company, the shares typically have characteristics that are similar to bonds. The preferred shares pay a cumulative dividend of 5% per annum for five years and 9% after the fifth year.[201] Under the original EESA provisions,

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195. CONG. OVERSIGHT PANEL, *supra* note 192, at 4.

196. *Id.*

197. *Id.* at 6–7.

198. *Id.* at 4.

199. *Id.* at 2.

200. *See* Kevin A. Hassett & Peter J. Wallison, *A Troubling Requirement*, 27 REG. 52, 54 (2004) (discussing the definition of "fair value").

201. The cumulative feature allows the board of a qualifying financial institution (QFI) to choose to not declare a dividend in a particular year. The amount that would have been paid "accumulates" as an amount owed to the preferred shareholders. No other dividends can be paid out, such as those to common shareholders, unless the QFI first pays out any dividends owed to preferred shareholders. Press Release, Dept. of the Treasury, Treasury Announces TARP Capital Purchase Program Description (Oct. 14, 2008), *available at* http://www.financialstability.gov/latest/hp1207.html.

banks could redeem the shares at par value within three years but only by raising other funds in the capital markets—through another preferred share offering or through common stock. However, ARRA eased the rules to allow banks to redeem shares prior to the contractual waiting period and from any source—be it public or private.[202] The easing of the redemption provisions were no doubt welcome by bankers, who sought to repay TARP loans earlier than anticipated in order to avoid new executive pay restrictions.[203] To the extent that a bank does not redeem its shares, the government can sell the preferred stock on the open market if it chooses to do so.

The preferred shares included a "warrant sweetener," which gave the government a right to purchase common stock worth up to 15% of the preferred share investment at a price that is the twenty-day trading average of the institution's share price at the time of the preferred share investment. The warrant sweetener is a typical term in some preferred share investments, especially those where the investor is taking some risk. If the common stock price goes up, the investor can exercise the warrants to purchase the common stock and then immediately sell it to pocket the difference between the purchase price as set forth in the warrants (the "strike price"), and the trading price on the day the warrants are exercised.[204] Given the amounts invested in this manner, such purchases and immediate sales could affect share prices since the float would radically increase. The government could also sell warrants on the open market, which would value not only the difference between the strike price and the market value but also the time value of the warrants.[205]

Given the complexity of preferred shares, the COP used three well-accepted valuation methods when valuing the ten largest TARP investments: (1) Yield-Based Discounted Cash Flow Approach; (2) Credit

202. Ivy M. Washington & Amy Sill, *Overview of the Troubled Asset Relief Program and Its Capital Purchase Program*, FED. RES. BANK OF PHILA., http://www.phil.frb.org/bank-resources/publications/src-insights/2009/second-quarter/q2si3_09.cfm (last visited Nov. 7, 2010).

203. *See* Stephen Labaton & Edmund L. Andrews, *Banks Finding Bailout Burdensome*, SIGNONSANDIEGO.COM (Apr. 11, 2009, 2:00 AM), http://www.signonsandiego.com/news/2009/apr/11/1n11banks003949-banks-finding-bailout-burdensome (observing that some banks wish to repay the TARP bailout money early to avoid the government restrictions placed on banks who received TARP funds).

204. *See* U.S. Dep't of the Treasury, *Capital Purchase Program*, FINANCIALSTABILITY.GOV, http://www.financialstability.gov/roadtostability/capitalpurchaseprogram.html (last updated Oct. 3, 2010).

205. Many formulas exist to value options and warrants. *See* Benjamin A. Templin, *Expensing Isn't the Only Option: Alternatives to the FASB's Stock Option Expensing Proposal*, 30 J. CORP. L. 357, 385–86 (2005) (discussing various valuation methods).

Default Swaps-Based Discounted Cash Flow Approach; and (3) Contingent Claims Analysis.[206] Each model was applied and then comparisons were made in order to verify the calculations. The warrants were valued separately using a Monte Carlo pricing model that is widely used in similar deals.[207] The models discounted the valuations between 5% and 20% to take into account the illiquid nature of Treasury's investment given the size of the investment.[208] COP found that, on average, the ten largest investments by Treasury—amounting to $184.2 billion[209]—received assets that were worth only $66 for every $100 invested at the time of the sale.[210] Some of the investments—those that involved less risk—were valued more fairly than the "at-risk" investments. In the case of U.S. Bancorp and Wells Fargo & Co., which the market deemed to be less risky in October 2008, the study showed that Treasury received assets that were 87% to 99% of the costs.[211] However for the high risk investment in AIG, Treasury received only 37% to 45% of the face value of the securities bought.[212] COP concluded that the reason for the wide variation in valuation was that Treasury offered the same terms (5% dividend rate rising to 9% after the fifth year) to every financial institution.[213] For banks and institutions that were likely to default, "the 5% dividend rate on the preferred shares was substantially below their market cost of capital, whereas for the healthier firms, it offered a smaller advantage over market rates."[214] Thus, Treasury purchased stable assets at slightly above par value and risky assets at well above par value. In other words, Treasury overpaid for all of the assets in the study.

Not surprisingly, private investors—notably Warren Buffet's Berkshire Hathaway, Qatar Holdings, and Abu Dhabi—made no such mistakes

206. CONG. OVERSIGHT PANEL, *supra* note 192, at 33. The first two methods estimate future cash flows from the securities and then apply an appropriate discount rate. The Credit Default Swaps-Based Discounted Cash Flow Approach better adjusts for a risk premium but is more applicable to common shares than preferred. Thus, the study used this valuation method as a check against the other two systems. The third methodology "relies on a probabilistic model of how the firm's asset value, and therefore, its ability to pay claimants, evolves over time." *Id.*

207. *Id.* at 34.

208. *Id.* at 35. The analysts "applied a 'reduced marketability discount factor' to reflect the fact that the large size of Treasury positions made them potentially costly to liquidate and hence less valuable." *Id.*

209. *Id.* at 6–7.

210. *Id.* at 4.

211. *Id.* at 36.

212. *Id.* at 37.

213. *Id.*

214. *Id.*

when investing their money in similar deals during the same period. Warren Buffet, the world's most famous value investor, purchased $5 billion in Goldman Sachs preferred stock as an investment for his company, Berkshire Hathaway.[215] Using the same valuation methods, COP found that Mr. Buffet purchased assets that were worth 108 to 112% of the face value of the stock.[216] Like a true value investor, Mr. Buffet waited until there was a mispricing in the market and then bought a valuable asset at a bargain price.[217] COP valued Abu Dhabi and Qatar Holding's investment of £7 billion in Barclays PLC at 122% to 125% of the price paid.[218]

The difference in valuations can be easily explained. The private investors accounted for risk and priced the securities accordingly, whereas Treasury treated all banks similarly—offering the same deal terms to both strong and weak banks. COP speculates that as a matter of policy, Treasury did not want to signal to the public that some banks may have been riskier than others by demanding harsher terms for riskier banks.[219] Such a negotiation strategy could lead private investors to assume that Treasury knew of nonpublic information. In such a situation, the demand for harsher terms sends a negative signal to the market, which can cause a sell-off in the stock.[220] If Treasury's motivation was to prevent such a sell-off, then it was certainly not effective. The S&P 500 index stocks dropped a staggering 41% from September 2, 2008 through November 20, 2008.[221]

Another material mistake on the part of Treasury in its initial TARP investments to banks under the Capital Purchase Program (CPP) was its failure to contractually bind the banks in how funds were to be used. Treasury's primary purpose in making the investment was to jumpstart the credit markets that had frozen up in October 2008. However, the sales

215. *Id.* at 35.

216. *Id.*

217. *See* Letter from Warren E. Buffet, Chairman of the Bd., Berkshire Hathaway, Inc., to the Shareholders of Berkshire Hathaway, Inc. (Mar. 1, 1993), *available at* http://www.berkshirehathaway.com/letters/1992.html (explaining Buffet's economic outlook and decisionmaking rationale in the context of investments).

218. CONG. OVERSIGHT PANEL, *supra* note 192, at 35.

219. *Id.* at 38.

220. Likewise, more favorable terms send an unintended positive signal to the public; thus raising the share price of a financial institution beyond its fair value through speculative buying.

221. The S&P closed on September 2, 2008, at 1277.58 and dropped 525.14 points to 752.44 by the close on November. 20, 2008. *See S&P 500 Index*, YAHOO FIN., http://finance.yahoo.com/q/hp?s=^GSPC&a=08&b=2&c=2008&d=10&e=20&f=2008&g=d (last visited Nov. 7, 2010). However, the market was liquid enough and had enough volume that the data was valid for the valuation formulas used in the Congressional Oversight Panel's report. CONG. OVERSIGHT PANEL, *supra* note 192, at 32.

agreement for the preferred stock did not include provisions for how the money was to be used, nor did it provide for reporting. The plan backfired. Instead of increasing the capital flow to businesses and consumers, it was "widely reported that banks were 'hoarding' the money, acquiring other banks, and paying off debt."[222] Later on in the crisis, however, Treasury made investments in the domestic auto industry only after prolonged and substantive negotiations resulting in investment contracts that included more conditions than earlier TARP investments.[223]

In addition to the mispricing of some investments and the lack of restrictions on use, Treasury gave up rights that would normally accrue to an investor. For example, Treasury agreed to waive its voting rights to any common shares that it purchased under the warrants.[224] In all likelihood the Bush Administration implemented this policy because of a reluctance to have government interfere in corporate governance. Although the Bush Administration tried to avoid interference in corporate governance, it failed to act as a prudent investor by contractually binding the companies in how it would deploy the funds.

2. *Political Influence in the Investment Decision Is Tolerated*

Despite rhetoric that political influences were largely absent from the investments made during the financial crisis, there were numerous instances where decisions to invest were made because of political preferences rather than economic exigency. One problem with policy-based investment is that decisions are driven by the political process. Thus, such investments are open to manipulation in the political bargaining process. Political influence does not necessarily suggest that unsound economic decisions may result; however, the presence of political bargaining in resource allocation raises issues of whether the greater public good is served.[225]

222. OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, SIGTARP: INITIAL REPORT TO THE CONGRESS: FEBRUARY 6, 2009, at 49 (2009), *available at* http://www.sigtarp.gov/reports/congress/2009/SIGTARP_Initial_Report_to_the_Congress.pdf.

223. CONG. OVERSIGHT PANEL, *supra* note 11, at 3.

224. CONG. OVERSIGHT PANEL, *supra* note 192, at 49. Voting rights as to common stock purchased by exercise of the warrants would pass to any purchaser of Treasury's common stock, so the value of the common stock would not diminish. *Id.* at 49. Moreover, the government could choose to just sell with warrants, which would have a tradable value if the exercise price was below the market price.

225. *See* Richard W. Painter, *Bailouts: An Essay on Conflicts of Interest and Ethics When Government Pays the Tab*, 41 MCGEORGE L. REV. 131, 134–36 (2009) (maintaining that while Congress members are expected to advocate for and serve their constituencies, government officials in the executive branch which run programs such as the bailouts should be guided by a "fiduciary principle" to serve the greater public good).

When politics control decisionmaking on the allocation of resources, there is a chance that politicians with greater political bargaining power will influence the decision to favor their constituencies to a greater degree than the general public as a whole.[226] Political influence can be pervasive in government agencies. In some agencies, nearly all decisions require approval of political actors without regard for the public good.[227] The issue of political influence over government investment decisions was prevalent well before the financial crisis. Commentators have long chastised politicians for manipulating public pension fund money to achieve political goals, as opposed to maximizing the wealth of such funds.[228]

The influence of politics on government investment decisions may lead to adverse consequences for market-driven economies. If the state, rather than market forces, determines winners and losers, some firms gain a competitive edge not based on efficiency and prudent management but on political influence and bargaining.[229] Such political interference can have consequences for the political economy as a whole since private investors may become reluctant to participate in some ventures if they know the state is going to interfere. This Section will first examine three instances of politically driven investments during the financial crisis, including: (1) investments made in financial institutions under TARP/CPP; (2) the AIG bailout; and (3) the Automotive Industry Financing Program. Instances of politically driven investments before the financial crisis will then be considered.

Under the TARP/CPP, the government acted to save some investment banks, thrifts, and commercial banks by brokering sales, but it let other banks fail, leading commentators to question whether there was a reasonable basis for the government's decisionmaking.[230] The federal government intervened on behalf of Bear Stearns by acting as a broker in the firm's sale to J.P. Morgan.[231] However, when faced with the collapse of

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226. *Id.*

227. *See* Philip J. Weiser, *Institutional Design, FCC Reform, and the Hidden Side of the Administrative State*, 61 ADMIN. L. REV. 675, 689–90 (2009) (describing the highly politicized environment at the FCC which resulted in discontent among staff).

228. Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796 (1993).

229. *See* BAUMOL ET AL., *supra* note 117, at 62–71 (criticizing economies that are guided by political influence by reviewing examples of countries that have done so in the recent past).

230. *See* Yomarie Silva, Note, *The "Too Big to Fail" Doctrine and the Credit Crisis*, 28 REV. BANKING & FIN. L. 115, 121–31 (2008) (examining government intervention in the Bear Sterns and Lehman Brothers bankruptcies, along with the difficulties faced by Wachovia and AIG).

231. *See* Walker F. Todd, *The Bear Stearns Rescue and Emergency Credit for Investment Banks*,

Lehman Brothers, Treasury Secretary Paulson let one of the five largest investment banks in the United States declare bankruptcy.[232] Secretary Paulson claimed the Federal Reserve did not have legal authority to make loans to Lehman;[233] however, the assertion does not appear credible given that the government used an emergency provision of the Federal Reserve Act[234] to fund Bear Stearns.[235] The controversial decision to let Lehman Brothers fail was more likely due to "political reality, personal preference," and a desire by Secretary Paulson to make a statement at that point in the crisis that not all banks would receive investments.[236] While the brokered sale of Bearn Stearns was justified to prevent systemic risk to the financial system, the same reasoning was not used when evaluating Lehman Brothers. Bear Stearns was determined to be "too big to fail,"[237] but officials appeared to have concluded that Lehman Brothers was not, despite the fact that Lehman Brothers' eventual bankruptcy was the largest in U.S. history.[238]

After the EESA was passed in October 2008, Treasury made the decision to invest only in "healthy banks" while letting unhealthy banks face a market solution[239]—seeking out a buyer or private investors, or eventually being closed by the Office of Thrift Supervision. Treasury maintains that political influence was absent from the investment decision and that it bases

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AM. INST. FOR ECON. RESEARCH, (Aug. 11, 2008, 2:48 AM), http://www.aier.org/research/briefs/445-the-bear-stearns-rescue-and-emergency-credit-for-investment-banks (reviewing the purpose of Section 13(3) and how it applied to the government's bailout of the Bear Sterns).

232. *See* Press Release, Lehman Bros. Holdings, Lehman Brothers Holdings Inc. Announces It Intends to File Chapter 11 Bankruptcy Petition (Sept. 15, 2008), *available at* http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf (announcing Lehman's plan to file for bankruptcy).

233. Davidoff & Zaring, *supra* note 1, at 493.

234. *See also* 12 U.S.C. § 343 (2006); Davidoff & Zaring, *supra* note 1, at 477.

235. *See* Davidoff & Zaring, *supra* note 1, at 477–79 (reflecting how the government's action to assist Bear Stearns proved to be novel but also short-lived).

236. *Id.* at 492–93.

237. *See* Ann Graham, *Bringing to Heel the Elephants in the Economy: The Case for Ending 'Too Big to Fail,'* 8 PIERCE L. REV. 117, 118, 123 n.26 (2010) (referring to Chairman Ben Bernanke's testimony regarding Bear Stearns and how it needed federal assistance because of its large size).

238. *See* Peter J. Henning, *In Lehman's Demise, an Elusive Search for Culprits*, N.Y. TIMES DEALBOOK BLOG, (Aug. 16, 2010, 1:30 PM), http://dealbook.blogs.nytimes.com/2010/08/16/in-lehmans-demise-an-elusive-search-for-culprits/ (examining how short-sellers remarks may have driven down the stock of Lehman Brothers before they announced its filing for bankruptcy).

239. *See* Damian Paletta & David Enrich, *Political Interference Seen in Bank Bailout Decisions*, WALL ST. J., Jan. 22, 2009, at A1 (reporting on the discontent among banks that were not bailed out by the government).

its decision on the recommendations of regulators.[240] However, the determination of whether a bank is healthy enough may also be influenced by the amount of pressure Congress members have put on agencies to favor home state banks. While Treasury has not funded every instance where a Congress member sought to change an initial rejection of TARP funds,[241] Treasury appears to have been receptive to reviewing applications supported by Congress members, especially after the Ohio congressional delegation threatened hearings.[242] Shortly thereafter, Congress members from Ohio, Alabama, and Massachusetts actively supported certain applications, and regional banks in their home states that otherwise had weak capital structures were given TARP funding.[243] After these incidents, and in response to calls for greater transparency, Treasury adopted voluntary procedures to counter lobbyist influences, such as certifications to Congress "that each TARP investment decision is based solely on objective investment criteria."[244]

The government support of a failing institution can create a competitive edge for that institution. After the AIG rescue, the massive insurance company had the resources necessary to offer discounts of over 30% on some of its products, thereby garnering business from competitors who had not received government financing.[245] Executives at competing insurance companies complained bitterly to Federal Reserve Chairman Ben Bernanke asking that discounting be halted.[246]

The Automotive Industry Financing Program (AIFP)[247]—popularly known as the "auto industry bailout"—also illustrates the fine line between

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240. *See* U.S. Dep't of the Treasury, *Transparency & Accountability*, FINANCIALSTABILITY.GOV, http://www.financialstability.gov/about/transparencyaccountability.html (last updated Oct. 4, 2009) (summarizing on the Treasury's role as politically neutral, transparent entity).

241. *See* Damian Paletta, *Politicians Asked Feds to Prop Up Ailing Bank*, WALL ST. J., Jan. 24, 2009, at A1 ("Lawmakers often seek to help home-state interests, and there is nothing illegal about forwarding requests to regulators and other government officials.").

242. *See* Paletta & Enrich, *supra* note 239, at A1 (reporting on the discontent among banks that were not bailed out by the government).

243. *See id.* at A1, A14 ("[S]ome weak regional banks have pocketed billions of dollars in TARP funds.").

244. U.S. Dep't of the Treasury, *supra* note 240.

245. *See* Liam Pleven & Sudeep Reddy, *AIG's Rivals Blame Bailout for Tilting Insurance Game*, WALL ST. J., Mar. 23, 2009, at A1 (reporting that because of government assistance, AIG could provide more competitive prices than years past).

246. *Id.*

247. *See* U.S. Dep't of the Treasury, *Automotive Industry Financing Program*, FINANCIALSTABILITY.GOV, http://www.financialstability.gov/roadtostability/autoprogram.html (last updated Oct. 22, 2010) (explaining that the purpose of AIFP is "to prevent a significant disruption of the American automotive industry").

decisions driven by views on economic policy for the nation as a whole and those that favor a political constituency. In a controversial series of loans, the government provided GM and Chrysler with $23.4 billion in order to avoid bankruptcy, only to later require that both companies go through a structured bankruptcy—a process that left the original lenders with little to show for their investment. As Chrysler and GM teetered toward bankruptcy in fall 2008, Democratic politicians mobilized to offer a bailout, arguing that it was necessary to preserve jobs and assure consumers of the viability of the companies that had warranted their purchases. Coming on the heels of what was largely perceived as a Republican-driven Wall Street bailout, the money destined to the car companies was seen by many as support for the unions—a key Democratic constituency.

Financing for the automobile industry occurred in a series of steps, starting with the creation of the AIFP as a TARP program. The House attempted to authorize $14 billion in funding separate from the EESA, but the Senate rejected it.[248] TARP funds were originally intended to be used for financing financial institutions; however, the EESA also grants authority to the Treasury Secretary to specify program requirements for the use of TARP funds.[249] Given the lack of other funding sources, President Bush used his executive power to ensure that the car companies fit within the broad definition of "financial institutions" as defined in the EESA,[250] and approved the allocation of a total of $17.4 billion in short-term loans for the two companies.[251] While there has been debate over whether the EESA actually authorized Treasury to use TARP funds for the automobile industry loans, COP concluded that given the ambiguity within the EESA as well as confusion about congressional intent, Treasury "has faced no effective challenge to its decision to use TARP funds for this purpose."[252] When faced with ambiguity, or when Congressional intent is unclear in a statute, courts grant agencies a great deal of deference so that any permissible interpretation of a statute is generally upheld.[253]

Additional funds were authorized in early 2010, though the loans

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248. Assoc. Press, *G.O.P. Senators Oppose Auto Bailout*, N.Y. TIMES (Nov. 17, 2008), http://www.nytimes.com/2008/11/17/business/17auto.html?fta=y; *see* CONG. OVERSIGHT PANEL, *supra* note 11, at 8 (stating that the Senate blocked the bill).

249. 12 U.S.C. § 5211(a) (2006 & Supp. 2009).

250. CONG. OVERSIGHT PANEL, *supra* note 11, at 72–73.

251. Chrysler initially received $4 billion, and GM received $13.4 billion in TARP funds. *Id.* at 8.

252. *Id.* at 4.

253. *See* Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843 (1984) ("[I]f the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.").

included a condition that both companies devise plans for long-term viability. By March 31, 2009, the Obama Administration determined the submitted plans were not viable[254] and then negotiated with management, labor unions, franchisees, and bondholders to create a preplanned bankruptcy for both GM and Chrysler. As part of the negotiated settlement, the government agreed to provide additional financing to both companies to see them through the restructuring.[255] In addition to providing funds to Chrysler and GM, the government also provided loans and equity investments in the two companies' financing arms, GMAC, and Chrysler Financial, thereby bringing the total of loans and equity investments made under AIFP to approximately $80 billion.[256]

The debate over whether Treasury should have pursued a preplanned bankruptcy earlier has broken down along party lines.[257] Democrats were of the opinion that a bankruptcy of GM and Chrysler would pose a systemic risk that could harm other sectors of the economy.[258] Republicans argued that the government intervention was a politically motivated move to maximize the interests of the labor unions at the expense of the bondholders. In the conservative view, the car companies should have entered into a structured bankruptcy before the initial government loans were made.[259] Chapter 11 is designed to give businesses a fresh start to become profitable again. Since a company in Chapter 11 continues its day-to-day business operations, bankruptcy does not necessarily result in huge layoffs.[260] An earlier reorganization may have done more in reassuring consumers than propping up inefficient companies with tax dollars. Moreover, the market failure of the car companies without government intervention would have opened opportunities for more efficient entrepreneurs to start new companies. In addition, there are broader

254. U.S. DEP'T. OF THE TREASURY, NEW PATH TO VIABILITY FOR GM & CHRYSLER 1–3, *available at* http://www.financialstability.gov/docs/AIFP/autoFactSheet.pdf.

255. *See id.* at 2, 4 (discussing broadly the terms of the agreement with GM and Chrysler).

256. U.S. DEP'T OF THE TREASURY, TROUBLED ASSET RELIEF PROGRAM (TARP) MONTHLY 105(A) REPORT—MAY 2010, app. 1, at 6 (June 2010), *available at* http://www.financialstability.gov/docs/105CongressionalReports/May%202010%20105%28a%29%20Report_final.pdf.

257. *See* CONG. OVERSIGHT PANEL, *supra* note 11, at 102 (discussing criticisms of the government's response to the Chrysler and GM bankruptcies).

258. *See id.* (describing certain opinions as to whether the Obama Administration's efforts would save jobs and avert further damage to the economy).

259. *See id.* (stating that Chrysler and GM should have filed "under ordinary bankruptcy rules").

260. *Corporate Bankruptcy*, U.S. SEC, http://www.sec.gov/investor/pubs/bankrupt.htm (last visited Nov. 7, 2010).

implications for a market-based political economy when there is government intervention. The effect of propping up inefficient firms that are headed for bankruptcy will "'falsify' the market's signals" thereby misleading investors and penalizing efficient firms.[261]

Finally, the Obama Administration's strategy was largely criticized because it interfered with the contractual rights of the bondholders by favoring unions in the post-bankruptcy ownership.[262] The preplanned bankruptcy plan advocated by the Obama Administration created a post-bankruptcy ownership structure that favored union-driven employment retirement funds rather than bondholders. Normally in a bankruptcy, secured bondholders stand first in line followed by unsecured creditors.[263] However, Old GM and Old Chrysler bondholders—those with bonds pre-dating the government's intervention—were left with pennies on the dollar. As the companies emerged from bankruptcy, the government owned 9.9% of New Chrysler and held a loan for $7.1 billion.[264] The largest New Chrysler shareholder (67.69%) to emerge out of bankruptcy was a retirement trust fund managed by the politically powerful United Auto Workers Union.[265] The government stake in the New GM was 60.8%, while an employee benefits group held 17.5%, and the pre-bankruptcy unsecured bondholders were reduced to 10%.[266]

Not all of the bondholders accepted the Obama plan willingly. Chrysler bondholders challenged the Bankruptcy Court decision in Federal District Court, but lost in an expedited appeal to the Second Circuit Court of Appeals.[267] The appeal to the Supreme Court was remanded "with instructions to dismiss the appeal as moot."[268] In litigation by a GM

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261. 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, 537 (2010).

262. *See* Declan McCullagh, *Chrysler Bankruptcy Exposes Dirty Politics*, CBSNEWS.COM (May 7, 2009), http://www.cbsnews.com/stories/2009/05/07/politics/otherpeoplesmoney/main4997900.shtml (arguing that Obama's involvement in Chrysler's financial status and similar institutions appears to be overly protective).

263. *See* U.S. SEC, *supra* note 260 (warning shareholders that buying stocks can be risky since secured and unsecured creditors get priority of assets of the company if it goes bankrupt).

264. *See* U.S. DEP'T OF THE TREASURY, *supra* note 256, app. 1, at 7, 21.

265. *Chrysler Bankruptcy Ends; Supreme Court Clears Sale to Fiat*, U.S. NEWS & WORLD REP. (June 10, 2009, 10:59 AM), http://usnews.rankingsandreviews.com/cars-trucks/daily-news/090610-Chrysler-Bankruptcy-Ends-Supreme-Court-Clears-Sale-to-Fiat/.

266. The Canadian government owned the final 11.7% in the post-bankruptcy reorganization. U.S. DEP'T OF THE TREASURY, supra note 256, app. 1, at 8.

267. *In re* Chrysler LLC, 576 F.3d 108, 111, 127 (2d Cir. 2009).

268. Ind. State Police Pension Trust v. Chrysler LLC, 130 S. Ct. 1015 (2009). For details on the negotiation, see Dennis K. Berman, *For GM Bondholders, Time is a Weapon*, WALL ST. J., Mar. 31, 2009, at C1, *available at* http://online.wsj.com/article/

bondholder, the District Court upheld the Bankruptcy Court's decision and found that the due process rights of the bondholders were not violated.[269] While the courts were not sympathetic to the bondholder's legal rights, some conservative commentators have argued that the Obama Administration's political maneuvering violated the spirit of the Constitution, given the implicit moral principles supporting contract and property rights found within the document.[270] From a political economy perspective, government interference with contractual and property rights fundamentally opposes one of the four primary institutional norms of a successful entrepreneurial economy.[271] If entrepreneurs cannot rely on the support of the government to enforce contractual rights, then they will be less willing to take risks in starting new companies.

Was the development of the AIFP and the pre-planned bankruptcy political payback for the unions who supported Democrats through large campaign contributions? It is entirely possible that the Obama Administration's plan was policy-driven rather than a political payback; however, the bondholders likewise had legitimate policy arguments favoring a different ownership structure.[272] The government-led effort that reduced bondholder rights is expected to make the private equity firms more cautious about lending money to politically powerful companies.[273] Future lenders to such firms will be wary of whether their investments will be protected during a potential bankruptcy. The cost of capital for such companies may rise in such circumstances, and that could potentially lower the company's profit margins, thereby making them less competitive in the marketplace.[274]

3. *Maximizing Economic Return Is Not Required*

When the state invests for policy reasons, the investment may lead to

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SB123845605025971539.html.

269. *In re* Motors Liquidation Co., No. 09 Civ. 7794, 2010 WL 1730802, at *99 (S.D.N.Y. Apr. 28, 2010).

270. CONG. OVERSIGHT PANEL, *supra* note 11, at 102; Hadley Arkes, *The Constitution and its Moral Warnings*, 33 HARV. J.L. & PUB. POL'Y 495, 496 (2010).

271. *See* BAUMOL ET AL., *supra* note 117, at 7–8 (discussing four elements of economic growth, including the importance of property and contract rights).

272. *See* Painter, *supra* note 225, at 138–39 (describing the varied policy and political reasons for the Chrysler bailouts).

273. *See* Chris Isidore, *Judging Obama's Driving Record*, CNNMONEY.COM (Aug. 7, 2009, 7:41 AM), http://money.cnn.com/2009/08/06/news/companies/obama_auto_bailout/index.htm?postversion=2009080707 (arguing that lenders may be hesitant to lend to companies, such as "automakers, airlines and aerospace and defense manufacturers").

274. CONG. OVERSIGHT PANEL, *supra* note 11, at 53; Isidore, *supra* note 273.

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

Treasury and administration officials have made much of the fact that many of the TARP investments have been repaid and the total cost of the program was less than anticipated.[275] By May 2010, banks and other entities paid back more than half of the $384 billion in TARP funds that had been invested.[276] Additionally, as of May 2010, the income received from all TARP investments (measured by warrant sales and dividend and interest payments) stood at more than $23 billion.[277] For the thirty-four entities that had completely repaid the government by the end of December 2009, the absolute return on investment for the government was 8.8%.[278] As expected, not all of the investments were successful. As of February 2010, 104 recipients of CPP funds failed to make timely dividend payments amounting to $188.98 million.[279] Due to continuing losses, AIG has consistently failed to pay dividends it owed the government amounting to missed payments of $4.2 billion as of March 31, 2010.[280]

While many individual investments showed a positive return, the headlines did not highlight two additional data points: (1) investments made under EESA and HERA will likely show negative returns; and (2) private investors would have likely yielded a much higher return. Given that many investments have not yet matured, any estimate of a gain or loss here is

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275. *See* U.S. DEP'T OF THE TREASURY, *supra* note 256, at 2 (highlighting that Treasury expects to spend "less than $550 billion of the $700 billion authorized, and expects to recover all but $117 billion of that amount").

276. *Id.* at 3.

277. *Id.* at 7.

278. OFFICE OF FIN. STABILITY, U.S. DEP'T OF THE TREASURY, WARRANT DISPOSITION REPORT 1 (Dec. 31, 2009), *available at* http://www.financialstability.gov/docs/TARP%20Warrant%20Disposition%20Report%20v4.pdf.

279. OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, *supra* note 10, at 77.

280. *Id.* at 91.

preliminary. The losses predicted under the TARP program have been a matter of speculation and sometimes widely differing opinions. The Congressional Budget Office (CBO) optimistically estimated in February 2010 that the CPP portion of TARP (the equity investments in banks) would result in a $2 billion gain, but the Office of Management and Budget (OMB) predicted a loss of $1 billion.[281] Everyone seems to agree that when all TARP programs are included, there is likely to be a loss. As of May 21, 2010, Treasury predicted that it will lose $105.4 billion on its TARP investments.[282] While the picture is still unclear, it is enough to say that financial losses are tolerated, though current predictions are far less than the original estimates given that much of the stock held by Treasury has increased in value. [283]

As for individual investments, it appears that investments made with a greater degree of political influence also have a greater degree of expected loss. The politically driven investments in GM and Chrysler are expected to trigger significant losses. The losses from the automotive industry investments are estimated to range from $31 billion (OMB prediction) to $34 billion (CBO estimate).[284] Treasury has already recorded a loss on its pre-bankruptcy loan to Chrysler when it recently accepted a payment of $1.9 billion for a loan that originally had a face value of $3.8 billion.[285]

Likewise, investments in organizations considered too big to fail appear to have a greater degree of an expectation of loss. OMB predicted the loss on the AIG bailout at $50 billion as of February 2010 although CBO pegged the total cost at $36 billion.[286] Despite these dire estimates, the CBO and Treasury were optimistic at mid-2010 that AIG would eventually pay back the entire investment.[287] Interestingly, a plan to accelerate the government's AIG exit strategy took shape during fall 2010 with estimates that it might result in a profit for taxpayers.[288] The payout, however, was still considered speculative given that Treasury would have to sell converted

281. *Id.* at 74.

282. *See* U.S. DEP'T OF THE TREASURY, *supra* note 256, at 4.

283. *See id.* (stating that the projected cost of TARP has decreased by $11.4 billion since the Fiscal Year 2011 Presidential Budget and that the decrease is primarily due to the appreciation in value of Treasury's 7.7 billion shares of Citigroup common stock).

284. OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, *supra* note 10, at 114.

285. *Id.* at 44.

286. *Id.* at 91.

287. *See* CONG. OVERSIGHT PANEL, *supra* note 187, at 196–97 (stating Treasury's belief that AIG will be able to fully repay the Federal Reserve Bank of New York by the end of 2010).

288. Paritosh Bansal, *AIG and U.S. Set Faster, Riskier Exit Path*, REUTERS, Sept. 30, 2010, http://www.reuters.com/article/idUSTRE68S3BM20100930.

shares on the open market, and it was not certain that the market would price the shares high enough for a full recovery of the investment.[289] The Fannie Mae and Freddie Mac investments are thought to have the largest potential for loss. In June 2010, the realized loss was $145 billion with estimates that it could reach $400 billion or even $1 trillion if the housing market worsens.[290]

Private investors who invested during the same period as the government showed a significant difference in their returns. Ten months after Mr. Buffett took a stake in Goldman Sachs, his $5 billion investment was estimated to be worth $9.1 billion—an annualized return of 111%.[291] In sharp contrast, Treasury realized only a 23% annualized return on the same investment.[292] In another comparative analysis taking into account all TARP investments that were repaid in 2009, economists demonstrated that private investors, who might have had the same opportunity as the government to purchase these selected investments in October 2008, would have realized a profit three times the size of the government, assuming the private investors negotiated a market price for the shares.[293]

Of course, the measure of the success of the government's investment is not necessarily that the overall TARP program was profitable or that the government maximized the wealth of the investment. Rather, the measure of success is whether the investments achieved the goals of preventing a collapse in the financial system. Treasury credits TARP and related investments with preventing a complete collapse of the credit markets in the short-term, given the rebound in the financial markets one year after the collapse.[294] Concerns over the long-term health of the economy persist.[295]

The economic success of policy-oriented investments has traditionally been difficult to assess. Given that the government's role is not geared

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289. *Id.*

290. Michelle Lodge, *Fannie-Freddie Bailout Could Cost Taxpayers $1 Trillion*, CNBC.COM (June 29, 2010 10:22 AM), http://www.cnbc.com/id/37982580/Fannie_Freddie_Bailout_Could_Cost_Taxpayers_1_Trillion.

291. Zachery Kouwe, *Buffett's Goldman Stake Pays Richly*, N.Y. TIMES, July 24, 2009, at B5.

292. *Id.*

293. Zachery Kouwe, *As Banks Repay Bailout Money, U.S. Sees Profit*, N.Y. TIMES, Aug. 30, 2009, at A1.

294. *See* CONG. OVERSIGHT PANEL, SEC'Y TIMOTHY F. GEITHNER WRITTEN TESTIMONY (2009), *available at* http://cop.senate.gov/documents/testimony-091009-geithner.pdf (stating that policy interventions of the Obama Administration and of Congress succeeded in preventing an economic meltdown).

295. *See* CONG. OVERSIGHT PANEL, DECEMBER OVERSIGHT REPORT: TAKING STOCK: WHAT HAS THE TROUBLED ASSET RELIEF PROGRAM ACHIEVED? 4–6 (2009), *available at* http://cop.senate.gov/documents/cop-120909-report.pdf (listing the remaining problems in the financial markets and economy).

toward wealth creation, it is natural that most government investments would be made for purposes other than wealth maximization. In a study of state government venture capital fund investments, Peter K. Eisinger found that most investments were geared toward creating jobs in a state rather than for the purpose of wealth creation.[296] However, there can be serious consequences in terms of the success of the government's goals when such political bargaining rather than pure policy goals drive the process. For government pension funds, policy-based investing has the potential to erode shareholder economic value and "adversely affect fund performance."[297] For example, investing in geographical regions that are economically depressed[298] would be a policy-based investment that may or may not result in the maximum return available to a fund. An investment in an ailing industry may preserve jobs within a politician's region for a short time but will not, ultimately, be profitable if the industry itself is in decline. The danger is that the entire investment by the government may be lost.[299] Pursuing a policy-based investment agenda sometimes results in better returns. For a long time, alternative energy projects were not thought to have much profit potential. However, when the price of oil skyrocketed in the mid-2000s and consciousness was raised about global warming, green technology and alternative energy companies became desirable investments.[300]

Government investment programs in existence before the financial crisis

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296. *See* PETER K. EISINGER, THE RISE OF THE ENTREPRENEURIAL STATE: STATE AND LOCAL ECONOMIC DEVELOPMENT POLICY IN THE UNITED STATES 257 (1988) (describing a Michigan state policy under which the state would make investments in small businesses if the businesses would locate at least half of its personnel or assets in Michigan).

297. Romano, *supra* note 228, at 829.

298. State legislatures put pressure on public pension plans to invest in local companies in order to promote regional employment. *Id.* at 796. If private investment is unavailable for a company and the investment markets are otherwise funding businesses (i.e., there is no market failure in the credit and investment markets as in 2007–2009) then the absence of private investors suggests that the company has competitive and profitably issues. If such is the case, the government investment could become valueless. *See id.* at 813 (suggesting if a small business is unable to attract financing from the private sector, the difficulty is likely due to the market efficiently pricing the risk at too great a cost).

299. *See id.* at 796 (noting that corporate managers can threaten public funds with economic loss through events like local plant closings). However, not all investments made for the purpose of creating jobs are doomed. *See* Gene J. Koprowski, *State-Run Venture Funds Picking Up Slack for Private VCs*, E-COMMERCE TIMES (Dec. 13, 2005, 5:00 AM), http://www.ecommercetimes.com/story/47747.html (highlighting a Maryland state-run firm that invested $48 million and received an annual internal return rate of almost 30% over its first ten years of operation).

300. Mark Veverka, *Cleaning Up*, BARRONS (July 16, 2007), http://online.barrons.com/article/SB118420428429964109.html.

illustrate the challenges and potential for an investment entity within the federal government. Two federal government corporations—the Overseas Private Investment Corporation (OPIC) and the Export–Import Bank of the United States (Ex–Im Bank)—are organizations that invest based on policy criteria. OPIC invests in development projects in emerging markets that would not otherwise receive funding given the political risk.[301] Since its inception in 1971, OPIC has been profitable every year.[302] In 2009, OPIC had a net income of $242.5 million, up from $166.5 million in 2008.[303]

Ex–Im Bank has had more mixed results. Similar to OPIC, Ex–Im Bank addresses markets where political or other risks prevent alternative private financing. The government bank extends credit and insurance to businesses hoping to export U.S. goods to these areas, though historically, the bank has had conflicting demands from the state and the market. While formed to meet the needs of private companies, the bank has felt political pressure from "policy makers in the White House, as well as the Departments of the Treasury, State, and War (later Defense)."[304] Ex–Im Bank also competes with other foreign export credit agencies in that each advances the business interests of its own nation.[305] Although Ex–Im Bank has a series of losses during the 1970s and 1980s,[306] it now claims that it has "returned to the U.S. Treasury $5.2 billion more than it received in appropriations for program and administrative costs."[307]

Even to the extent that the government makes a conscious choice to pursue social or economic goals over financial gain in its investments, it does not always achieve its stated goals. In other words, while the government might not seek wealth maximization to measure ROI, it should seek some way to measure the social or economic gain as a form of ROI. Under the CPP program within TARP, one economic goal was to increase

301. Projects range from funding housing projects in South Africa to expanding a cellular network in Bangladesh. *See* Current OPIC Projects, OPIC, http://opic.gov/projects/current-opic-projects (last visited Nov. 8. 2010) (use the country query to select South Africa to view a list of projects in that country; do the same for Bangladesh).

302. *See* Kenneth W. Hansen, *PRI and the Rise (and Fall?) of Private Investment in Public Infrastructure*, *in* PRIVATISING DEVELOPMENT: TRANSNATIONAL LAW, INFRASTRUCTURE AND HUMAN RIGHTS 113 (Michael B. Likosky ed. 2005).

303. OVERSEAS PRIVATE INV. CORP., ANNUAL REPORT FOR 2009, at 28 (2009), *available at* http://www.opic.gov/sites/default/files/docs/annualreport_2009.pdf.

304. WILLIAM H. BECKER & WILLIAM M. MCCLENAHAN, JR., THE MARKET, THE STATE, AND THE EXPORT–IMPORT BANK OF THE UNITED STATES, 1934–2000, at 1 (2003).

305. *Id.* at 191.

306. *Id.* at 7.

307. EXPORT–IMPORT BANK OF THE U.S., ANNUAL REPORT 2009, at 26 (2009) *available at* http://www.exim.gov/about/reports/ar/ar2009/documents/2009AnnualReport.pdf.

lending to small businesses during a period of market failure.[308] However, that policy goal was not achieved since lending declined for banks that received over 81% of TARP funds under the CPP.[309]

4. *Preference for Short Holding Periods*

To the extent that the government intervenes during a financial crisis by purchasing securities, the holding period is typically limited, which is consistent with the political economy of an LME. In making the TARP investments, Treasury reflected the government's predisposition for short-term holding periods.[310] Senators sought to make the informal rule favoring short holding periods into a formal law through a proposed bill that would have mandated a maximum eighteen-month holding period for any investment where the government owns more than 20% of an entity.[311] Under the bill, the government would have to put all such assets in a trust and the trustee would be required to liquidate any investment before the eighteen month holding period passed unless the trustee determined that maximizing the value of the investment required additional time.[312]

One consequence to this approach is that the long-term potential of some investments will never be realized. The warrants issued pursuant to the TARP/CPP preferred stock purchases illustrate the point. The taxpayers again did not receive the full potential of the warrants when companies repurchased the securities earlier than expected. Part of the lost potential was due to mispricing and part was due to the missed opportunity of holding onto the warrants for greater appreciation. Using well-accepted valuation techniques, COP found in its July 2009 report that Treasury received only 66% of the market value when banks repurchased warrants.[313] By the time COP issued its February 2010 report, Treasury had improved its methodology but was still receiving only 92% of the value

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308. CONG. OVERSIGHT PANEL, MAY OVERSIGHT REPORT: THE SMALL BUSINESS CREDIT CRUNCH AND THE IMPACT OF THE TARP 3 (2010), *available at* http://cop.senate.gov/documents/cop-051310-report.pdf.

309. *Id.* at 26.

310. *See* Press Release, U.S. Dep't of the Treasury, Treasury Department Releases Text from Secretary Geithner to Hill Leadership on Administration's Exit Strategy for TARP (Dec. 9, 2009), *available at* http://www.financialstability.gov/latest/pr_12092009.html (describing Treasury's exist strategy and indicating the intent to return equity investments to private hands as quickly as possible).

311. *See* CONG. OVERSIGHT PANEL, *supra* note 11, at 89 n.397.

312. *Id.* at 89–90.

313. CONG. OVERSIGHT PANEL, JULY OVERSIGHT REPORT: TARP REPAYMENTS, INCLUDING THE REPURCHASE OF STOCK WARRANTS 4 (2009), *available at* http://cop.senate.gov/documents/cop-071009-report.pdf.

in the repurchases of warrants.[314] The value of a warrant is tied to the stock price as well as numerous other factors including the expiration date and volatility of the stock. Despite the complexity of pricing models and potential risks, if the government had held onto the warrants for a longer period of time, it could have resulted in a greater recovery of taxpayer dollars. Provided that a particular bank's stock price goes up, the valuations of the warrants would rise as well.[315] While there is also the possibility that some warrants may expire as worthless, the redemption feature did not allow Treasury to make a prudent investment decision as to which warrants to retain in order to realize further gains.

This institutional favoring of short-term holding periods has been U.S. policy well before the TARP investments. The Resolution Trust Corporation (RTC) is a prime example.[316] RTC was created to sell off the assets of failed savings and loans during the late 1980s and 1990s. During this period, the U.S. government was faced with being the receiver of assets of failed savings and loans. The response was to create the RTC, which had the primary purpose of selling off the assets. RTC's directive was to get rid of the assets quickly rather than have the government hold and manage the property.[317] In the government's rush to divest itself of the holdings, allegations arose over excessive fees charged to the RTC by consultants[318] and sales that were made for less than the book value.[319] The primary goal of the RTC was to divest assets quickly with secondary goals of promoting jobs and opening opportunities for businesses owned by women and minorities.[320] The ultimate cost to the taxpayer in selling assets in this

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314. CONG. OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: COMMERCIAL REAL ESTATE LOSSES AND THE RISK TO FINANCIAL STABILITY 149 (2010), *available at* http://cop.senate.gov/documents/cop-090909-report.pdf.

315. *See* CONG. OVERSIGHT PANEL, *supra* note 313, at 39 (noting that since healthy banks are currently repaying, the value of their warrants has increased).

316. *See generally* FED. DEPOSIT INS. CORP., MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 1980–1994 (1998), *available at* http://www.fdic.gov/bank/historical/managing/history1-01.pdf (describing the formation and usage of the Resolution Trust Corporation (RTC)).

317. *See* Barry Meier, *The Bailout Handbook: The Savings and Loan Crisis 19 Years Ago May Be Instructive*, N.Y. TIMES, Sept. 29, 2008, at C1 (stating the goal of RTC was to return money to taxpayers as quickly as possible).

318. *See id.* (stating that consultants hired by the RTC presented huge bills, far in excess of the value of the services they provided).

319. *See* MARK CASSELL, HOW GOVERNMENTS PRIVATIZE: THE POLITICS OF DIVESTMENT IN THE UNITED STATES AND GERMANY 32 (2003) (explaining that the RTC aggressively tried to sell combinations of desirable and undesirable assets well below book value rather than seek the highest return on each asset).

320. *Id.* at 35.

manner was $150 billion.[321]

The RTC directive reflected the economic policies of the Reagan and Bush Administrations in reducing government involvement in the market. Government competition with private actors is considered a form of public regulation. Governments typically have a distinct advantage over private firms because the state does not incur the same costs (e.g., the government pays no income tax) as private firms and by having a regulatory advantage when competing. Despite the likelihood of higher returns through long-term investment, free market political considerations prevent the government from becoming an investor in private enterprise because of fears that such investment could result in a state-directed economy. Interestingly, the RTC was held out as a model entity that could manage the sale of toxic assets during the recent financial crisis.[322] Although such an organization was never established, the model of a federal government corporation could be useful to insulate investments from political pressure. To the degree that political interference in corporate governance can be minimized, the institutional constraint on short holding periods might be removed, thus allowing for the potential of greater returns on taxpayer investments.

5. *Preference in Favor of Public–Private Ventures and Against Nationalization*

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

Consistent with its LME, the United States typically tries to find a private solution to rescue troubled financial firms before investing public funds. When Long-Term Capital Management faltered in 1998, the Federal Reserve arranged for private entities to save the firm.[323] During the initial months of the current financial crisis, Treasury likewise attempted to broker deals, such as the Bear Stearns sale to J.P. Morgan. While the government provided federal loans of $28.2 billion to facilitate the sale, "much of the risk was borne by private parties."[324] As the crisis unfolded and it became apparent that AIG was nearing bankruptcy,

321. GARY SHORTER, CONG. RESEARCH SERV., RS 22959, RESOLUTION TRUST CORPORATION: HISTORICAL ANALYSIS 5 (2008).

322. *See generally* Meier, *supra* note 317 (discussing the history of the Savings and Loan Crisis and the role of RTC).

323. CONG. OVERSIGHT PANEL, *supra* note 187, at 8.

324. *Id.*

Treasury and the Federal Reserve took on the entire risk of the rescue rather than using its leverage to force a rescue among many lenders.[325] The government has been widely criticized for fostering moral hazards by not enlisting private lenders in the AIG rescue. Treasury and Federal Reserve bankers justified their actions by maintaining that private lenders should not be coerced into making loans and that the rapid deterioration of the markets required an immediate response.[326]

However, the government stopped short of full nationalization in any of its rescue attempts. Unlike some state-directed capitalist economies, the United States generally avoids state-owned enterprises. The government owns some federal government corporations that provide services to the public, such as Amtrak or the U.S. Post Office; however, liberal market economies disdain full ownership in the absence of market failure.[327] Even in the absence of a market solution during the financial crisis, the government did not completely nationalize bailed out firms. In the case of Fannie Mae, Freddie Mac, and AIG, the government took a maximum equity stake of 79.9% letting existing shareholders maintain an interest.[328]

The reasons behind the 79.9% cap on investment are partly practical and partly political. On the practical side, the government did not want its ownership in these companies to suddenly cause the companies to be deemed government entities for accounting purposes.[329] If the government owned 100% of the company, it would be compelled to put the firm's liabilities onto the government's balance sheets,[330] thus potentially increasing the federal deficit. In addition, full ownership of the firms would mean that the companies would have to change their accounting practices to conform with the specialized accounting rules that pertain only to agencies.[331] The designation of a private corporation as wholly controlled

325. *See id.* (discussing officials' choice between governmental and private-sector rescue of AIG).

326. *See id.* (describing Treasury's reluctance to force the hand of private parties).

327. The government nationalized Amtrak because it was widely believed that an affordable national passenger rail system was in the public interest but the market did not support the economics of such a system. *See generally* Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 383–84 (1995) (describing the history behind Amtrak and some of the legislative intent).

328. *See* Davidoff & Zaring, *supra* note 1, at 488 (Fannie Mae and Freddie Mac), 495–96 (AIG).

329. *See id.* at 489 (discussing various reasons for the percentage limit).

330. Philip Swagel, *The Financial Crisis: An Inside View*, *in* BROOKINGS PAPERS ON ECONOMIC ACTIVITY 28 (Spring 2009), *available at* http://www.brookings.edu/economics/bpea/~/media/files/programs/es/bpea/2009_spring_bpea_papers/2009_spring_bpea_swagel.pdf.

331. Davidoff & Zaring, *supra* note 1, at 489. Davidoff and Zaring also suggest two other

by the government could also lead to a determination that it is "an agency or instrumentality of the United States for the purpose of individual rights guaranteed against the Government by the Constitution."[332] Such a designation would mean that newly acquired corporations would have to comply with constitutional and possibly other legal restrictions under which agencies operate.[333] Interestingly, by 2010 the government apparently became more comfortable with a higher percentage ownership. In September 2010, AIG and Treasury announced a plan whereby Treasury would increase its ownership to 92.1% by converting some of its AIG holdings into common shares.[334]

Davidoff and Zaring describe Treasury's approach to deal-making as a "venture capitalist model" rather than a "private equity model."[335] In the venture capital model, the government "leave[s] the management of the firm in place . . . but offer[s] money and expertise to the venture."[336] In contrast, in the private equity model, investors "tend to take control of the firm with an eye to restructuring it and selling it off later for a profit."[337] While such an approach allowed the government to maintain that it had not nationalized the banks, the government's objective in making the investments—to jumpstart the credit markets—was not necessarily achieved.[338] Politically, nationalization may have been difficult to achieve in Congress. Complete control of a corporation by the government might require congressional approval under the Government Corporation Control Act of 1945,[339] and resistance to the bailouts was already fierce in Congress.

Another example of an attempted public–private partnership is Treasury's Public–Private Investment Program (PPIP). PPIP's purpose was

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practical reasons for the limit: (1) the 79.9% threshold would allow firms to still deduct interest on government loans under IRS rules in the event that the companies actually had a profit; and (2) under the Employee Retirement Income Security Act (ERISA), the threshold meant the government would not be jointly and severally liable for the firms' pension commitments. *Id.* For the tax code provision on interest, see generally 26 U.S.C. § 163 (2006 & Supp. II 2008).

332. *Lebron*, 513 U.S. at 394.

333. *See* Froomkin, *supra* note 7, at 560–62 (discussing the constitutional limitations and obligations of government corporations).

334. *See* Bansal, *supra* note 288.

335. *See* Davidoff & Zaring, *supra* note 1, at 538–42 (discussing venture capital versus private equity deal models and concluding the government's actions fit the venture capital model).

336. *Id.* at 539.

337. *Id.*

338. *See* CONG. OVERSIGHT PANEL, *supra* note 295, at 4–6 (describing Congress' broad goals for EESA and TARP and their effects on credit availability).

339. Davidoff & Zaring, *supra* note 1, at 496–97.

to use TARP funds to create a market in legacy assets (also referred to as "toxic assets")—the securities backed by sketchy, often subprime, real estate loans whose dropping value is widely acknowledged as a contributing factor to the credit crisis.[340] Given the uncertain value of the loans and mortgage-backed securities, trading in the secondary market ceased in fall 2008. The lack of a secondary market for the loans and securities led to a "negative economic cycle" where declining asset prices generated further uncertainty, which led to fire sales of assets, which created further uncertainty and so on.[341] Under PPIP, Treasury attempted to create investment partnerships with private firms to share the risk and purchase these toxic assets from banks at a discount.[342] As of early 2010, the program was not considered successful in restarting the market for mortgage-backed securities since the program had just recently started and was underfunded to handle the market for both commercial and residential mortgage-backed securities.[343]

6. *Government Willingness to Bail Out Firms Considered "Too Big to Fail" Leads to Moral Hazards*

Much has been written about the creation of moral hazards when the government either implicitly or explicitly offers a guarantee to bail out firms that are deemed to be "too big to fail."[344] The government creates a moral hazard when it gives an implicit or explicit guarantee on losses. Private entities are generally assumed to make riskier decisions that may lead to higher rewards if they know that the government will bail them out in the event of losses. Government guarantees are thought to give incentives to market actors to take on riskier bets, thus leading to a cycle of guarantee, market crash and government bailout. The cycle of guarantees and bailouts creates distortions in a liberal market economy—in essence putting the government in the role of guarantor rather than requiring private actors to take responsibility. Moral hazards are thought to be one of the leading

340. U.S. DEP'T OF THE TREASURY, *Public–Private Investment Program*, FINANCIALSTABILITY.GOV, http://www.financialstability.gov/roadtostability/publicprivatefund.html (last updated Feb. 22, 2010).

341. Press Release, U.S. Dept. of the Treasury, Treasury Department Releases Details on Public Private Partnership Investment Program (March, 23, 2009), http://www.financialstability.gov/latest/tg65.html.

342. *See* U.S. DEP'T OF THE TREASURY, supra note 256, app. 1, at 10–11 (providing a broad overview of the Public–Private Investment Program (PPIP)).

343. CONG. OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: COMMERCIAL REAL ESTATE LOSSES AND THE RISK TO FINANCIAL STABILITY 128–29 (2010), *available at* http://cop.senate.gov/documents/cop-021110-report.pdf.

344. *See* BENTON E. GUP, TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS 143–44 (2004) (introducing the concept of too big to fail in the United States).

causes of market crashes in general[345] and of the 2007–2009 financial crisis specifically.[346]

Within the political discourse, agencies and politicians shun moral hazards;[347] however, in practice, the too big to fail rationale has been repeatedly used to bail out firms on the brink of bankruptcy. Government may support firms that are thought to be too big to fail under the assumption that bankruptcy for such firms poses a systemic risk to the broader economy.[348] Government bailouts were justified during the financial crisis by a too big to fail rationalization that started with the government brokered sale of Bear Stearns[349] and continued through the takeover of Fannie Mae and Freddie Mac, and AIG. In one notable exception during the financial crisis, the government did not rescue Lehman Brothers because of the moral hazard issue,[350] though commentators have since judged Lehman as an entity that was too big to fail, given the subsequent breakdown in the financial system.[351] While government intervention under the too big to fail rationalization was thought to stem economic crisis, the bailouts and subsequent investments during the financial crisis perpetuate the cycle of implicit and explicit guarantees that lead to moral hazards.

The moral hazard problem and insolvency of Fannie Mae and Freddie Mac are both well documented. In fact, predictions of the insolvency were made for years before the government takeover.[352] Both Fannie Mae and Freddie Mac were created as government sponsored enterprises (GSEs).

345. *See* Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741, 757–59 (2000) (introducing the concept of moral hazard in the financial system). Partnoy gives three reasons for why a market might crash: (1) cognitive error, (2) moral hazard, and (3) information asymmetry. *Id.* at 755–62.

346. *See generally* Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 183 (2009) (asserting that moral hazard was the root cause of the financial crisis).

347. *See* Davidoff & Zaring, *supra* note 1, at 479–80 (describing Treasury's efforts to avoid moral hazard problems in the future).

348. *See* Graham, *supra* note 237, at 132 (describing how systemic risk concerns displaced other concerns).

349. Davidoff & Zaring, *supra* note 1, at 474.

350. Silva, *supra* note 230, at 123–24.

351. *See* David Callaway, *History Will Judge Lehman Mistake Harshly*, MARKETWATCH (Sept. 9, 2009, 12:01 AM), http://www.marketwatch.com/story/history-will-judge-lehman-mistake-harshly-2009-09-09 (stating that "Lehman was indeed too big to fail"); Davidoff & Zaring, *supra* note 1, at 493 (asserting that "[m]any observers would accuse the government of making a mistake in failing to bail out Lehman").

352. For a discussion of the controversy that has surrounded Fannie Mae and Freddie Mac, see Bradley K. Krehely, *Government Sponsored Enterprises: A Discussion of the Federal Subsidy of Fannie Mae and Freddie Mac*, 6 N.C. BANKING INST. 519–20 (2002).

GSEs are distinguished from federal government corporations (FGCs). The government typically retains full ownership of FGCs, but GSEs have both private and public ownership. Partial ownership by the government led to criticism that there was an implicit government guarantee of debt issued by the entities, thus leading to risk-taking by managers—a prediction that came true in 2008. In September 2008, the Federal Housing Finance Agency put Fannie Mae and Freddie Mac into conservatorship after months of deteriorating credit markets and a determination by government auditors that that accounting records of the two entities "significantly overstated their capital."[353]

However, at the time of the Fannie Mae and Freddie Mac takeover, the government was presented with an opportunity to address the moral hazard issue. If it completely wiped out the interest of shareholders and bondholders, future managers and shareholders would be less likely to take on the risks that led to the moral hazard.[354] Davidoff and Zaring maintain that if the government had been serious about preventing moral hazard, it would have wiped out the equity and bondholders entirely.[355] However, the government took only a 79.9% interest, leaving a sizeable stake for existing shareholders. Moreover, Treasury also announced that it would guarantee $5.4 trillion in Fannie Mae and Freddie Mac mortgage-backed securities and debt.[356] In late 2008, the Federal Reserve also began a program to purchase as much as $600 billion in mortgage-backed securities and other debt on the secondary market that was originally issued by Fannie Mae, Freddie Mac, Ginnie Mae, and Federal Home Loan banks.[357] That was later expanded to a total of $1.25 trillion on March 18, 2009.[358] The response by the Federal Reserve was likely driven by back-channel political maneuvering. Some commentators believe that the United States took over the two corporations as a result of pressure from the Chinese Central Bank and other countries' sovereign wealth funds, which invested

353. Davidoff & Zaring, *supra* note 1, at 486–87.

354. *See id.* at 489–90 (stating that the government could have reduced moral hazard by impairing certain securities, but ultimately chose not to for various reasons).

355. *See id.* at 490 (asserting that the prevention of moral hazard would not have been sufficient to justify the government's restructuring).

356. U.S. DEP'T OF THE TREASURY, RESPONSES TO QUESTIONS OF THE FIRST REPORT OF THE CONGRESSIONAL OVERSIGHT PANEL FOR ECONOMIC STABILIZATION 3 (2008), *available at* http://www.financialstability.gov/docs/123108%20cop%20response.pdf.

357. Press Release, Bd. of Governors of the Fed. Reserve Sys., Press Release on Program to Purchase Mortgage-Backed Securities (Nov. 25, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081125b.htm; *see also* Ruth Simon, *Homeowners' Refinancing Jumps By Record Pace*, WALL ST. J., Dec. 4, 2008, at C1.

358. *FAQs: MBS Purchase Program*, FED. RESERVE BANK OF N.Y., http://www.newyorkfed.org/markets/mbs_faq.html (last visited Nov. 8, 2010).

in Fannie Mae and Freddie Mac securities.[359]

While the government bailout of Freddie Mac and Fannie Mae was predictable, the AIG liquidity unfolded much more quickly. Given that AIG was a private firm, rather than a GSE, the bailout response led COP to conclude that the Federal Reserve and Treasury have "fundamentally changed the rules of America's financial marketplace."[360] Through a series of loans and equity investments, the Federal Reserve Bank of New York and Treasury provided AIG with $182 billion in assistance and took a 79.9% ownership interest.[361] The government has been soundly criticized for not seeking out private lenders to support the bailout effort or forcing AIG's creditors to assume some of the costs associated with the bailout. In a stunning rebuke, COP accused Treasury of "undermining the basic tenets of capitalism" when it gave AIG "a full government rescue with no shared sacrifice among the creditors."[362] The bailout in essence created a market expectation that the government will bail out other firms deemed too big fail thus creating a moral hazard issue that has undermined the credibility of the U.S. financial markets and shifted the burden of risk to taxpayers.[363]

The Obama Administration is not blind to the moral hazard issue. The monitoring of banks that accepted TARP funds and the initiatives on executive pay are also said to be geared to counteract moral hazard.[364] Additionally, government officials insist that financial regulatory reform will create a set of rules that will monitor risk and prevent moral hazard.[365]

B. Institutional Norms Regarding Shareholder Rights and Corporate Governance

After the government makes an investment, issues arise over potential conflicts of interest between the government's role as a regulator and its financial interest in a particular firm's success. At the heart of the controversy is a tension between the government's mandate to operate in

359. Davidoff & Zaring, *supra* note 1, at 488–89 (describing the foreign lender concerns faced by the United States); Colin Barr, *Paulson Readies the 'Bazooka,'* CNNMONEY.COM (Sept. 7, 2008, 9:56 AM), http://money.cnn.com/2008/09/06/news/economy/fannie_freddie_paulson.fortune/?postversion=2008090615.

360. CONG. OVERSIGHT PANEL, *supra* note 187, at 230.

361. *Id.* at 7, 72.

362. *Id.* at 139.

363. *See id.* at 230 (discussing the affects of the AIG bailout on the credibility of the United States).

364. *See* David Cho, *Banks 'Too Big to Fail' Have Grown Even Bigger*, WASH. POST, Aug. 28, 2009, at A1 (stating that regulatory reform may mean penalizing banks for being big).

365. Treasury Secretary Timothy F. Geithner maintained that, "[t]he dominant public policy imperative motivating reform is to address the moral hazard risk created by what we did, what we had to do in the crisis to save the economy." *Id.*

the public interest and the desire of most shareholders to maximize the value of a firm. Some of the resistance to government investment in a liberal market economy comes from the fear that the involvement of the government shareholder in corporate governance runs the risk of advancing policies in the public interest that will make the firm less competitive.[366]

Of course, not all shareholders are interested in maximizing the value of a firm. The stakeholder theory of the firm holds that corporations should operate in the long-term interest of the various stakeholders, such as employees and the surrounding community, and not just maximize short-term financial gain.[367] Advocates of policy-driven management of state investments can rely on a stakeholder (or constituent) theory of the firm in which management considers not only shareholder interests but also interests of labor and the community-at-large when making firm-level decisions.[368] Stakeholder theories are more consistent with CMEs than with LMEs; so while firms may still thrive under a stakeholder theory, there are likely negative consequences to entrepreneurism and innovation if a stakeholder theory of the firm ultimately prevails. Additionally, when the state is a majority shareholder, as in the case of GM and AIG, an issue also arises over whether the state owes minority shareholders a fiduciary duty to maximize the wealth of the corporation.[369]

Given all of these concerns, there has been much pressure on the U.S. government to forgo its shareholder vote when it owns equity in a private enterprise. Under TARP and other programs, Treasury cut back on its shareholder voting rights considerably but still exerted considerable influence over firms by using other methods. In practice, politicians extracted concessions from companies not through the use of a shareholder proxy vote, but through regulation, legislation, and intimidation. Conservative commentators' worst fears of government meddling in the

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366. *See* Laurence S. Seidman, *Making the Case for Funding Social Security*, 81 TAX NOTES 241, 244 (1998) (describing the pay-as-you-go financing of Social Security and the opinion by some that it reduces competitiveness by reducing real investments in business).

367. *See* Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1411 (1993) (observing that the stakeholder theory has been used to allow corporate management to consider other competing interests).

368. *See* J.W. Verret, The U.S. Government as Control Shareholder of the Financial and Automotive Sector: Implications and Analysis 3 (George Mason Law & Economics Research Paper No. 9-13, 2009, *available at* http://ssrn.com/abstract=1348256) (describing corporate constituents in the form of labor, locals, environmentalists, and consumer rights advocates).

369. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 685 (Mich. 1919) (holding that minority shareholders are not estopped from demanding proper dividends if the corporation is not using the money to maximize the wealth of the corporation).

market were realized as Washington replaced executives and boards, made executive compensation a political issue, and advanced policy goals by pushing GM and Chrysler to pursue a business strategy based on the policy goal of building fuel-efficient cars.[370] This is not to suggest that pursuing fuel efficiency is undesirable or unprofitable. The point is merely that the government's motivation was based on policy rather than the economics and expertise of those particular firms.

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

Not surprisingly, the government is more active in corporate governance when it owns a larger stake in a company or if the company is faltering. Treasury has stated that it "will not interfere with or exert control over day-to-day company operations" in companies in which it owns an interest.[371] However, the degree of agency involvement has varied considerably according to industry. COP noted that the automotive sector was subject to much more hands-on involvement than the financial industry under TARP, although there are some exceptions.[372] Major investments in the financial industry, such as AIG, were subject to "significant control."[373]

Interestingly, Treasury had no direct shareholder voting rights in its AIG stock yet the agency exerted a great deal of control through other means. The 79.8% ownership interest in AIG was put into a trust set up by the FRBNY with Treasury as the beneficiary. Treasury was given no formal legal control over the trust, though Treasury was granted the right to be consulted before any shareholder vote or disposition of the shares.[374] One principal reason for the trust structure was to protect against political influence and avoid the conflict of interest created between the government's role as both a regulator and an owner.[375] Critics of the AIG trust suggested three modifications to the structure: (1) trustees should manage for the benefit of the U.S. taxpayer rather than Treasury; (2) trustees should be under a duty to manage the trust so as to "maximize the value for the trust beneficiaries"; and (3) trustees should be prohibited from being personally enriched out of "investment opportunities that might

370. Jeffrey McCracken, John D. Stoll & Neil King Jr., *U.S. Threatens Bankruptcy for GM, Chrysler*, WALL ST. J., Mar. 31, 2009, at A1.

371. U.S. DEP'T OF THE TREASURY, *supra* note 256, app. 1, at 20.

372. *See* CONG. OVERSIGHT PANEL, *supra* note 11, at 86–87 (explaining Treasury's policy for exceptional cases).

373. *Id.* at 87.

374. U.S. DEP'T OF THE TREASURY, *supra* note 256, app. 1, at 20–21.

375. *See* CONG. OVERSIGHT PANEL, *supra* note 11, at 87–89 (discussing reasons why the trust structure was chosen).

belong to AIG."[376] In sharp contrast, other large holdings, such as the government's stake in GM, Chrysler and Citigroup, were not put into trusts. There was a move in Congress to require the government to create trusts for any TARP investment in which the government owned more than 20% of a company, but the bill did not advance beyond the committee stage.[377]

While the AIG trust provides the legal construct of a buffer from the political process, in practice, political actors have asserted a great deal of control over corporate governance. Treasury has performed as a seasoned activist investor—playing a significant role in corporate governance. For example, Treasury, in cooperation with the Federal Reserve and FRBNY, has been involved in the recruitment of new members for the board of directors and the senior management and "have taken on an active role with respect to planning and strategy."[378] Treasury does have more express legal rights in AIG's corporate governance because of the preferred shares sold through TARP.

Treasury's preferred stock purchases under TARP were made without acquiring any voting rights, though certain rights do accrue to Treasury.[379] If a financial institution misses six dividend payments then Treasury can appoint two directors to the entity's board of directors. Also, Treasury holds a veto right on mergers, exchanges, and the issuance of shares senior to the preferred stock.[380] Treasury exercised its right to appoint two directors to the AIG board in April 2010 after the company missed six dividend payments.[381]

Treasury acquired voting stock in GM, Chrysler, Ally Financial, and Citigroup, but indicated that it would only exercise its voting rights on important governance issues, such as: (1) board of director votes; (2) mergers, exchanges, sale of substantial assets, and dissolution; (3) issuance of securities requiring a shareholder vote; and (4) amendments to the bylaws and charter. Treasury bound itself contractually to these terms for public companies through either shareholder agreements or voluntarily for private

376. *See id.* at 90 (pointing out criticisms of the trust structure).

377. *See generally* TARP Recipient Ownership Trust Act of 2009, S.1723. 111th Cong. (2009) (prohibiting the disbursement of any federal funds to TARP recipients unless a trust structure is established).

378. CONG. OVERSIGHT PANEL, *supra* note 187, at 180–81.

379. *See* U.S. Dep't of Treasury, *Factsheet on Capital Purchase Program*, FINANCIALSTABILITY.GOV, http://www.financialstability.gov/roadtostability/CPPfactsheet.htm (last updated Oct. 3, 2010) (stating the limitations of Treasury's voting rights).

380. *See id.* (describing Treasury's voting power and Senior Preferred shares).

381. U.S. DEP'T OF THE TREASURY, *supra* note 256, app. 1, at 21.

companies.[382] Treasury is also contractually bound to not vote any shares of common stock that come into Treasury's portfolio from the exercise of warrants issued as part of the TARP/CPP preferred stock purchases.[383] Treasury waived these future common stock voting rights in response to concerns over government interference in corporate governance.[384]

Should the government have waived or otherwise restricted its ability to exercise a shareholder vote? One way to mitigate political interference would be to have the government shareholder forgo exercising its voting rights.[385] However, waiver of voting rights may be undesirable if the goal is to maximize shareholder value. Shareholder activism is an important tool in preventing management waste.[386] Shareholders serve an important oversight function, and some activist investors are needed to fulfill that function.[387] Recently, shareholder activism has been on the rise. Activist investors, such as hedge funds and pension plans, have mobilized to exert even greater control, often to the chagrin of management, by initiating proxies on business direction initiatives—issues that are traditionally reserved for boards and managers.[388] Few scholars dispute that shareholders have a right to use the proxy process, though controversy exists as to whether those rights should be expanded or limited.[389]

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382. *Id.* at 20.

383. U.S. Dep't of the Treasury, *supra* note 379.

384. CONG. OVERSIGHT PANEL, *supra* note 193, at 49 (analyzing Treasury's agreement to waive voting rights with respect to common shares acquired upon exercise of warrants).

385. Although Congress allowed the Federal Retirement Thrift Investment Board to invest in index-based funds in 1986, it restricted the entity from exercising any voting rights. Karen C. Burke & Grayson M.P. McCouch, *Privatizing Social Security: Administration and Implementation*, 58 WASH. & LEE L. REV. 1325, 1333, 1345 (2001). One example of a government shareholder without voting rights is the Federal Retirement Thrift Investment Board. *See* 5 U.S.C. § 8438(f) (prohibiting exercise of any voting rights).

386. *See* Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227, 227, 251 (1996) (discussing how shareholder activism is used to keep management in check).

387. *See* Deborah M. Weiss, *The Regulation of Funded Social Security*, 64 BROOK. L. REV. 993, 997–98 (1998) (discussing activist investors).

388. *See* Marcel Kahan & Edward Rock, *Hedge Fund Activism: The Case For Non-Intervention*, 33 ADMIN. & REG. L. NEWS 6 (2008) (examining the increasing influence of activist hedge funds). Public pension funds, such as the $200 billion California Public Employees' Retirement System (CalPERS) fund, are also leaders in shareholder activism. CalPERS has initiated several proxy contests on social and political issues, such as environmental disclosures and limiting executive pay. *See* Gina Chon, *Calpers Aims Director List at Increasing Board Sway*, WALL ST. J., June 18, 2010, at C1 (describing CalPERS activist shareholder plans).

389. Some advocate an expansion of such rights. *See generally* Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225 (2007) (advocating an activist, hedge fund style of investing). Others suggest

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

2. Political Influence in Corporate Governance

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

The interference of politicians in the decisionmaking of public pensions provides examples of political meddling. In 2007, several state legislatures tried to force their state pension plans to divest holdings in companies operating in Iran because of Iran's support of insurgents in Iraq. Through a coalition, the state pension plans sent a response that they considered the issue to be a matter of corporate governance rather than foreign policy.[390] The coalition urged companies operating in Iran to weigh whether the risks outweighed the rewards.[391] However, political interference is greater when

that the rights for a public shareholder should "ideally, be eliminated, and certainly not expanded or enhanced." *See generally* Lawrence E. Mitchell, *The Legitimate Rights of Public Shareholders*, 66 WASH. & LEE L. REV. 1635, 1635 (2009) (arguing that shareholder activism adversely affects firm managers "who place strong emphasis on stock price at the expense of long-term business health").

390. *See* Craig Karmin, *Pension Funds Weigh in on Iran*, WALL ST. J., July 24, 2007, at A3 (analyzing the state fund coalition's move to pressure companies).

391. *Id.* (describing the actions taken by the coalition).

the investment is made as a result of a bailout rather than a public pension fund investment. Since the legislative branch authorizes specific funds in a bailout, such as the EESA, politicians have a more direct oversight role.

During the financial crisis, the issue of executive salaries and retention bonuses highlights the tension that arises when the political and legislative process attempts to modify contract terms retroactively. No one disputes that executive salaries and bonuses, especially those of Wall Street bankers, are widely considered to be excessive.[392] Even prior to the financial crisis, much had been written about disproportionate executive salaries and bonuses and the need to link compensation to performance.[393] The ultimate solution will largely be driven by changes in government regulations, and many different solutions have been proposed.[394] For purposes of this Article, the question is whether the government, in its role as a shareholder in private enterprise, interfered with contract rights and corporate governance. An important distinction exists between the government as regulator and the government as shareholder. When the government uses its regulatory power to coercively interfere in corporate governance or change contract terms, it harms the underlying institutional norms of entrepreneurial capitalism, which require enforcement of strong contract and property rights.[395]

The issue of executive salaries became highly politicized when it became public that executives at companies receiving government funds would receive billions in bonuses despite the financial downturn.[396] Naturally, the issue of executive compensation is appropriate both as a political issue and as a legitimate shareholder concern. As a political and regulatory matter, the government can and should investigate and legislate on the issue of executive compensation as it applies to industries as a whole. In addition, the government can and should assert its rights as a shareholder and use any legal means available through contract negotiation or corporate

392. *See* Richard A. Posner, *Are American CEOs Overpaid, and, if so, What if Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1013–14 (2009) (noting general public consensus over excessiveness of executive compensation).

393. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 1 (2004) (discussing executive salaries reaching "unprecedented levels").

394. Reform proposals are outside the scope of this Article. For a normative evaluation and framework for proposed solutions, see generally Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010); Michael B. Dorff, *Confident Uncertainty, Excessive Compensation & the Obama Plan*, 85 IND. L.J. 491 (2010); David I. Walker, *The Challenge of Improving the Long-Term Focus of Executive Pay*, 51 B.C. L. REV. 435 (2010).

395. BAUMOL ET AL., *supra* note 119, at 7–8.

396. *See* Dorff, *supra* note 394, at 492 (noting how public outrage over the bonuses spurred a political reaction against excessive executive pay).

governance to curb excessive salaries.

However, there are significant consequences when the government uses its regulatory and legislative powers in a coercive manner to target executives at companies in which the government holds an interest. Constitutional questions arise regarding bills of attainder and ex post facto laws. During the financial crisis, the government sought modification of existing compensation contracts with its portfolio companies through a public process that included coercive threats of litigation and public shaming of individuals[397]—possibly violating privacy rights and engaging essentially private persons within the political arena. This Section will first review the rights in general of shareholders, and then examine how the government responded to the executive compensation issue and the degree to which it used its leverage as a regulator and legislator to change contractual terms.

Any investor—whether it is the government or private persons—can contractually set limits on executive compensation when negotiating the investment contract. Indeed, many investment contracts—especially for risky endeavors—set limits on compensation or require approval of the investors before granting bonuses or raises. To the extent that shareholders are not protected through the investment contract, they can assert their rights under corporate law. Two ways in which shareholders can attempt to curtail excessive executive pay are through the proxy process or as a litigant charging boards of directors with a breach of their fiduciary duties in awarding excessive compensation package.[398] Neither method is generally thought to be effective, given the separation between ownership and control.[399] Despite the legal constraints, institutional investors have increasingly sought to use their proxy rights to limit executive compensation.[400] The recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 provided shareholders of public companies with more expansive proxy rights related to executive compensation, requiring—among other provisions—that public companies

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397. *See, e.g.*, Jake DeSantis, *Dear A.I.G., I Quit!*, N.Y. TIMES, Mar. 25, 2009, at A29 (describing one employee's fallout with AIG over broken promises made by management and government persecution).

398. *See generally* Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 108, 131 (2006) (comparing social norms against legal accountability mechanisms in the context of enforcing fiduciary duties).

399. *See* Claire Hill & Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporation Law*, 4 VA. L. & BUS. REV. 333, 334 (2009) (stating that "law on the books and as enforced is not well situated to deal with structural bias").

400. Cari Tuna, *Shareholders to Focus on Executive Compensation*, WALL ST. J., Jan. 12, 2009, at B4.

seek a nonbinding shareholder vote on executive compensation at least once every three years.[401] Alternatively, some shareholders have used shareholder derivative lawsuits to limit compensation packages claiming that the approval process used by a board of directors breached a fiduciary duty or otherwise constituted an ultra vires act. Given the deference afforded boards of directors through the business judgment rule, such efforts have also met with limited success.[402]

Controls over executive compensation were built into the initial TARP investment contracts; however, voter outrage sparked political action in Congress when it was revealed that AIG planned $165 million in bonuses.[403] Initially, the TARP funds provided some limited restrictions on executive and employee salaries and bonuses by prohibiting compensation that encouraged unnecessary risk-taking, banning excessive golden parachutes, and lowering the amount of salary that could be deducted for tax purposes on the company's tax returns.[404] These soft restrictions provide a disincentive for a company to give large salaries and bonuses but do not outright prohibit the payment of large bonuses or salaries, except in cases of misrepresentation. The restriction provides that the CEO, CFO, and the next three most highly compensated executive officers are not compensated in such a way that would encourage "excessive risks that threaten the value" of the qualifying financial institution (QFI).[405] Golden parachutes of three times an executive's base salary were prohibited, compensation over $500,000 could not be deducted by the QFI for tax purposes, and bonuses and incentive compensation would be "clawed back" in the event that statements of earnings, gains, or other criteria "are later proven to be materially inaccurate."[406]

After AIG announced $165 million in bonuses, the subsequent political uproar led the House to pass legislation that would tax some bonuses granted to employees working in firms receiving significant government financing under TARP and other programs.[407] The proposed tax would

401. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010).

402. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 746–47 (Del. Ch. 2005) (describing the business judgment rule and the deference it grants directors and officers).

403. *See* Greg Hitt, *Drive to Tax AIG Bonuses Slows*, WALL ST. J., Mar. 25, 2009, at A1 (describing the congressional response to the AIG bonuses).

404. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(b)(2), 122 Stat. 3765, 3777.

405. OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, *supra* note 222, at 54.

406. *Id.*

407. *See* Hitt, *supra* note 403 (discussing House action to tax bonuses at certain institutions which received bailout funds).

have effectively canceled out much of the bonuses by applying a levy of 90% on money paid out to employees who worked at companies receiving $5 billion or more in government financing and whose household income was over $250,000.[408] Commentators suggested that the tax could be unconstitutional under a theory of prohibitions on bills of attainder or an expanded ex post facto clause.[409] The Senate tabled its measure, and the proposal never gained any additional support.[410]

Another option open to the government would have been to compel AIG to breach the bonus contracts with its employees or seek rescission through a court action. Efficient breach of a contract is condoned in a market economy so long as the innocent party is made whole through damages.[411] The White House considered breaching the AIG bonus contracts but concluded that legal fees would be greater than the cost of the bonuses.[412] The government could also have sought to rescind the contracts under a variety of theories, including employee breach for nonperformance, fraudulent conveyance, nondisclosure, and impracticability, although it is not certain that any of these theories would have held up in court.[413] A suit could also have been brought under the restitutionary theory of unjust enrichment, though it was also considered a long shot.[414] The House Judiciary Committee went so far as to introduce a bill titled the "End Government Reimbursement of Excessive Executive Disbursements (End GREED) Act" that authorized the Justice Department

408. *See* H.R. 1586, 111th Cong. § 1(a)(2)–(c)(2)(A) (2009) (imposing an additional tax on bonuses received from certain TARP recipients).

409. *See* Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 383 (2009) (stating the proposed bonus bill may be an unlawful bill of attainder); Opinion, *A Smoot-Hawley Moment?*, WALL ST. J., Mar. 23, 2009, at A14 (stating the proposed tax would apply ex post facto). The rule against ex post facto laws typically applies to criminal law but scholars have criticized the Supreme Court on this issue and suggested that it should also apply to civil measures. Steve Selinger, *The Case Against Civil Ex Post Facto Laws*, 15 CATO J. 191, 192 (1995).

410. *See* Hitt, *supra* note 403 (describing the reactions from the House and the Senate to AIG bonuses).

411. For a discussion of efficient breach, see generally Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629, 630 (1988).

412. *See* Jonathan Weisman et al., *Treasury Will Make Grab to Recoup Bonus Funds*, WALL ST. J., Mar. 18, 2009, at A1 (noting the White House's acknowledgement of the prohibitive cost of litigation).

413. *See* Lawrence A. Cunningham, *A.I.G.'s Bonus Blackmail*, N.Y. TIMES, Mar. 18, 2009, at A27 (examining various legal theories which may be applicable).

414. *See* Tracey A. Thomas, Comment, *Bailouts, Bonuses, and the Return of Unjust Gains*, 87 WASH. U. L. REV. 437, 441 (2009) (considering the applicability of restitution to the AIG scenario).

to bring lawsuits against executives who had received bonuses from some companies, but the measure was defeated.[415]

Some politicians used their investigatory powers and access to the media to shame the recipients of the AIG bonuses into giving back the money.[416] The attorneys general for New York and Connecticut each announced investigations that would "name and shame" recipients of the bonuses.[417] While it was politically expedient to rally against executive compensation, some of the AIG bonuses were actually consistent with the market salaries for talented finance professionals. Given that it was in the government's interest to retain the best people available to make AIG profitable, the granting of some bonuses could be prudent.[418] AIG's president justified the bonuses by noting that the FDIC and aides to Treasury Secretary Geithner were involved in the decisionmaking,[419] and the highest paid bonuses had gone to people who had saved AIG hundreds of millions of dollars by unwinding complex derivatives.[420] The public and moral outrage over the bonuses convinced many at AIG to give back at least a portion of the bonuses, with fifteen out of the twenty highest compensated employees agreeing to return the money.[421] Conservative commentators chastised politicians for using their public office as leverage in renegotiating compensation packages.[422] Some dedicated employees who were actively

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415. End Government Reimbursement of Excessive Executive Disbursements Act, H.R. 1575, 111th Cong. §§ 2(2), 3(b)–(c) (2009).

416. *See* Jonathan Weisman et al., *Political Heat Sears AIG*, WALL ST. J., Mar. 17, 2009, at A1 (recounting the public anger and response from the media when the Obama Administration could not halt the payment of AIG employee bonuses that were partly responsible for its "near collapse").

417. DeSantis, *supra* note 397, at A29.

418. *See* Holman W. Jenkins, Jr., Op-Ed., *The Real AIG Disgrace*, WALL ST. J., Mar. 25, 2009, at A11 (explaining that the AIG employees who received the bonuses agreed to remain at the company so they could help AIG minimize further losses during the government takeover).

419. *See* Michael M. Phillips & Sudeep Reddy, *Geithner Aides Worked with AIG for Months on Bonuses*, WALL ST. J., Mar. 23, 2009, at A4 (describing Secretary Geithner's continued involvement in major AIG issues through federal staffers).

420. Jenkins, Jr., *supra* note 418, (citing New York Attorney General Anthony Cuomo, who assured that the bonuses the government honored were for the remaining employees at AIG).

421. *See* Hitt, *supra* note 404, at A2 (stating that the section that produced large losses for AIG pledged to return nearly $50 million in bonus pay). After a year, however, little of the money that had been pledged was actually returned. *Kenneth Feinberg and Executive Compensation: 'My Number-One Priority: Repay the Taxpayer,'* KNOWLEDGE@WHARTON (Mar. 17 2010), http://knowledge.wharton.upenn.edu/article.cfm?articleid=2448.

422. *See* DeSantis, *supra* note 397 (accusing AIG's CEO. of failing to defend AIG employees who did not participate in credit default swaps against critics in Congress who questioned the promised retention bonuses).

part of the solution quit in disgust after politicians and AIG executives brought pressure to give back bonuses to which they were contractually entitled.[423]

After realizing that the EESA provisions on executive compensation were considered inadequate, Congress amended EESA when it passed ARRA.[424] The new provisions placed caps and other restrictions for TARP recipients entering into employment contracts after February 11, 2009. The salaries of some executives were capped at $500,000, and the changes required that companies issue restricted stock for any additional compensation.[425] One question that arose was whether the corporate recipients of TARP funds prior to ARRA should have been bound by these new provisions. The TARP investment contracts entered into with Treasury specified that recipients be bound by the initial version of EESA. Because those prior contracts did not anticipate rigid compensation standards, banks that received TARP investments prior to February 11, 2009, could argue that the new restrictions would not apply to any post-February 11, 2009 employment contracts, as well as prior contracts. The government, in effect, changed the TARP investment agreements through legislation rather than negotiation.

For past TARP investments, Treasury had an interesting provision that allowed the government to unilaterally modify the contracts for the initial round of TARP investments. In an interesting twist that is likely to inhibit private enterprise from accepting government investment in the future, Treasury contractually provided for future political interference. One little-discussed term in the purchase agreements gave Treasury a "unilateral right to amend any provision of the purchase agreement to the extent required to comply with any changes after the signing date in federal statutes."[426] The Oversight Panel suggested that such a clause could be used to provide for reporting requirements. However, its use here allows Congress to unilaterally change a provision of EESA, which could materially alter the original contract. Naturally, any contract would be modified if it provided for performance that was made illegal by subsequent legislation. However, the provision here allows Congress to modify EESA to give the government additional rights under prior contracts. Under a

423. *Id.*

424. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–20.

425. FIN. STABILITY OVERSIGHT BD., QUARTERLY REPORT TO CONGRESS PURSUANT TO SECTION 104(G) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008, at 53–54 (2009), *available at* http://www.financialstability.gov/docs/FSOB/FINSOB-Qrtly-Rpt-033109.pdf.

426. CONG. OVERSIGHT PANEL, *supra* note 192, at 50.

strict view of contract law, a unilateral right to modify a contract could arguably make a contract unconscionable, illusory, or void for lack of consideration. Since the right to modify rests with the political arm rather than objective managers, the action can be used coercively to extract additional terms which were not bargained for.

One express provision of ARRA amendments to EESA made clear that the new restrictions did not apply to employment contracts entered into prior to February 11, 2009. However, ARRA required that Treasury review all bonus payments made prior to the passage of ARRA and to negotiate with companies and employees to return payments made that the Secretary deemed to be "contrary to the public interest" or otherwise inconsistent with TARP.[427] By authority granted to it under ARRA, Treasury promulgated regulations to establish the Office of the Special Master for TARP Executive Compensation[428]—known colloquially as the "Pay Czar."

However, by politicizing the issue and using its leverage to renegotiate existing contracts, as well as changing terms of the TARP investment contracts, the state acted in a way that is inconsistent with the political economy of entrepreneurial capitalism. One consequence of the politicization of the compensation issue was that firms sought to pay back TARP funds earlier than originally planned,[429] thereby leading to questions of whether the banks were still adequately capitalized.[430] The broader political economy issue surrounding the government's reaction to compensation was that the sanctity of contract rights—one of the fundamental institutions of entrepreneurial capitalism—had become open to political risk—the risk that the government would interfere with property rights in the interest of "redistributionist justice."[431]

3. *Conflicts of Interest Create Tension When the Government Is Both Regulator and Shareholder*

Critics of government investment maintain there is an inherent conflict of interest when the government is both a shareholder and a regulator. Government's role as a regulator can have an enormous effect on the value

427. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 111(f)(1), 123 Stat. 115.

428. 31 C.F.R. § 30.16(a) (2009).

429. *See* Labaton & Andrews, *supra* note 203, (observing that some banks wish to repay the TARP bailout money early to avoid the government restrictions placed on banks that received TARP funds).

430. *See* Opinion, *supra* note 409, at A14 (theorizing that banks will quickly pay off the TARP funds regardless of the hazard it causes to their capital base).

431. *Id.* (internal quotation marks omitted).

of a firm.[432] Decisions by the Federal Reserve on the money supply can have an enormous effect on Wall Street firms.[433] Given the government's ownership interest in financial institutions, it would be natural to suspect conflicts arise if the individuals with responsibility for interest rate decisions are the same ones charged with returning the taxpayer's money from TARP investments. This is not to suggest that any nefarious decisions were made—only that the appearance of conflicts undermines credibility. Potential conflicts also arise over the award of government contracts. Might the government as a controlling shareholder exert influence over a corporation to award a sweetheart deal with a state agency, or conversely, might the government draft contract bids in a way that the outcome favors its portfolio companies?[434]

Additional conflict of interest issues come up when the government owns shares in competing companies, such as GM and Chrysler. While many investors hold a portfolio of companies in which there are bound to be some competitors, the role of Treasury as a controlling shareholder could give accusations of conflicts and possible breaches of a fiduciary duty. With a different twist, the government can also launch broader policy initiatives and use taxpayer dollars to drive customers to its portfolio companies. The Cash for Clunkers program, although nominally aimed to improve fuel efficiency in cars, helped jumpstart sales for GM and Chrysler.[435]

The ethics rules governing conflicts of interest in government bailouts are considered inadequate.[436] Conflicts also arose during the crisis given that many of the regulators were formerly Wall Street professionals.[437] The close relationship between the regulators and the executives at financial institutions receiving TARP investments led to the appearance that the

432. *See* SYLVESTER J. SCHIEBER & JOHN B. SHOVEN, THE REAL DEAL: THE HISTORY AND FUTURE OF SOCIAL SECURITY 348 (1999) (stating that government should have the fiduciary responsibility to not threaten the value of a company).

433. *See* Theodore J. Angelis, *Investing Public Money in Private Markets: What Are the Right Questions?*, *in* FRAMING THE SOCIAL SECURITY DEBATE: VALUES, POLITICS, AND ECONOMICS 287, 314 (R. Douglas Arnold et al. eds., 1998) (remarking on the relationship between the Federal Reserve Board's decisions and fluctuating interest on financial products).

434. Templin, *supra* note 97, at 440 (contemplating interactions where the power of the government is improperly used to the benefit of a corporation).

435. *See* CONG. OVERSIGHT PANEL, *supra* note 11, at 82 (naming GM and Chrysler as beneficiaries of the Cash for Clunkers program, which generated new sales of approximately 700,000 new vehicles).

436. *See* Painter, *supra* note 225, at 138–39 (proposing changes from an ethical perspective).

437. *See* CONG. OVERSIGHT PANEL, *supra* note 187, at 234 (describing the intertwined attorney relationships resulting from attempts to wind up AIG's affairs).

banks received a better deal than the automobile industry.[438] Concerns over ethical conflicts of interest in government investments have not been limited to TARP and the other programs. Critics of the Ex–Im Bank charge that political influence drives the lending decision process.[439] Before the Enron scandal surfaced, Ex–Im Bank loaned or guaranteed loans of $650 million to the corrupt power trader. Enron and its executives had contributed generously to both political parties. In fact, an Enron executive sat on the board of Ex–Im Bank. It was later discovered that some of the loans were used to fund bogus sales of energy. Over $500 million of the loans were unpaid when Enron faced liquidation.[440]

4. Conclusions

The issues that arise in government investment have led commentators to oppose government ownership of private enterprise for four interrelated reasons: (1) the government bureaucracy does not have the market expertise necessary to efficiently purchase and manage assets; thus leading to waste;[441] (2) investments will be made for social or political purposes rather than for economic gain;[442] (3) an inherent conflict of interest arises when the government acts as both a regulator and an investor;[443] and (4) fear of political interference in corporate governance.[444] The next Section discusses the norms that lead to the last two fears.

III. REGULATING PUBLIC OWNERSHIP OF PRIVATE ENTERPRISE

Can state investment and ownership of private enterprise be reconciled with a neoliberal market economy and the American entrepreneurial

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438. CONG. OVERSIGHT PANEL, *supra* note 11, at 85–87.

439. *See, e.g.*, Timothy P. Carney, *Bank Scam: The House of Representatives keeps Enron on Welfare*, NAT'L REV. ONLINE (May 31, 2002, 8:45 AM), http://old.nationalreview.com/comment/comment-carney053102.asp (listing various occasions when Ex–Im Bank lending decisions appeared to be fueled by political gains, including lending to Enron).

440. *Id.*

441. *See Investing in the Private Market: Hearing Before the Subcomm. on Soc. Sec. of the Comm. on Ways and Means*, 106th Cong. 41–43 (1999) (statement of Michael Tanner, Dir., Health and Welfare Studies, Cato Institute), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=106_house_hearings&docid=f:57507.pdf (stating his belief that the government would "meddle" too much in corporate affairs).

442. *See* Romano, *supra* note 229, at 803 (1993) (describing the pressure public funds put on investments to stimulate local economic activities.

443. *See id.* at 812–14 (demonstrating potential negative effects of the government acting as regulator and investor).

444. *See* SCHIEBER & SHOVEN, *supra* note 432, at 347–51 (sounding concerns for corporate independence in the presence of concentrated economic power at the government's disposal).

culture? This Section attempts to establish a set of rules of the game—both formal and informal—that will guide and constrain state decisionmaking regarding investments in private enterprise in order to address the problems identified above. To differentiate these behaviors from state capitalism, this Article uses the term "state entrepreneurism" to describe the underlying principles of the proposed rules.

"State entrepreneurialism," "state entrepreneurism," "state entrepreneurship," and the "entrepreneurial state" are terms that have been used by economists, academics, and politicians to describe a developmental role for the state; yet, the term has also been misused to describe investment activities that are politically-driven rather than classically entrepreneurial.[445] State entrepreneurism has often been associated with CMEs rather than LMEs. Some may object to the use of the term state entrepreneurism as just another descriptor for state capitalism. However, a classic Schumpeterian definition of entrepreneurism necessarily includes profit seeking, risk taking, innovation, and market-based transactions. These characteristics are inconsistent with politically motivated investments and the institutions that characterize CMEs.

This Article proposes that *state entrepreneurism* should be redefined to describe government participation as a market actor in a way that supports and preserves the flourishing of innovation and economic growth in an LME. State entrepreneurism, as a normative matter, provides that the government will abide by the rules of the game of a liberal market economy, such as maximizing the return on all investments. In order to achieve that goal, investment and portfolio decisions must be insulated from direct influence by politicians. In a state entrepreneurial model, investments are purchased at fair value without coercive threats, such as nationalization. Moreover, the government does not use its legislative or regulatory power to extract concessions from private companies in a state entrepreneurial model. While government remains a regulator, the investment function is separated from the political and bureaucratic arm in order to prevent rent-seeking behavior. In this model, the state does not seek to control; rather, the state seeks to both feed and harness the power of an entrepreneurial capitalist society by investing in a diversified portfolio of

445. Identifying entrepreneurial trends within government investment is not a new idea. Peter K. Eisinger first identified the state's entrepreneurial function in his book, *The Rise of the Entrepreneurial State*. David M. Hart, *The Politics of "Entrepreneurial" Economic Development Policy of States in the U.S.*, 25 REV. POL'Y RES. 149, 152 (2008) (identifying Eisinger as the first scholar to document the trend of states to develop and invest in businesses within its borders as opposed to putting resources into the competitive process of attracting business from out of state).

stocks, bonds and other marketable assets. Through investment, the state ensures the free flow of capital—a key ingredient for private entrepreneurs to flourish.[446]

One descriptive model of government investment that emerged from the financial crisis was the private equity model versus the venture capital model.[447] Davidoff and Zaring use this distinction to describe degrees of control—where private equity investors have a greater say in managing the firm while venture capital investors exert less direct control but provide capital and advice.[448] Critics of TARP suggest that the government should have used the private equity model since the program did not achieve its goals of jump-starting the credit markets.[449] Under a state entrepreneurism approach, the government could use either the venture capital model or the private equity model since both models occur frequently and successfully in an LME. The choice between the models would depend upon following the principles below, such as maximizing the return on investment.

Why use the word entrepreneurism? As David Pozen reflected in his engaging rhetorical study, *We Are All Entrepreneurs Now*, it is fashionable among academics and policymakers to label any innovation as "entrepreneurial."[450] "Social entrepreneurs," "norm entrepreneurs," and "moral entrepreneurs" foster innovative change within academic disciplines.[451] Pozen explains that the buzzword proliferated because it easily identifies the concept of innovation and resourcefulness within a particular academic field.[452] Moreover, the term captures positive connotations. The entrepreneur—certainly through the 1980s and 1990s if not before—had become an American hero and a folk legend, especially as breakthrough technology companies proliferated from the garages and apartments of Silicon Valley engineers.[453] Given its positive connotations,

446. Entrepreneurs rely on active credit markets to fund their enterprises. JOSEPH A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT: AN INQUIRY INTO PROFITS, CAPITAL, CREDIT, INTEREST, AND THE BUSINESS CYCLE 102–08 (Redvers Opie trans., Transaction Publishers 3d prtg. 1993) (1934).

447. *See* Davidoff & Zaring, *supra* note 1, at 538–42 (detailing the differences between venture capital and private equity deal models).

448. *Id.*

449. CONG. OVERSIGHT PANEL, *supra* note 295, at 4–6.

450. *See* David E. Pozen, *We Are All Entrepreneurs Now*, 43 WAKE FOREST L. REV. 283, 283 (2008) (introducing the idea that society attaches the "entrepreneur" label to a variety of people).

451. *Id.*

452. *See id.* at 315 & n.157 (describing the attributes of corporate entrepreneurship, including increased innovation and resourcefulness).

453. *See id.* at 320 (recounting the rise of the entrepreneur and the mythical nature given her by Americans).

actors within a system are more likely to accept change—whether political, social, or institutional—when it is characterized as entrepreneurial.[454]

However, characterizing government investment as state entrepreneurism is not a mere rhetorical exercise to relabel or market an American brand of socialism. In order to characterize government investment as state entrepreneurism, this Article argues that the government must operate according to the same rules of the game as private investors in an entrepreneurial economy. Moreover, the government should try to achieve its goals of fostering economic growth without creating moral hazards or rent-seeking behavior.

Measuring the success of an investment, however, is more complicated when the government is involved than when the investor is a private money manager. In the latter case, the measure of success is most often wealth creation, although there are notable exceptions to that rule.[455] The goals of government investment, however, are more broadly conceived to serve the public good, which may or may not include maximizing the cash flows from the investment. In order to elaborate upon state entrepreneurism within an LME, this Article first creates a typology of government investments which describes the different sets of goals for any particular investment. The Article then describes an overarching set of institutional norms that can apply to any given type of investment.

A. *Typology of Government Investment*

Government investment can be broadly categorized into the following five types: (1) infrastructure investments; (2) social investments; (3) political investments; (4) economic investments; and (5) financial investments. While government investment occurs with more frequency in CMEs than LMEs, all five types of government investment typically exist in any given political economy. The degree of investment in any given category may be greater in one form of political economy than another. The principal differences in government investment between CMEs and LMEs can be found in the institutions that shape and constrain those investments. Government invests for many different reasons, and this typology tries to identify the principal reasons for state investment. By isolating the motivation of the government in making the investment, one can better determine the ROI

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454. *See id.* at 319–20.

455. There are many mutual funds and other investment vehicles focused on social goals, such as investing in companies that are environmentally conscious. *See generally What is Socially Responsible Investing?*, SOCIAL INVESTMENT FORUM, http://www.socialinvest.org/resources/sriguide/ (last visited Nov. 8, 2010) (encouraging investors to invest in environmentally conscious institutions instead of polluting institutions).

and whether or not the investment was successful.

Infrastructure Investments. The most common and well accepted form of government investment is the infrastructure investment, such as building roads, schools, and hospitals. These investments have indirect, though still tangible, returns by increasing commerce through transportation and a healthier and better-educated workforce. The Erie Canal, the Panama Canal, and the interstate highway system are all seen as investments that paid off both economically and socially.[456]

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

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

Economic Investments. Economic investments are made to improve GDP mostly through the creation of jobs. Public venture capital funds that make investments to help improve the economy in a region or a sector of the economy are considered developmental. These investments are economic in the sense that they could lead to a rise in GDP by creating jobs and adding products or services to the economy. Investments made to prevent systemic risk, such as the AIG investment made under the TARP program,[457] are economic because, without the government intervention, the collapse of the company would cause greater harm to the economy than the cost of the investment.

Financial Investments. Financial investments refer to investments made to help fund social programs. In other words, the investment is a savings mechanism to finance the future cost of another government program. For

456. *See generally* FELIX ROHATYN, BOLD ENDEAVORS: HOW OUR GOVERNMENT BUILT AMERICA, AND WHY IT MUST REBUILD NOW 4 (2009) (discussing some of the United States' major social investment projects).

457. *See* William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 977–78 (2009) (stating the fear that the failure of AIG could lead to widespread economic consequences).

example, the Social Security Trust Fund is a financial investment in which government bonds are being held to finance retirement benefits for the Baby Boomer generation.[458] A growing number of nations have established sovereign wealth funds with asset allocations that include both equity (stocks) and fixed income (bonds) in order to provide savings for future generations of citizens.[459]

It may be difficult in some situations to isolate just one motivation or to classify the investment as being in only one category. The investment made by the government in GM and Chrysler through the Automotive Industry Financing Program[460] could be construed as economic, political, and social.[461] The investment was economic to the extent that the government's motive was to prevent systemic risk to the economy.[462] Yet, the investment was also arguably politically driven given the influence of labor unions within the Democratic party. To the extent that the government mandated that the car companies produce fuel-efficient vehicles, the investment was arguably made for social purposes.[463]

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

The challenge here is to describe a set of norms whereby the state is constrained to act according to the rules of a prudent investor when it acts

458. Many commentators contend that the U.S. Treasury bonds held in the Social Security Trust Fund are merely accounting entries and not actual investments earning interest. *See* ALLEN W. SMITH, THE LOOTING OF SOCIAL SECURITY 42 (2004) ("The government pays interest on funds borrowed from the Social Security trust fund by posting 'special-issue' securities . . . . *This means that both the assets and the earnings of the Social Security trust fund are in the form of government IOUs that have no commercial value.*"). For a more complete discussion of the bonds, see generally Templin, *supra* note 97, at 408–15 (presenting opposing views on the safety of the Social Security trust fund bonds).

459. *See* IMF, GLOBAL FINANCIAL STABILITY REPORT, ANNEX 1.2. SOVEREIGN WEALTH FUNDS 46–49, *available at* http://www.imf.org/external/pubs/ft/gfsr/2007/02/pdf/annex12.pdf (describing the various objectives of different sovereign wealth funds and the kinds of products they require).

460. U.S. DEP'T OF THE TREASURY, *supra* note 247.

461. The stated objectives of Treasury's investment in the automotive industry have varied and provide little clarity as to the primary reason behind the investment. CONG. OVERSIGHT PANEL, *supra* note 11, at 3–4 (emphasizing congressional concern over Treasury's elusive objectives, cited varyingly as providing temporary bridge funding, preventing uncontrolled liquidation, and advancing policy goals).

462. *See id.* at 3 (characterizing a recently stated Treasury goal as avoiding disorderly bankruptcy within the automotive industry that would pose a systemic risk to the economy).

463. *Id.* at 39. *See also id.* at 3–4 (suggesting that Treasury at least at one point considered the preservation of American manufacturing and jobs as other critical social goals).

as a market participant and kept from using its leverage as a regulator to modify market incentives for innovation and growth. In order to create a set of norms, it is first useful to identify the characteristics of a successful market economy. Baumol, Litan, and Schramm's four characteristics of a successful entrepreneurial economy include: (1) market-based institutions and organizations that make it efficient for an entrepreneur to create, finance, and hire labor for the enterprise;[464] (2) strong property and contract rights;[465] (3) protections against coordinated market activities and rent-seeking behavior;[466] and (4) policies that support free trade, innovation and the prevention of monopolies.[467] Baumol, Litan, and Schramm's four characteristics help inform how the state should act when it becomes a market participant in order to foster an entrepreneurial LME. If the state destroys property or contractual rights when it enters the market, entrepreneurs will be less incentivized to create new businesses. As discussed above, the United States' intervention in the GM and Chrysler bankruptcies affected the contractual rights of bondholders. Such action is likely to raise the cost of capital for these businesses. Likewise, the government action of bailing out firms deemed too big to fail is a coordinated market activity which gives an edge to some firms by providing insurance at no cost.

Some commentators argue that the only set of norms which would encourage an entrepreneurial economy would be a complete ban on government investment except in the case of market failure. A more practical approach is adopted here given the emergence of government investment both domestically and internationally. With the characteristics of an entrepreneurial economy in mind and the assumption that government investment is inevitable, this Article now turns to analyze how the government, as an investor and market participant, should behave in order to preserve an entrepreneurial economy while still engaging in long-term investment as a means of economic development.

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

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

464. BAUMOL ET AL., *supra* note 117, at 7–8.
465. *Id.*
466. *Id.*
467. *Id.*

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

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

Principle # 4: Political Insulation. Investment and portfolio management decisions should be insulated from improper political influence without sacrificing accountability.

Principle # 5: Noncoercive Regulatory Action. The government must separate its regulatory function from its investment function and must not use its regulatory or lawmaking powers to target companies or employees for reasons related to the investment.

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

These six institutional constraints are designed to be complementary in that the presence or efficiency of one increases the returns from or efficiency of the others.[468] For example, political insulation helps lessen the possibility of coercive regulatory action, and following prudent investor standards will more likely maximize the return on any given investment. The application of a principle will differ depending on the type of investment made by the government. For example, the meaning of maximizing ROI will differ according to the type of investment. If an investment is made for financial reasons, the principle of maximizing ROI suggests that the government pursue a portfolio management strategy of wealth maximization; whereas maximizing ROI for a political investment will be measured according to the degree that the investment furthers the political agenda for which the investment was made.

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

1. *Principle # 1: Market-Driven*

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

Regardless of the type of investment (i.e., infrastructure, social, political,

468. *See* HALL & SOSKICE, *supra* note 20, at 17–21 (explaining the concept of "institutional complementarities" and its centrality to the study of comparative capitalism).

economic, or financial), each state investment should be market-driven in that it is constrained by market demand, which is broadly construed to include both real and potential market demand. Market demand is classically defined as the range of quantities demanded at various given prices. Thus, market-driven investments are those that are determined by market forces. To the extent that there is no market demand for the investment, the government would refrain from making the investment. Indeed, government investment typically occurs when the market fails to provide a desirable good, such as infrastructure. As to government purchase of financial instruments—equity, debt, or other assets—a constraint that the investment be market-driven will help prevent overpayment or investments in non-performing assets.

Additionally, each investment should only be made if there is a discernable and potential positive ROI. This will act as a constraint on government waste or political investments of the sort that are the result of cronyism. Administrative law, as it relates to informal adjudications, helps inform the standard by which the government will be judged when making investments. Whether a given investment might produce a potentially positive return would be measured by the low threshold of a reasonability standard, wherein the government could make an investment so long as the investment decision had a reasonable basis in fact and was supported by the record. Furthermore, no investment may be arbitrary or capricious.[469] These lower standards would not preclude including some riskier investments in the broader portfolio since a diversified portfolio often produces outsized returns. Thus, an investment in nanotechnology, an industry that may take over twenty years to see broader commercial application, would have a reasonable basis for a potential positive return so long as the investment was also supported by some documentation of its potential.

How would the market-driven standard operate given the different types of government investment? Principally, government investment is made when there is market failure; thus, any investment made for economic development reasons or to prevent systemic risk would be market-driven. The government also steps in to provide liquidity in a crisis or to provide funding for a project that is too big for the private sector to absorb. Thus, the TARP investments in banks and financial organizations are

469. *See, e.g.*, Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843–44 (1984) (limiting the court's review of an administrative rulemaking to the determination of the reasonableness of the agency's interpretation, and stating that agency interpretations should be "given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute"). These same principles could effectively be applied to review of government investment.

appropriately market-driven investments made for economic reasons. However, bailouts of industries that have a declining market or the high probability of a negative ROI would not be made. For example, the buggy whip industry faced extinction because the automobile replaced the horse and carriage. In that instance, the state would not invest in a declining industry because no future market exists for buggy whips.[470]

Financial investments—those investments made purely for the purpose of funding social programs—would occur only if welfare programs need funding and investment constitutes a Pareto improvement.[471] For example, Social Security faces a funding crisis given that incoming taxes are projected to be insufficient to pay anticipated benefit payments.[472] Investing the Social Security Trust Fund in a diversified portfolio of stocks, bonds, and other marketable assets could help decrease the funding deficit without raising taxes or cutting benefits since a diversified portfolio has been shown to outperform bond-only portfolio over the long term.[473]

Thus, a potentially positive ROI might indicate that an investment is market-driven. Social investments would be made only if it could be shown that the government somehow comes out ahead—that this is some positive ROI in that a social goal is advanced by the investment. For example, if it can be shown that government health care expenditures for the poor can be reduced by starting preventive care clinics, then the investment has a discernable positive ROI and the investment should be made. The investment, of course, needs to be monitored continuously to ensure that the ROI is optimized.[474] Examples of successful market-driven public organizations already exist. Take for example the public university systems in California and other states that encourage their professors to conduct patentable research which is then commercially exploited.[475] Some government expenditures are naturally "non-market resources that support the market."[476] Yet, these expenditures are distinct from government investments.

470. The buggy whip industry example is a classic economics illustration of supply and demand that should be familiar to any student of economics.

471. *See supra* note 121 and accompanying text.

472. BD. OF TRUSTEES, FED. OLD-AGE AND SURVIVORS INS. AND DISABILITY INS. TRUST FUNDS, 2010 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS 2–3, 38 (2010).

473. SIEGEL, *supra* note 94, at 26–28, 27 fig.2, 28 tbl.2–1.

474. See Principle # 3, Wealth Maximization *infra*.

475. CROUCH, *supra* note 29, at 140–41. Crouch goes on to state that the simple hypothesis of market-driven university research is more complex when one takes into account the public research that is conducted by these universities. *Id.*

476. *See id.* at 141 (identifying the public research base as an example).

2. *Principle # 2: Prudent Investor Standards*

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

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

State entrepreneurism distinguishes itself from state capitalism by not using coercive techniques, such as nationalization, in order to acquire assets. Purchases by the government should be on the open market and valued in the same way that a reasonable private investor would value the purchase. This does not mean that the government should overpay. In fact, to be consistent with Principle #3, Wealth Maximization, the United States should drive a hard bargain in private purchases. As discussed previously, the government severely undervalued the initial investments under the TARP/Capital Purchase Program.[477]

In drafting any future enabling legislation, lessons can be learned from the successful Canadian Pension Plan Investment Board Act.[478] The structure of this legislation illustrates how investments can be made to ensure that politics remain out of the decisionmaking process that the agency is required to apply. For example, the Canadian Pension Plan Investment Board Act requires that its fund be broadly diversified.[479]

3. *Principle # 3: Maximizing Return on Investment*

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

For any given investment type—infrastructure, social, political, economic or financial—the government should seek to maximize the ROI. The measure of an investment's ROI differs depending on the type of investment.

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477. *See supra* note 314 and accompanying text.

478. Canada Pension Plan Investment Board Act, S.C. 1997, c.40 (Can.), *available at* http://www.canlii.org/en/ca/laws/stat/sc-1997-c-40/latest/sc-1997-c-40.html.

479. *See* CAN. PENSION PLAN INV. BD., POLICY ON RESPONSIBLE INVESTING 1, 2 (2009), *available at* http://www.cppib.ca/files/PDF/Responsible_Investing_Policy_2009.pdf (listing additional principles of the Canada Pension Plan Investment Board Act, such as the overriding duty to maximize returns without undue risk of loss); Can. Pension Plan Inv. Bd. Act, S.C. 1997, c.40 (Can.), *available at* http://www.canlii.org/en/ca/laws/stat/sc-1997-c-40/latest/sc-1997-c-40.html.

For financial investments, the ROI is simply the degree to which the investment has increased monetarily. Thus, maximizing ROI for financial investments merely means wealth maximization. As a practical matter, one way to achieve wealth maximization would be to mandate a diversified portfolio of stocks, bonds, and other assets to help reduce the risk of a downturn and ensure that political influence does not skew holdings to one region or section. In addition, financial investments might be held for much longer periods of time than is currently the norm for government ownership of equity provided that the longer holding period maximizes the ROI—the wealth of the investment.

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

4. *Principle # 4: Political Insulation*

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

In order to depoliticize the investment decision, government investments should be managed through a centralized state investment authority that exists outside of the federal agency structure.[480] As already discussed, the inherent conflicts of interest between the regulatory function and the investment function require a separation between the executive arm of the state and the legislative arm.[481] While a federal sovereign wealth fund should remain independent of political influence, it must also be held accountable. Within the current federal organization structure, there already exists a form of entity—the FGC—that has often been used to create political insulation and give government access to business methods and tools not normally accorded to agencies.[482] Congress has created FGCs to help manage the nation's finances since the eighteenth century,[483]

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480. Such an entity will, in effect, join other foreign sovereign wealth funds as a new class of financial intermediary.

481. *See, e.g.*, Hong Li, *China Investment Corporation: A Perspective on Accountability*, 43 INT'L LAW. 1495 (2009) (evaluating the development of investment policy for the China Investment Corporation and finding it to be plagued by a lack of legal accountability and an opaque internal structure with no "firewall" between the state and the market).

482. *See* Froomkin, *supra* note 7, at 557–59 (elaborating on four strategic reasons to create an FGC: efficiency, political insulation, subsidy, and subterfuge).

483. *See, e.g.*, Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 386–87 (1995) (detailing Congress's authorization for the government to be a 20% owner of the Bank of the United States in 1791); McCulloch v. Maryland, 17 U.S. (4. Wheat.) 316, 411 (1819)

and many government agencies that deal with financial matters are normally structured as FGCs. Adopting the FGC model as the organizational structure would separate the sovereign wealth fund from political influence and give professional investment advisors the latitude they need to make investment decisions that maximize wealth.

Other countries have effectively used such a structure. In 1997, Canada created a federal Crown Corporation that was charged with creating wealth to fund the country's social insurance programs. While some politicians have tried to exert influence, the Canadian government corporation has remained politically neutral.[484]

FGCs are controversial. Scholars have raised questions about the legitimacy, accountability, and transparency of American FGCs. From a constitutional point of view, it is uncertain under the state action doctrine whether an FGC would be considered a federal agency which would require it to comport with U.S. constitutional requirements and federal law governing agencies.[485] Other constitutional questions that are raised include the impact of the nondelegation doctrine and the Appointments Clause.[486]

FGCs came under close scrutiny in the debate over the privatization of government functions. Much has been written about government outsourcing of traditional government functions, such as the operation of prisons, schools, and the delivery of welfare benefits.[487] In the debate over the public–private divide, scholars have focused their attention primarily on the privatization of public functions and the constitutional implications of

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(finding the power to create a corporation to be a means by which other sovereign ends are accomplished). The *McCulloch* Court was, perhaps, impressed with an attorney's argument that a bank would likely assist in the sovereign ends of collecting and disbursing taxes and regulation of the currency. *See id.* at 325.

484. *See* Benjamin A. Templin, *The Public Trust in Private Hands: Social Security and the Politics of Government Investment*, 96 KY. L.J. 369, 400–01 (2008) (discussing how the Canada Pension Plan Investment Board weeds out political influence by appointment procedures providing that the day-to-day fund managers are "at least one step removed" from the political process).

485. *See* Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1031–60 (2005) (deliberating addressing whether the Public Company Accounting Oversight Board (PCAOB) is part of the federal government for constitutional purposes and discussing the factors that go into the deliberation and the consequences that follow, such as requiring PCAOB to give its employees constitutional rights and liberties).

486. *Id.* at 1043–44.

487. *See* Gillian E. Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367, 1370 (2003) (finding that giving private entities powers as "stand-ins" for the government to be particularly constitutionally troubling).

having a private entity deliver public services, such as private prisons.[488] This has led to a wide body of scholarship which speculates that the public–private distinction is archaic and that some entities should be deemed quasi-public. The public–private entity distinction creates the opportunity to discuss not only private actors that take on a public role as quasi-public institutions but also public actors which play a role in the private markets—quasi-private institutions. The characterization of a U.S. sovereign wealth fund as an FGC which follows the principles of state entrepreneurism suggests an entity that conceptually has the power, tools, and autonomy of a private hedge fund yet is still held accountable as a public entity to its sole shareholder: the U.S. government. Needless to say, such an entity must be made accountable and controllable so that rogue managers do not engage in waste, rent-seeking behavior, or pursuing a political agenda.

As to the constitutional question of whether a federal investment authority structured as an FGC is a state actor, Congress can avoid costly court battles by just conceding in the enabling legislation that a federal sovereign wealth fund is a federal agency for constitutional purposes. Scholars concerned over FGCs and the state action doctrine are primarily focusing on the transfer of the state's powers to investigate, regulate, and create rules with regard to a private actor. A federal investment authority will not be charged with any of those functions. Indeed, the whole point is to separate those functions away from the investment authority so that investment and management decisions are not coercive. It is possible that political influence may affect a federal investment authority through the appointment process for directors;[489] however, the enabling legislation could mandate that there be minimum requirements so that only qualified financial professionals would be appointed.[490]

Constitutional provisions provide the greatest protection against meddling by politicians.[491] A constitutional amendment seems extreme,

488. *See* Chris Sagers, *The Myth of 'Privatization*,' 59 ADMIN. L. REV. 37, 43 nn.14–17 (2007) (listing law reviews, books, and symposia since 2006 that deal with the issue of privatization).

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

490. For a discussion of some standards that might apply, see Templin, *supra* note 484, at 403–04 (citing certification as a "Chartered Financial Analyst," academic credentials, professional credentials, work experience, and references as factors that should be considered when determining qualifications).

491. *See id.* at 442–43 for a discussion of constitutional protection of the Social Security Trust Fund and the inevitable desire of politicians to "tap" the fund for pet projects, leading to the ultimate conclusion that the only "sure protection" will be through the courts and the

but is not unprecedented on the state level. Both California[492] and Oklahoma[493] provide protection to their state employee pension funds against political meddling by mandating that the fiduciary duty of fund managers is to the fund's beneficiaries. Of course, many amendments are proposed but few pass. Defining the purpose of the sovereign wealth fund as a funding mechanism for entitlement programs, such as Social Security and Medicare, would help create political will within the electorate to maintain the fund's driving principle of wealth creation in order to provide for a retirement income.

A federal investment authority that is structurally separate from agencies must, of course, be held accountable. FGCs are subject to the same agency problems that plague corporate governance for private companies. Within private corporations, accountability for the actions of managers is achieved through board of directors' oversight,[494] shareholder voting rights,[495] derivative lawsuits,[496] market takeovers,[497] and government regulation.[498] For an FGC, many of these tools, such as market takeovers, are not relevant. If the goal is to insulate the fund politically, then giving the Executive or Congress the same rights as a board of directors or shareholders would not achieve that goal. Instead, the political process must be used to choose an independent board with strict fiduciary duties and obligations that could be enforced through the courts if necessary.

5. *Principle # 5: Noncoercive Regulatory Action*

The government must separate its regulatory function from its investment function and must not use its regulatory or lawmaking powers

Constitution. For an alternative view as to the viability of constitutional protections, see Romano, *supra* note 228, at 843–44 (1993) (admitting constitutional protection of board independence has "obvious popular appeal" but concluding that it only "prevents the more flagrant forms of legislative interference in fund affairs").

492. *See* CAL. CONST. art. XVI, § 17.

493. *See* OKLA. CONST. art. XXIII, § 12.

494. *See* Froomkin, *supra* note 7, at 587–88 (concluding that though the directors of an "ordinary corporation" have the same duties as the privately elected directors of an FGC, the former are much more responsible for "traditional duties of diligence and loyalty to the corporation and its shareholders").

495. *See id.* at 585–86 (identifying two types of discipline from shareholders: a potential vote to replace the management and an option to sell shares to advance a takeover).

496. *See id.* at 590–91 (noting that "traditional corporate claims," like waste, do not clearly apply to federally chartered corporations).

497. *See id.* at 577 (contrasting the incentives of FGCs with those of private corporations, which must be efficient to work within the "market discipline").

498. *See id.* at 627 (calling regulation a "blunt and familiar tool" and suggesting that administrative sanctions could be used to "back up" the rules).

to target companies or employees for reasons related to the investment.

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

6. *Principle # 6: Accountability and Transparency*

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

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

Built within the EESA are several mechanisms meant to establish transparency and accountability for TARP. While many governmental and nongovernmental groups monitor the program, watchdogs have been critical about Treasury's investment criteria and management of assets, calling for even greater transparency and accountability.[499] Monitoring the TARP investments became the function of five different groups, including: (1) Financial Stability Oversight Board,[500] a group consisting of executive branch officers; (2) U.S. Office of the Special Inspector General for the

499. CONG. OVERSIGHT PANEL, *supra* note 11, at 103 (explaining that without a "consistent and cohesive message" regarding the rationale behind TARP, it is difficult to determine "which metrics are the best indicators of Treasury's performance"); CONG. OVERSIGHT PANEL, *supra* note 187, at 9 (declaring that the "rescue" of AIG distorted the marketplace and encouraged risky behavior).

500. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, Div. A, § 104, 122 Stat. 3765, 3770–71.

Troubled Asset Relief Program;[501] (3) the Congressional Oversight Panel;[502] (4) the Congressional Budget Office;[503] and (5) the Government Accountability Office.[504]

Additionally, the courts would serve as a possible means for oversight of government investment. Given that investments were made by Treasury, the judicial deference[505] given to agencies may result in a lack of rigorous judicial review. In some circumstances, judicial deference is justified because courts often lack the expertise that particular agencies have to decide whether an action is in the public interest.[506] The Federal Reserve, for example, is given great deference in making loans at favorable rates to stressed banks unless the action is deemed to be arbitrary or capricious.[507] Thus, the Federal Reserve justified the guarantees made in the Bear Stearns sale to J.P. Morgan by pointing to the agency's determination that to let Bear Stearns proceed to bankruptcy would pose a systemic risk to the entire banking system.[508]

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

CONCLUSION

This Article sought to normatively assess the performance of the government as a shareholding entity and to create a prescriptive model by which government could coexist in a market economy as an investor while still fostering entrepreneurship. New institutionalism and the evolving theories of institutional change help inform how new rules of the game may develop to shape the government shareholder into a market actor that complements a liberal market economy. Adapting government investment

501. *Id.* § 121, 122 Stat. at 3788–90.

502. *Id.* § 125, 122 Stat. at 3791–93.

503. *Id.* § 202, 122 Stat. at 3800–01.

504. *Id.* § 116, 122 Stat. at 3783–86.

505. *See generally* Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842 (1984) (detailing the great deference shown to an agency's interpretation of a statutory scheme it is charged to administer).

506. *See id.* at 864–65 (positing that delegation of authority to an agency could manifest that Congress "consciously desired" the experts to make the decisions and admitting that "[j]udges are not experts in the field").

507. *See* Davidoff & Zaring, *supra* note 1, at 478 (emphasizing that "[w]hile no court has held that [such] decisions are unreviewable as a matter of law," they still shy from substantively reviewing monetary policy).

508. *Id.* at 478–79 (describing Chairman Bernanke's testimony that the fall of Bear Stearns would lead to catastrophic "domino losses").

to free market capitalism advances a number of useful policy goals including fostering innovation and economic development, and creating a funding mechanism for social programs. The emergence of foreign sovereign wealth funds suggests an evolution of the role of government as an active participant in markets and serves as a model by which the United States might form an independent investment authority to manage its investments.

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