The Bailout Through a Public Choice Lens: Government-Controlled Corporations as a Mechanism for Rent Transfer

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The purse & the sword ought never to get into the same hands whether Legislative or Executive. — George Mason[1]

I. INTRODUCTION

Through the Troubled Assets Relief Program (TARP) bailout, the government took a controlling interest in a number of companies that remain publicly traded. There is significant prior debate over the consequences of government control of private-sector resources, but the present dynamic of government ownership through voting equity in publicly traded equity is fairly novel in the modern U.S. economy. This Article considers how the government is likely to put political pressure on firms taking bailout support through its equity voting power to cater to politically influential interest groups.

This Article first explores a number of instances of government pressure at bailed-out firms that have worked in favor of politically influential interest groups. It then explains the process by which this occurs through a novel contribution to public choice theory. This contribution treats rent-seeking as a two-step process by which government-controlled firms use their politically conferred rents to subsidize transfers to interest groups. The Article also examines the incentives facing bureaucrats in overseeing the government's investment.

This Article then considers the constraints of administrative law and reveals how in this context they offer little remedy against the public choice conflicts of government-controlled firms. In part this is

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[1] JAMES MADISON, NOTES OF DEBATES IN THE FEDERAL CONVENTION OF 1787 81 (Ohio Univ. Press 1984) (1840).

due to the exceptions to administrative law constraints found in the bailout legislation, but in larger part it is due to the fact that the government's power is often implicit in this context.

This Article closes with an examination of the TARP Recipient Ownership Trust Act, which would house the government's investment in a number of trusts governed by independent trustees, which among other provisions is designed to serve as a buffer between political pressure and private industry.[2] This Article also offers criticism of a counter-proposal from Professor Emma Coleman Jordan, issued through the Center for American Progress, that requires nomination of "public directors" to the Boards of bailout recipients who are accountable directly to the government.[3]

The result is a thorough understanding of how public choice theory offers some predictions for how the government will use its controlling investment in bailout recipients and an understanding of whether, and to what extent, properly designed trusts can limit some of these costs.

II. INTRODUCTION TO GOVERNMENT-CONTROLLED CORPORATIONS: THE TARP BAILOUT

The primary objective of this Article is to shed light on how the government can be expected to act in the management of its controlling equity holding in the large private firms in which it has a controlling equity interest. The firms covered by this analysis include American International Group, Inc. (AIG), Citigroup, General Motors (GM), Chrysler, Fannie Mae, Freddie Mac, and dozens of other large banks and financial companies. To lay a foundation for the discussion, some history of the bailout of 2008 that precipitated (or in the case of Fannie Mae and Freddie Mac, more deeply entrenched) the government's controlling ownership is appropriate.

Under the bailout authorization and other policy responses to the financial crisis of 2008, the federal government took a number of unprecedented steps that have enhanced the government's control over private sectors of the U.S. economy.[4] In addition to its controlling equity stake, the government's power to regulate compensation for TARP recipients also enhanced its control. For example, in response to pay restrictions initiated by the government's "pay czar,"

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[2] S. 1723, 111th Cong. (2009); H.R. 3594, 111th Cong. (2009).

[3] *See infra* Part V.A.

[4] For more analysis of the government's status as a controlling shareholder in these firms, see J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283, 299–307 (2010).

Robert Benmosche indicated his intent to resign as chief executive officer (CEO) of AIG.[5] The government's powers as a regulator also more generally enhanced its control over TARP firms.

Control certainly does not require that the government own a majority of shares in companies; indeed courts that have looked into the question for the purposes of determining whether a government-owned company is under government control and therefore, a state actor for purposes of constitutional restrictions, have examined the actual exercise of control by the government.[6] Controlling equity ownership by the federal government also gives a company immunity from the market for corporate control, since various agencies within the government can threaten the viability of a merger proposal.[7] Thus for those bailout recipients in which the government is a sub-majority shareholder its control is cemented more deeply.

Through the TARP, which was one element of the bailout, the government ultimately invested roughly $245 billion in banks through stock purchases, roughly $70 billion of which remains outstanding.[8] The government also spent roughly $49.5 billion under the TARP bailing out GM, $14.9 billion doing the same for Chrysler, $13.4 billion on GMAC (the financing arm of GM), and $1.5 billion on Chrysler Financial.[9] The government obtained control over decisions at those firms through the bailout both through taking direct voting equity, as at GM,[10] as well as indirectly through replacing board members, as at Chrysler.[11] The government also took a controlling equity position in AIG in exchange for its $185 billion bailout of that company.[12] GMAC and AIG in particular appear to remain unable to raise private capital and will need the government's support for the

[5] Liam Pleven et al., *AIG's Benmosche Threatens to Jump Ship*, WALL ST. J., Nov. 11, 2009, at C1.

[6] Michael A. Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543, 572–73 (1995).

[7] *Id.* at 585.

[8] Bob Davis et al., *After the Bailouts, Washington's the Boss*, WALL ST. J., Dec. 28, 2009, at A1.

[9] OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 46 (Oct. 21, 2009).

[10] Press Release, U.S. Dep't of the Treasury, Fact Sheet: Obama Administration Auto Restructuring Initiative, General Motors Restructuring (June 1, 2009), *available at* http://www.financialstability.gov/latest/05312009_gm-factsheet.html.

[11] Press Release, U.S. Dep't of the Treasury, Treasury Department Statement on Chrysler's Board of Directors Appointments (July 5, 2009), *available at* http://www.financialstability.gov/latest/tg197.html.

[12] Matthew Karnitschnig et al., *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 16, 2008, at A1.

foreseeable future.[13] Finally, the government spent or offered guarantees of an initial $200 billion to take Fannie Mae and Freddie Mac under federal conservatorship, two firms that are likely to also need continued government support for the foreseeable future.[14]

A. Specific Instances of Political Influence over Bailed-Out Firms

This Article will examine the government as a controlling shareholder in TARP firms through the lens of public choice theory. Before that step, however, it may be helpful to survey some particular instances that evidence the public choice dynamic for government-controlled firms described in this Article.

A number of developments throughout the course of the bailout have highlighted the concerns about government ownership of business ventures. The government's holdings at the automotive companies offer the most controversial examples. The membership of the President's Auto Task Force consists of a number of cabinet secretaries and political appointees, including the administrator of the Environmental Protection Agency and the Secretary of Energy.[15] After GM's contract with a Montana palladium mine was nullified in bankruptcy court and GM found a cheaper source overseas, Montana's congressional delegation pressured GM to reinstate the contract at significant cost to the firm.[16] Through a similar process, dealerships that closed under the GM bankruptcy were able to use congressional influence to pressure GM to reinstate the dealerships.[17]

This Article will offer in part an argument that the government gives preferential regulatory treatment to the entities it controls. For example, around the time that 600 of the nation's banks—including most of the nation's largest banks—received TARP funding in exchange for preferred stock, members of Congress pressured the accounting industry to relax mark-to-market accounting rules for the banking industry.[18] In an even starker example, the regulator for Fannie Mae and Freddie Mac has been explicitly instructed to make

[13] Davis et al., *supra* note 8, at A1.

[14] OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, *supra* note 9, at 137.

[15] *See* Neil King, Jr. & John D. Stoll, *Auto Task Force Set to Back More Loans—With Strings*, WALL ST. J., Mar. 26, 2009, at A1.

[16] Neil King, Jr., *Politicians Butt in at Bailed-Out GM*, WALL ST. J., Oct. 30, 2009, at A12.

[17] *Id.*

[18] Susan Pulliam & Tom McGinty, *Congress Helped Banks Defang Key Rule*, WALL ST. J., June 3, 2009, at A1.

the firms' effort to cut monthly mortgage payments for American households its first priority,[19] even at the risk of jeopardizing its own stakes in the firms' capital structures to keep it financially viable.

As an example of the distortionary effects of government guarantees on the private market, the Department of Energy's generous $40 billion loan to businesses working on alternative energy technology has caused much of the venture capital industry to focus on those firms able to obtain funding through negotiations with the government rather than on firms able to germinate profitable ideas.[20] Government funding is typically obtained by firms agreeing to build production plants in congressional districts of influential legislators.[21] Large firms also play a similar game, as General Electric has offered its support to the Obama administration's stimulus programs in exchange for a large share of stimulus project contracts.[22]

The government's interaction with bailed-out firms with whom the government develops fractious relationships is also informative for this Article's thesis. Bank of America's ("BOA") former CEO, Ken Lewis, announced his resignation on September 30, 2009, citing the difficulties of government supervision and government interference into the bank's management policies as a central reason for his resignation.[23] After Lewis initially agreed to acquire Merrill Lynch, he considered backing out of the deal by exercising his contractual rights under the Material Adverse Change ("MAC") clause in the deal.[24] Federal Reserve and Treasury officials pushed Lewis not to exercise the MAC clause, but instead to proceed with the acquisition with the assistance of additional TARP loans out of concern that by backing out, BOA would cause investor panic and financial instability.[25] Secretary Paulson threatened to fire Lewis if he did not comply.[26] One e-mail communication between Federal Reserve officials indicated their desire to get a "pound of flesh" from Lewis.[27]

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[19] Davis et al., *supra* note 8, at A1.

[20] Neil King Jr., *Venture Capitol: New VC Force*, WALL ST. J., Dec. 15, 2009, at A18.

[21] *Id.*

[22] Elizabeth Williamson & Paul Glader, *General Electric Pursues Pot of Government Stimulus Gold*, WALL ST. J., Nov. 17, 2009, at A18.

[23] Carrick Mollenkamp & Dan Fitzpatrick, *With Fed, BofA's Lewis Met His Match*, WALL ST. J., Nov. 9, 2009, at A1.

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.*

Lewis argued that he was unsuitable for the job of running a bank under government ownership, as it required him to "kowtow to politicians and regulators."[28] Federal Reserve officials later filed a confidential memorandum of understanding against BOA registering concerns about governance and risk management, which BOA directors claimed were a direct result of BOA's forced acquisition of Merrill Lynch.[29] In April 2009, six directors of BOA were replaced and three more directors stepped down under the direction of Federal Reserve officials.[30] Lewis indicated a strong desire to repay TARP funds as quickly as possible.[31] BOA's attempt in the summer of 2009 to repay part of its TARP funds was rebuffed by the government.[32]

One of the central reasons Lewis was ultimately asked to leave BOA was his unwillingness to cooperate with the Obama administration to achieve its political goals.[33] His replacement, Brian Moynihan, was chosen because of his assurances to the Obama administration that he would work with the White House to achieve their goals of increasing small business lending and preventing foreclosures.[34] The Securities and Exchange Commission (SEC) brought an action against BOA alleging that BOA failed to disclose to its shareholders the extent to which Merrill Lynch employees were required to receive bonuses, resulting in a false disclosure to shareholders of the value of the Merrill Lynch acquisition.[35] The SEC subsequently attempted to settle the case for a $33 million fine, but the judge in the case rejected the settlement as too lenient.[36]

AIG, on the other hand, was much more willing to cooperate with the federal government, resulting in a far less tenuous relationship. AIG's competitors have alleged that it is able to undercut competitors' prices because of its continued backing from the federal government.[37] AIG's former CEO, Ed Liddy, indicated that "[e]verything we do, we do in partnership with the Federal Reserve."[38]

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[28] *Id.*

[29] Mollenkamp & Fitzpatrick, *supra* note 23, at A1.

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *See id.*

[34] Davis et al., *supra* note 8, at A1.

[35] Mollenkamp & Fitzpatrick, *supra* note 23, at A1.

[36] Zachery Kouwe, *Judge Rejects Settlement over Merrill Bonuses*, N.Y. TIMES, Sept. 14, 2009, at A1.

[37] Liam Pleven & Sudeep Reddy, *AIG's Rivals Blame Bailout for Tilting Insurance Game*, WALL ST. J., Mar. 23, 2009, at A1.

[38] *Id.*

In sales presentations, AIG boasted that its government backing lowers its cost of capital.[39]

When Fannie Mae proposed to sell $3 billion in tax credits to Goldman Sachs and Berkshire Hathaway—credits that were valueless to Fannie Mae without operating profit against which to obtain the credit and that also directly harmed Fannie Mae's balance sheet by requiring write-downs in value every quarter that Fannie Mae was not able to use them—the Treasury blocked the sale on the grounds that it would result in a net loss in tax revenue for the government.[40]

A final example reveals how the government can use its leverage over a firm to acquire regulatory turf over competing independent government regulatory agencies. When GMAC's banking subsidiary, Ally Bank, decided to implement a strategy of offering higher rates to bank deposits, the Federal Deposit Insurance Corporation (FDIC) responded with an order that Ally Bank lower its rates on bank deposits and focus its auto lending to lower-end car buyers.[41] The FDIC's public explanation for this pressure was that deposits acquired through competitive rates, particularly online, that are not based on bank loyalty are more prone to bank runs in times of panic.[42] GMAC also faced pushback from the Federal Reserve to increase its capital reserves by accepting more loans from the Treasury.[43] After being granted a charter as a bank-holding company, GMAC became subject to Federal Reserve regulation, but since its Ally Bank subsidiary is a state-chartered bank, it is subject to oversight by the FDIC.[44] GMAC originally received $5 billion in TARP injections.[45] The FDIC initially opposed a plan to inject additional capital into GMAC, but a deal was later negotiated by the Treasury in which GMAC would drop its plan to seek transfer of its charter to the Federal Reserve in exchange for the FDIC dropping its opposition to additional injections of capital into GMAC.[46] Subsequently, the FDIC agreed to guarantee an additional $7.4 billion in GMAC debt, the Treasury injected an additional $7.5 billion in capital, and the Federal Reserve waived a rule prohibit-

[39] *Id.*

[40] Nick Timiraos, *Treasury Blocks the Sale of Tax Credits by Fannie*, WALL ST. J., Nov. 7, 2009, at B1.

[41] Dan Fitzpatrick & Damian Paletta, *U.S. Turns Screws on Bailed-Out GMAC*, WALL ST. J., Nov. 2, 2009, at A1.

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] *Id.*

ing transfers of capital between bank-holding companies and their subsidiaries in order to permit GMAC to transfer capital to Ally Bank.[47] In the end the regulatory turf battle was settled but only after Ally Bank agreed to the demands of all three regulators.[48]

These situations provide clear examples of public choice dynamics operating in the context of government-owned or government-controlled firms. The next step in this Article is to consider how public choice theory can offer a more sophisticated explanation for the simple observations from these sources. In doing so, the final step will consider whether there is any viable method to limit the tensions of public choice conflicts on government-owned or government-controlled firms.

III. PUBLIC CHOICE LITERATURE MEETS THE GOVERNMENT-CONTROLLED CORPORATION

In order to understand how the government will make decisions in the stewardship of its controlling equity interest in private companies, it is necessary to appreciate that government actors face incentives just as private-market participants. These incentives have been explored in depth in the literature of public choice theory. This literature will be the primary lens for this Article's analysis of government as the controlling equity owner in companies. One of the key insights public choice theory offers to the political science discipline is to break up the monolithic notion of government into a variety of institutional players who respond to differing incentives and utilize different forms of government power. Public choice theory also offers a wide range of insights into how groups supporting political candidates, companies supporting or attacking new regulations for various reasons, and bureaucrats seeking to enhance their own careers all contribute to a full understanding of the institutions at work in this context.

A. *Rent Seeking, Rent Dissipation, Rent Extraction, Rent Sharing, and a New Concept of Rent Transfers Considered*

The government itself has frequently expressed an outward desire to minimize the influence of government pressure over bailout recipients[49] despite the fact that its actions reveal an inability to stop

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[47] Fitzpatrick & Paletta, *supra* note 41, at A1.

[48] *Id.*

[49] *See, e.g.*, Verret, *Treasury Inc.*, *supra* note 4, at 295 ("The Treasury published a white paper regarding its ownership in GM in which it offered four key principles for how it would try to minimize political influence in GM's operations . . .").

the pressures of public choice conflicts. In part, this view is informed by an abiding sentiment that the U.S. system of capitalism would be threatened by the presence of government power in the economy. There is significant literature on the effect of government-controlled firms that supports this view.[50] Indeed, the most useful source of support for the public choice challenges faced by government-controlled companies is through the direct study of their efficiency. Maxwell Stearns and Todd Zwyicki cite to a review of seventy-one academic studies of government-controlled firms, which shows that in fifty-six of those studies, state-owned firms consistently operated less efficiently than their private counterparts.[51] Professor Roberta Romano has also examined the costs of political participation in investment decisions.[52] The bailout, and the government's controlling ownership, is nevertheless a fact of life that must be addressed. As such, it is important to understand not only that government ownership distorts market outcomes, but also a fuller explanation of how that occurs. This Article attempts to provide that understanding.

In public choice literature, economic rents are typically defined as returns to owners of an asset above their opportunity cost.[53] Stearns and Zywicki explain that government-conferred rents are typically created through the erection of barriers to entry such that the entry of new competitors, which would otherwise result in the erosion of rents through competition, is stifled.[54] For example, regulations that make it difficult for new competitors to enter a business will work to the advantage of existing firms in the industry.[55] Deadweight losses are the initial cost of rent seeking, as outputs are constrained by the resulting changes in incentives for producers.[56] Gordon Tullock also notes that there is an additional cost to politically conferred rents be-

[50] For a thorough discussion of the literature in this area, see J.W. Verret, *Separation of Bank and State: The Bailout Meets Federal Budget Law*, 2011 BYU L. REV. (forthcoming 2011).

[51] *See* MAXELL L. STEARNS & TODD J. ZYWICKI, PUBLIC CHOICE CONCEPTS AND APPLICATIONS IN LAW 349 (2009) (citing DENNIS C. MUELLER, PUBLIC CHOICE III 373 (2003)).

[52] *See generally* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

[53] STEARNS & ZYWICKI , *supra* note 51, at 49.

[54] *Id.*

[55] *See id.*

[56] *See id.*

cause industry will expend resources to obtain rents, which he describes as "rent dissipation."[57]

In considering the interest groups most likely to engage in rent seeking by encouraging the development of regulation, one of the foundational principles is that interest groups will be more or less effective in their pursuits depending on whether they suffer from collective action constraints or whether the costs of staying informed exceed the potential benefits.[58] Smaller, more organized groups thus obtain an advantage over larger, less compact ones.[59] In this case, the retail shareholders in government-controlled firms are the least powerful under interest-group theory because they actually have strong and rational incentives to diversify their investment. This keeps the group as a whole larger and less organized than the other interest groups with which the firm interacts. In the exceptional case of institutional shareholders, like union or state pension funds, the shareholder's stake in a particular firm may be large enough that they could become a powerful interest group. And yet, the presence of conflicted objectives for many of those shareholders could still work against diversified retail shareholders. For example, union pension funds may also share the goals of employee interest groups interacting with the government-controlled firm and may thereby actually be able to coordinate with one another to facilitate rent-seeking behavior between the pension fund and the represented employees.

In some ways the traditional public choice analysis of rent seeking is complicated in the context of a previously private corporation that becomes subject to control by a government shareholder. The literature has considered private firms seeking rents or economic benefits conferred not through additional marginal value of inputs but instead by enhancing their competitive position through regulation. Firms and interest groups would induce government regulators and legislators to pass regulations that allow firms to capture rents by sharing the value of those rents through lobbying expenses, employing regulators subsequent to their public employment, or other means. In the context of government-controlled firms, both the initial stage of rent-seeking behavior and the second stage in which government uses its leverage to extract rents should be considered. But

[57] *See* Gordon Tullock, *Efficient Rent Seeking*, *in* TOWARD A THEORY OF THE RENT-SEEKING SOCIETY 97, 97–112 (James Buchanan et al., eds., 1980) [hereinafter Tullock, *Efficient Rent Seeking*]; Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224, 226, 232 (1967).

[58] STEARNS & ZYWICKI, *supra* note 51, at 56.

[59] *See id.* at 57.

this Article will argue that in the context of government-controlled firms, the method the government uses for rent extraction is fairly unique, as the government uses the firm as a mechanism to transfer rents to interest groups.[60]

Fred McChesney presented a new spin on the rent-seeking dynamic when he argued that in addition to actual rent creation, government actors may have incentives to extract rents once they are created through threats to roll-back regulatory bargains.[61] He develops a model in which elected officials can obtain returns by threatening to extract returns that are part of previous rent-seeking deals and then seeking forbearance from the regulation in a way that would eviscerate those rents.[62]

In the context of government-controlled firms, the politician could extract rents by withdrawing some of the forbearance that firms receive and which benefit managers.[63] Or, more simply, and more powerfully, the politician can threaten to use the government's equity power to replace the board members and directors if the firm does not comply.[64] With respect to withdrawing regulatory benefits, the politician would have an interest in not losing those rents that are passed through to interest groups, yet in a situation like TARP where the number of government-owned firms is significant, the political actor might make an example out of one firm in order to increase his rent-extraction ability at all the others.[65]

McChesney also observes that politicians using rent-extraction methods to obtain private rents, rather than politically-conferred rents will not be limited by the value of their political bargain but instead by the value of the private rents created by the firm itself.[66] In this context, that observation may mean that governments will actually have a greater interest in maintaining their ownership of profitable firms than those that are struggling, although they may also have to keep the latter for lack of an alternative buyer.

Another method the government could use to extract rents from government-owned banks, even if the intent is merely to hold the government's investment for a short time, would be to threaten to in-

[60] *See infra* text accompanying notes 65–68.

[61] Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101, 102 (1987).

[62] *Id.* at 102.

[63] *See id.* at 103–05.

[64] *See id.*

[65] *See id.* at 109.

[66] *Id.* at 107.

crease the minimum requirements needed for the bank to repay its government loan and exit the government's ownership. Regulators have a great deal of discretion to alter capital adequacy ratios, and can change these requirements by informal consultation rather than formal rulemaking, so such threats may not be readily made public.[67]

The rent seeking then becomes part of a two-step process through the government corporation as an intermediary for rent seeking by interest groups and firms that interact with the government-controlled corporation. The government-controlled firms capture rents in the traditional way, through regulatory forbearance or through lobbying to get regulations passed that enhance their competitive position, but then they use those rents to subsidize a transfer of wealth to the interest groups with whom they do business.[68] They also obtain rents in a non-traditional way, through the benefits of an implied or express debt guarantee. In effect, rather than investing directly in rent seeking by paying legislators and regulators, they pass the benefits of rent seeking directly to interest groups. This pass-through of rents works to the benefit of political actors because the interest groups that receive the transfers from the government-controlled corporation are the same groups who provide support to the legislators. The government-controlled firm then becomes effectively a rent-transfer agent. As the rents are passed through the government-controlled firm, they can take a variety of forms. To consumers it can involve a price subsidy, to employees it can take the form of a wage subsidy. As the government's accounting rules do not require it to consolidate the liabilities of those firms or to recognize the cost of implicit guarantees on the government's books, there is little cost to the politician, particularly in the short-term.[69]

McChesney argues that politicians can extract not only politically-conferred rents, which go beyond being mere transfers and can actually inhibit incentives to innovate, but also privately developed rents that incentivize private innovation and development.[70] In this context, that second-order problem would depend on whether the subsidies provided to interest groups by the government-controlled firm were funded more by the political rents obtained by the firm or by the private rents held by the firm.[71] If the issue was solely one of extraction of private rents, rather than political rents, then there might

[67] *See infra* notes 81–84 and accompanying text.
[68] *Id.*
[69] *See* Verret, *Separation of Bank and State*, *supra* note 50.
[70] McChesney, *supra* note 61, at 103.
[71] *See id.*

be some benefit to forcing the government-controlled company to transfer those rents, if it was assumed that such a dynamic would quickly lead to insolvency. It would limit the incentives of companies to accept and rely on government bailout, and thus limit some of the moral-hazard concerns present in bailout dynamics. Since it would be impossible to assure the politically conferred rents were not also accruing to the firm, particularly since the government's guarantee is often implicit, it would still, however, present the concern of off-budget transfers through guaranty spending as well as distortions of the private securities markets, particularly if the government-controlled firm is able to remain, or appear to remain, solvent for a long period of time, as was the case with Fannie Mae and Freddie Mac. Further, in practice, private and political rents are not likely to be segregated or easily identified but are instead pooled together within the assets of the government-controlled firm.

Since government-controlled firms obtain regulatory benefits as part of their rents, and some of those regulations are designed to limit principal-agency conflicts of executives, one might expect executives to obtain private rents as part of the bargain. Additionally, one might expect competition for rents to occur since rents are transferred through government-controlled entities and the mangers of entities serving in this capacity obtain some private benefit—for example, the regulatory preferences that attend government ownership also could hide their own tunneling of firm assets through executive compensation or other means.[72] Three distinct layers of Tullock's rent dissipation could develop, if not more.[73] The government-owned firms might compete for more rents, and the executive's will compete for their share of rents, then interest groups will compete for their share of the transfer of rents passed through the firm.

If the benefit obtained by government-owned firms that is then directed to interest groups is merely funded by the government's guarantee, then the dynamic resembles deficit spending. If, however, the benefits transferred are funded by political rents given to the government-controlled firm through regulation or regulatory forbearance, then classical analysis of rent seeking applies. McChesney's model of rent extraction also offers a unique explanation if the benefits transferred come from private or political rents held by the government-controlled firms. The particular mix of rents and subsidies supporting transfers through the government-controlled entity will

[72] *See* Tullock, *Efficient Rent Seeking*, *supra* note 57, 97–112.

[73] For an explanation of the process of rent dissipation, see STEARNS & ZYWICKI, *supra* note 51, at 59.

depend on the nature of the firm and the particular attributes of its competitive position within its industry.

McChesney notes that the method of obtaining rents from government actors can include bribes but can just as easily be obtained through contributions of in-kind service or property.[74] One method for government officials to obtain benefits from rent seekers is simply campaign contributions.[75] The method of indirect benefits through directed transfers, occurring off-budget to interest groups who support the politician, is actually less costly to the political actor since he would not have to report the contribution and is unlimited on the contributions he is able to obtain.

Rent dissipation for government-controlled firms could come in the form of firms bidding up the price discount they are willing to give consumers—for example, discounts on loans for consumers at particular income levels or in particular regions that can correlate to benefits for political actors. This could involve transfers on behalf of the political actor in exchange for the rents they seek as a firm, such as regulatory forbearance or an increase in the government's explicit (or, for that matter, implicit) guarantee that its competitors do not share. But the act of transferring that rent itself actually increases the risk that the government eventually will need to make good on its implicit guarantee. The rents flowing from an implicit guarantee that government-controlled firms obtain can be exacerbated by the fact that the firms themselves can control the size of the subsidy by controlling the amount of debt that they decide to issue.[76]

The notion of government using a controlled corporation as a mechanism for off-budget transfers is actually a method of indirect rent seeking. The rents subsidize the transfer, or at least keep the transfer vehicle afloat long enough for the legislator or regulator to maximize his or her share of the rent extraction. What results is a sort of triangulated rent extraction. Some have argued that rents created through the typical process are capitalized into the value of shares, but that may no longer be the case for government-controlled entities if politically conferred rents are instead transferred entirely through the firm and shareholders have to depend entirely on excess

[74] McChesney, *supra* note 61, at 103.

[75] John R. Lott, Jr., *A Simple Explanation for Why Campaign Expenditures Are Increasing: The Government Is Getting Bigger*, 43 J.L. & ECON. 359, 363 (2000).

[76] *See* David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab*, 42 GA. L. REV. 1019, 1049 (2008).

returns from private rents.[77] In the case of Fannie and Freddie, some have argued that rents were shared between consumers, equity holders, and debt holders, [78] though calculating the exact value of rents obtained is tricky since Fannie and Freddie had no competitors.

Stearns and Zywicki also explain that on the production frontier, firms can be thought of as facing a trade-off based on the relative relationship between the returns they can earn from rent seeking against the returns they can earn from the next available investment activity.[79] If that is true, TARP recipients may decide to pay back their government loans and exit the TARP regulatory regime on that basis. As such, we might expect to see an Akerlof lemons problem come into play for purchasers of the government's securities in the private markets, which would itself inform the price a firm would be willing to pay the government.[80] Because potential buyers of the government securities would be at an informational disadvantage given the preferential treatment that government-owned firms receive in disclosure rules, the investors would assume that all sales of securities by the government were "lemons" and would discount them accordingly.

Another advantage of the government using corporations as transfer agents is that the government will enjoy the ability to camouflage the rent-seeking activity from public view through the use of an intermediary.[81] This advantage may arise because the government is able to keep the firm off of the government's financial statements, the national debt, and the federal budget.[82] The advantage may also result from the bailed-out entity's ability to pool its politically obtained rents with its other assets, thus making it difficult to track the payoffs from political actor to interest group.

Some have argued that the central reason why the federal government creates corporations is solely to take activities off budget while allowing the government to continue to subsidize interest groups by collecting rents.[83] As such, the government's new share of ownership through the bailout should present a tempting target for political actors. Countervailing forces may deter the government

[77] *See* McChesney, *supra* note 61, at 105.
[78] Froomkin, *supra* note 6, at 600.
[79] STEARNS & ZYWICKI, *supra* note 51, at 62.
[80] George A. Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 489 (1970).
[81] *See* Froomkin, *supra* note 6, at 599.
[82] For further analysis of this issue, see Verret, *Separation of Bank and State, supra* note 50.
[83] Froomkin, *supra* note 6, at 596.

from running bailed-out firms into the ground. But at the very least, the government's involvement could be expected to skim off value, both for the companies and for the government's investment. For instance, merely because the government, as of this writing, appears to be able to sell off its interest in some of the larger TARP recipients at a small profit does not mean that the government did not extract significant value over the term of its investment through rent transfers.[84]

There are other forces which will complicate this dynamic. For instance, equity markets—markets for a firm's factors of production (suppliers) and the firm's consumers—should all be expected to take into account the costs of rent seeking and rent transfers in determining whether to do business with the government-controlled firm and at what price. But the presence of a government implicit guarantee, combined with the fact that government-controlled firms obtain regulatory benefits which limit disclosure rules which apply to other non-government-controlled firms, complicates the operation of market discipline in this area. Another aspect to this dynamic may be that the question of whether a government will bail out a government-controlled firm and to what extent (whether to make creditors partly whole or entirely whole, or make equity holders partly whole or entirely whole) could present the a tail-end risk that some commentators are arguing cannot be properly modeled by market participants.[85]

One area of public choice theory that will not be particularly applicable in this context is the role of the judiciary in public choice. The government's activities as owner of TARP firms are protected by particularly strong sovereign immunity provisions, including those in the TARP legislation itself.[86] As such, William Landes and Richard Posner's analysis of the role of the independent judiciary as enforcer of rent-seeking bargains is also muted.[87] However, the government's ability to actually replace the directors of TARP firms would mean that the courts' role as enforcer of rent-seeking bargains would become largely irrelevant anyway.

[84] *See* Deborah Solomon, *Bailout Looking Much Less Pricey*, WALL ST. J., Apr. 12, 2010, at C1. A recent news story reports the Treasury's assertions that it will be able to sell off its interest in Citigroup and GM through a public offering in 2010. *Id.*

[85] *See generally* NASSIM NICHOLAS TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE (2007) (discussing surprise risk events and their disruption of market expectations).

[86] *See* Verret, *Treasury Inc.*, *supra* note 4, at 307.

[87] *See* William M. Landes & Richard A. Posner, *The Independent Judiciary in an Interest Group Perspective*, 18 J.L. & ECON. 875 *passim* (1975).

This section has considered how the government can use its leverage over government-controlled firms to facilitate rent transfers. It shows how traditional rent-seeking models from existing public choice literature provide a useful lens to understand the process in this context, but it also considers dynamics unique to the government-controlled corporation context such as the notion of rent transfers. But one may ask why the government could not use regulatory leverage and liquidity guarantee over all firms to do the same thing with equal ability. The answer, and what makes government-controlled firms a unique animal in these contexts, is that the government can replace the board of directors and the managers of the companies it controls. As such, it has a bonding mechanism to ensure that the government-controlled company stands by its end of the bargain. This mechanism gives the government the power to potentially encourage rent extraction of privately conferred rents in the ways that McChesney suggests but to a much greater degree.[88] Indeed, the government could go beyond mere rent extraction and extract actual value from the corporation, depending on its leverage versus that of the company's executives. The power to replace the executives and the board limits the company's freedom to push back against the government's demands.

To the extent that the rent enjoyed by the government-controlled firm is forbearance from monopoly regulation, that rent also has the secondary consequence of constraining product market constraints that would otherwise serve as a check on agency costs.[89] In many cases, capital markets would have the ability to still serve as a powerful constraint even on monopoly firms.[90] But in this case, because one of the rents that firms enjoy is a government guarantee, that constraint is limited. Mark Roe also argues that more monopoly power results in higher managerial agency costs as managers and employees engage in competition for the rents.[91]

The final dimension of rent seeking, the competition of different groups for existing rents, may be the most difficult to predict in this context. The process whereby rents are shared with workers and other constituencies in firms that are not directly controlled by the government has been somewhat of a black box. Roe notes that wages for unionized industries subject to monopoly power were shared with

[88] *See supra* notes 66–71 and accompanying text.

[89] Mark J. Roe, *Rents and Their Corporate Consequences*, 53 STAN. L. REV. 1463, 1468–69 (2001).

[90] *Id.* at 1468.

[91] *Id.* at 1472.

union workers in the form of higher wages than similar workers in other areas of the economy.[92] One study examined the effect of interstate banking deregulation on wages to determine how the firms, who through state restrictions on bank entry enjoyed rents, shared those rents with employees as compared to employee salaries after the rents were taken away.[93] The study found that regulatory barriers permitted firms to share rents with employees through higher wages.[94]

The relative share of rents enjoyed by regulators and politicians, managers, workers, consumers, and other constituents of the government-controlled firm will depend on the relative leverage they are able to exercise. For instance, during Franklin Raines' tenure at Fannie Mae, he was able to exert significant leverage over members of Congress.[95] Under his watch the firms coordinated political interest group pressures, keeping detailed records of the level of mortgages they subsidized by congressional district.[96] But after the scandals of 2004 broke, Raines was quickly forced out and the firm's clout diminished considerably.[97]

Thus it may be difficult to predict just how the firms' rents will be shared as it will be the result of a dynamic negotiation. The power relationships between the various groups seeking to share in rents, and the alliances that those groups form with legislators and bureaucrats, should shift with the tides of political outcomes. For example, one of the reasons Fannie Mae has maintained such a powerful presence is through its alliance with other interest groups that profit from Fannie Mae's presence, including mortgage brokers, realtors, and other Wall Street investment banks, that may otherwise be unlikely members of an interest group coalition that includes community activists.[98] These allies were loyal to Fannie Mae because Fannie Mae had a reputation for ending relationships with groups or businesses that did not support its interests or criticized it, including its notable decision to cancel ads in magazines like *The Economist* that ran critical editorials.[99]

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[92] *Id.* at 1467.

[93] Sandra E. Black & Philip E. Strahan, *The Division of Spoils: Rent-Sharing and Discrimination in a Regulated Industry*, 91 AM. ECON. REV. 814, 814–16 (2001).

[94] *Id.*

[95] *See* JONATHAN G.S. KOPPELL, THE POLITICS OF QUASI-GOVERNMENT, HYBRID ORGANIZATIONS AND THE DYNAMICS OF BUREAUCRATIC CONTROL 99, 101 (2003).

[96] *See id.* at 99.

[97] *See id.* at 118.

[98] *Id.* at 112.

[99] *Id.* at 100.

The relationship between the government-controlled firm's managers and the government and interest groups will also shift in relation to events that invite public scrutiny. It will also depend in large part on the firm's ability to maintain and capitalize on information asymmetries and unverifiable information to generate an appearance of interest-group transfers that are higher than the actual rents transferred.[100] Information asymmetries can also run against the political actors. For instance, a government-controlled firm may be able to convince an interest group or a political actor that it is sharing more rents than is actually the case. The relationship will further depend on the firm's ability to mask the costs of the implicit guarantee, which is aided by difficulty in measuring those costs.[101] Finally, it will depend on a firm's ability to maintain normal profits and to mask financial strains in order to delay a need to make use of the government's guaranty at which time the government may feel compelled, as it did in 2008, to replace management as a necessary condition of making good on its implicit guarantee.

Now that rent seeking has been analyzed, including concepts such as rent extraction, rent dissipation, rent sharing, this Article's contribution to the literature of rent transfer theory, and the incentives facing political actors in all of these concepts, the second step is to consider the incentives of bureaucratic actors that are in some ways insulated from the political process but still remain coordinating agents of those political actors.

B. Bureaucratic Incentives in Government-Controlled Companies

While rent-seeking objectives guide the decisions of political actors, an alternative but related literature has developed to consider the set of incentives that guides bureaucratic actors. In part, this is because most bureaucratic actors are intentionally protected from political pressure by civil service laws.[102] Another unique characteristic of bureaucratic actors is that their compensation is typically based on seniority and not on the performance of the bureaucrat or the performance of the bureau.[103] And yet, the rent-seeking dynamics also seem to seep into bureaucratic decision making through indirect

[100] *Id.* at 131.

[101] KOPPELL, *supra* note 95, at 128.

[102] See STEARNS & ZYWICKI, *supra* note 51, at 340 (citing Herbert Kaufman, *Major Players: Bureaucracies in American Government*, 61 PUB. ADMIN. REV. 18, 20–21 (2001)), for an estimate that the Civil Service Act protects roughly 90% of non-defense government employees.

[103] *See id.* at 341.

means, particularly congressional oversight and budgeting of the bureau. This section will examine the incentives of bureaucratic actors and explore whether the level of incentives can be melded with the interest-group rent seeking facilitated by political actors in the previous section. This analysis will also add a useful framework for considering the government's management of its shareholder interests.

To the extent that the chartering agencies, like the Office of the Comptroller of the Currency (OCC) and the FDIC, who can only be removed for cause, retain significant power over TARP recipients as regulators, their willingness to coordinate with political actors is an important consideration. The Treasury's Assistant Secretary for Financial Stability, a political appointee, is the lead coordinator for the government's investment in bailout recipients and reports to the Secretary of the Treasury and serves at the pleasure of the President. It is particularly relevant that current Assistant Secretary for Financial Stability Herb Allison was most recently the CEO of Fannie Mae, [104] the one government-controlled firm that most acutely highlights the rent transfer problem. As such, rent seeking and bureaucratic incentives will blend together when considering the full set of incentives of all the government elements bearing on this question. The Assistant Secretary for Financial Stability is also likely to be supported by a large staff of civil service employees, thus reinforcing the need to combine views of political appointees and civil servants.

One central theory to explain the motivations of bureaucratic actors is the agency expansion hypothesis. This view, originating with William Niskanen, argues that the utility function of bureaucratic actors is likely to be largely influenced by a desire to increase variables like power, patronage, agency size, prerequisites, and salary.[105] Niskanen's model predicts that agency officials will seek to maximize their budgets and their jurisdiction to achieve this goal.[106] Niskanen's seminal *Bureaucracy and Representative Government* helps explain the behavior of bureaus collectively.[107] In order to see how bureaus act when pressured, Niskanen assumes that the "benefactor"—the government entity sponsoring the bureau—is not passive but actively en-

[104] U.S. Treasury, Herbert M. Allison, Jr.: Assistant Sec'y for Financial Stability and Counselor to the Sec'y, http://www.ustreas.gov/organization/bios/allison-e.html (last visited Aug. 2, 2010).

[105] WILLIAM A. NISKANEN, JR., BUREAUCRACY AND REPRESENTATIVE GOVERNMENT 38 (1971).

[106] STEARNS & ZYWICKI, *supra* note 51, at 343.

[107] NISKANEN, *supra* note 105.

gaged to the fullest extent possible in the affairs of the bureau.[108] The assumption of a passive benefactor is only relevant when informational boundaries make it hard for the benefactor to evaluate the bureau (an assumption that depends upon the extent to which the government-controlled firm can hide information from the agency exercising control).[109] Niskanen nevertheless disagrees with the classic assumption that officers within a bureau are entirely self-interested.[110] Indeed, he expects officers to work hard and to have a mixed calculus of objectives—some may focus more on personal goals than others, but officers are "neither philosopher-kings nor, in the modern terminology, Pareto-optimizers."[111] Another reason that the government often fails to efficiently allocate resources is that higher level bureaucrats have poor information on the true minimum costs to supply a specific service.[112] Niskanen argues that monopolistic providers of government services are much like monopolists in the free market—they do not have a viable supply function.[113] This is especially acute on the federal level as municipalities can compare themselves to other similarly situated municipalities but federal bureaus have few peers.[114]

All of this may partially explain the Treasury's push to use the TARP to obtain controlling equity over businesses because this use would result in the Treasury obtaining power over the budgets of those entities as well. The bureaucrats coordinate with political actors in rent extraction through the budget process, where legislative committees oversee and approve bureau budgets in exchange for the cooperation of bureaucrats. Another incentive tempting bureaucratic actors is that they may obtain opportunities for lucrative post-government employment because of their experience at the agency; therefore, they may design rules that increase the agency's power and jurisdiction to maximize those opportunities.[115] In this context, consulting work for government-controlled firms, or for firms that may seek to do business with government-controlled firms, may present lucrative opportunities.

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[108] *Id.* at 127.
[109] *Id.*
[110] *Id.* at 128.
[111] *Id.*
[112] *Id.* at 136.
[113] *See* NISKANEN, *supra* note 105, at 136.
[114] *See id.*
[115] *See* STEARNS & ZYWICKI, *supra* note 51, at 346.

Cotton Lindsay's work also runs contiguous to the Niskanen view.[116] Lindsay notes that there are both supply side and demand side differences inherent in government enterprises.[117] Although consumers continue to affect firm behavior through commercial relationships, Lindsay notes that they use the political process to affect the provision of goods as well. He notes that consumers are likely to seek a different bundle and a greater degree of services through the exercise of political will than through market-based demand.[118] Lindsay notes that the distinguishing feature guiding bureaucrats in their production decisions is the desire to please Congress, and in doing so they will divert resources from the production of attributes not observed or targeted by Congress.[119] As such, the bureaucrat manager will have an interest in increasing Congress's perception that the bureau is important. We have already explored the possibility that the government-controlled firm may find ways to use informational disadvantages to generate for the political actors the appearance of interest group transfers that exceed actual transfers. But the same dynamic may also come into play as the executive bureaucrats overseeing the government's investment interact with members of Congress or the President. To the extent that executives at government-controlled firms or bureaucrats mislead about the extent to which rents are transferred and that misperception benefits the financial health of the government-controlled enterprise, then the surprisingly long periods of time before a government-controlled enterprise becomes insolvent may be more readily appreciated.

Lindsay's "Theory of Government Enterprise" paints a bleak future for the prospect that the government can effectively supply goods that can otherwise be supplied in the marketplace.[120] Within the first three sentences, Lindsay states that "the typical customer of a government bureau expects inconvenience and delay in receipt of service."[121] But Lindsay also asserts that until 1976, economists had not created a model analogous to the profit maximizing model of private firms, which could judge government action.[122]

[116] *See* Cotton M. Lindsay, *A Theory of Government Enterprise*, 84 J. POL. ECON. 1061 (1976).
[117] *Id.* at 1062.
[118] *Id.* at 1062.
[119] *Id.* at 1065.
[120] *See id.*
[121] *Id.* at 1061.
[122] Lindsay, *supra* note 116, at 1062.

In Lindsay's view, the typical consumer of government services can influence the government in two distinct ways: (1) as a normal consumer, demanding services as with any other business, and (2) through political channels.[123] The second type of influence commands Lindsay's focus in his article.

Lindsay asserts that political forces exerted on government bureaus can affect behavior in two ways: (1) collectively, a group may demand a different bundle than its members would as individual consumers and (2) because government agencies are judged by factors beyond profitability, bureaucrats act differently than they would within a free-market organization.[124] In sum, there are distinct demand-side influences (the product demanded, either from individuals or special interest groups) and supply-side influences (criteria other than profitability that the bureau must meet).[125]

Until the publication of Lindsay's work, many theorists operated from the simple assumption that bureaus acted in a way that would maximize their budget.[126] While this theory was rational, it did not fully explain their behavior or how they managed to maximize their budget.[127] Explaining the situation aptly, Lindsay writes that "[t]o say that bureaucrats have a taste for bureaus, therefore, tells us no more about their behavior as managers than does the assertion of any other taste."[128] In addition, budgets are largely set by Congress and are exogenous from the bureaus themselves.[129] Instead, they must please their congressional benefactors, who in turn are interested in pleasing their constituents.[130] In this context, the Assistant Secretary for Financial Stability may not have as keen an interest in maximizing the bureau's budget because the resources he controls exist on the private budgets of the government-controlled firms. He will, however, coordinate his activity with the Treasury's interest in budget maximization, which itself will be muted by the variety of other factors influencing the bureaucratic actor.

If the size of a bureau budget is to be interpreted as the sole metric of productivity, then Congress must interpret budget size as an

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[123] *Id.*
[124] *Id.*
[125] *Id.*
[126] *See id.* at 1063.
[127] *Id.*
[128] Lindsay, *supra* note 116, at 1063.
[129] *Id.*
[130] *Id.*

indication of output.[131] Lindsay argues that severe informational constraints must be in place if this is to be the result.[132] Even in the bureau setting, having an effective manager is important. But determining effectiveness in the bureaucratic setting is tricky. In ordinary profit-maximizing organizations, financial statements allow one to judge the effectiveness of a manager.[133] Although not the only factor, financial statements provide an indication of effectiveness.[134] A bad manager at a firm will have higher input costs, lower overall output, or both.[135] Any combination of these factors would most likely result in lessened earnings.[136]

But in the bureau setting, many times the bureau is charged with producing a good that would not be supplied at market prices.[137] For example, the bureau charged with providing medical care to the disadvantaged could not charge market prices because, by definition, that bureau's customers are unable to pay for the services they need.[138] For these bureaus, the true measure of productivity is the importance that the political process puts on bureau output.[139] Further, the earnings of the government-controlled firms in this context will not be a useful measure for legislative overseers because they are more interested in how the firm transfers benefit to interest groups.

Legislators have to estimate the output, directly, by whatever attributes it judges to be both important and capable of being monitored.[140] Because Congress cannot judge intangible or immeasurable factors, both Congress and the bureau will focus on those factors that are measurable.[141] Another factor in the behavior of bureaus is the effect of a change in demand.[142] With a profit-maximizing firm, output changes to reflect demand. With a bureau, this factor is largely absent because the government sets the price of the good supplied at zero, with the only indication of changes in demand coming from

[131] *Id.*
[132] *Id.*
[133] *Id.* at 1064.
[134] Lindsay, *supra* note 116, at 1064.
[135] *Id.*
[136] *Id.*
[137] *Id.*
[138] *Id.* at 1064.
[139] *Id.*
[140] Lindsay, *supra* note 116, at 1065.
[141] *Id.*
[142] *Id.*

changes in Congressional demand.[143] Accordingly, Lindsay predicts that bureaus will move toward congressionally measurable attributes over time.[144]

Lindsay expects that chasing measurable outputs will lead to non-optimal results. For example, a policeman whose output is judged on the number of general summonses issued will overly patrol roads that allow him to conceal his vehicle because the policeman can issue more summonses when he cannot be spotted.[145]

Lindsay's view offers a more refined lens for our purposes than the Niskanen view. It may help to explain the different effects that rent transfer may have on different firms. Although the metric by which interest groups and members of Congress can judge how much benefit they obtain from the rent transfer activity is not readily apparent, it will in part be framed by the government-controlled firm and the bureaucrats charged with direct responsibility for it. Thus it may be the case that the tradeoff between profits and transfer is subject to various indifference curves for the political actors depending on their perceptions of benefits obtained, which will be influenced by reports from the bureaucrats overseeing government-controlled firms and in part, by tradeoffs between the cost of the implied guaranty. Therefore, the cost to firm profits from rent transfer might be heterogeneous depending on the firm. For firms like Fannie Mae and Freddie Mac that serve as clearinghouses for mortgages, the output is more readily measurable in mortgage rates and so the cost to firm profits from the rent transfer is higher. But for other government-owned firms, outputs like small business lending volume or minority business loan volumes may have a lower cost proportionate to their perceived benefit for political actors. Bureaucrats may be able to focus political actors on different trade-offs and reduce the cost of the rent transfer. This dynamic may explain why some government-controlled firms are able to limit the cost of rent transfers to their profits.

An alternative view to Niskanen and Lindsay's theories of bureaucratic behavior is expressed by James Wilson, who posits that a prime focus for agencies is minimizing their conflict with other agencies and their risk of failure.[146] And yet, particularly with regard to banking regulation, regulatory competition is an inherent part of the

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[143] *Id.* at 1065–66.

[144] *Id.* at 1066. The inverse is also true, i.e., that "government agencies will devote no resources to the production of invisible output." *Id.*

[145] *Id.* at 1066–67.

[146] *See* STEARNS & ZYWICKI, *supra* note 51, at 346–47.

landscape because the Comptroller, the Treasury, the FDIC, and the Federal Reserve all have overlapping jurisdiction in the regulation of banks.[147] The OCC regulates the charter for federally chartered banks, and though the Comptroller, as head of the OCC, is a Treasury official, he remains independent from the Secretary of the Treasury (much like the FBI Director's relationship with the Justice Department and the Attorney General) and may be removed by the President only with cause during his five-year term of office.[148] Because of this, the Treasury's decision to take controlling equity stakes in banks may be viewed as a way to enhance its competitive position in relation to its competitor regulators.

Wilson argues that the risk-averse agency will seek to avoid scandals that might align the public and government against them because those agencies require strong public support to engage in expansive empire building.[149] The scandal in this context would be that the government-controlled enterprise becomes insolvent. But in the event of such insolvency, even risk-averse agency officials may be confident in their abilities to outlast that occurrence, precisely because they are able to expand information asymmetries through forbearance of regulatory disclosure and capital requirements by the Treasury and other agencies. Fannie Mae and Freddie Mac's exemption from SEC filings is a prime example.[150] This would extend the time period under which the government-controlled entity could continue to operate before the eruption of scandal. The bailed-out entities were considered failures when the government took them over,[151] so the fact that the government failed to turn them around may be less of a scandal than the insolvency of an entity that started off solvent, as in the case of Fannie Mae and Freddie Mac.

[147] Howell E. Jackson, *A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States* (Harvard Law Sch. Pub. L., Working Paper No. 09-19, 2008), *available at* http://ssrn.com/abstract=1300431.

[148] *See* 12 U.S.C. § 2 (2006) ("The Comptroller of the Currency shall be appointed by the President, by and with the advice and consent of the Senate, and shall hold his office for a term of five years unless sooner removed by the President, upon reasons to be communicated by him to the Senate.").

[149] STEARNS & ZYWICKI, *supra* note 51, at 348.

[150] *See generally* Peter Wallison, *Regulating Fannie Mae and Freddie Mac*, AM. ENTER. INST. FOR PUB. POLICY RESEARCH, May 2005, *available at* http://www.aei.org/docLib/20050513_FSOMay_g.pdf (discussing the possibility of Congressional regulation in light of Fannie Mae's and Freddie Mac's growing portfolios).

[151] *See, e.g.*, Karnitschnig et al., *supra* note 12.

Some models of bureaucratic action focus on congressional control as the most powerful driving force behind bureaucratic actors.[152] This partially explains the willingness of other regulatory agencies, like the SEC, to provide regulatory forbearance to government-controlled companies in the form of reduced transparency rules and reduced enforcement for regulatory violations to assist the agencies, like the Treasury, in stewarding government control of companies. The SEC would be doing so at the behest of congressional committees, which have an interest in maintaining the viability of those firms.

Stearns and Zywicki note an interesting anecdote from John Allison, chairman of BB&T Corporation, which considers how bureaucratic incentives and political actors can contradict.[153] In the midst of the financial crisis, the executive branch wanted to encourage banks to make more loans, but frontline bank examiners had precisely the opposite incentive—to minimize the risk that loans in portfolios at banks they oversaw would default.[154] If those incentives remain in force, the balance of power has been distinctly shifted from the banking examiners at the FDIC, the Federal Reserve, and the OCC to political actors and bureaucrats within the Treasury Department and the Office of Financial Stability through the government's holding.

One way that government overseers may be able to appease interest groups and reduce bank risk would be to encourage government-controlled banks to buy more Treasury bonds to help fund deficit spending by the administration. In effect, the government-controlled firm could become a mechanism for transferring rents through the entity and back to the government. The rents produced could be used to finance deficit spending if the government controlled firms artificially increase their appetite for Treasury bonds. The Federal Reserve has begun to push banks to reduce their risk. For instance, on October 22, 2009, the Federal Reserve released a discussion draft on compensation that linked its review of executive compensation, including performance based bonuses and golden parachutes, to risk.[155] The proposal included two supervisory initiatives,

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[152] *See* STEARNS & ZYWICKI, *supra* note 51, at 350 (citing Gary J. Miller & Terry M. Moe, *Bureaucrats, Legislators, and the Size of Government*, 77 AM. POL. SCI. REV. 297, 297 (1983)); Barry Weingast & Mark J. Moran, *Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission*, 91 J. POL. ECON. 765, 767 (1983).

[153] STEARNS & ZYWICKI, *supra* note 51, at 360.

[154] *See id.*

[155] James Morphy, *Fed Proposes Incentive Compensation Policies for Banking Organizations*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 3, 2009, 10:22 AM),

the first of which applied to the twenty-eight largest complex banking organizations and the second of which applied to all other Federal Reserve regulated banks.[156] The proposal indicated that compliance with its provisions would be included in the bank's supervisory ratings by the Federal Reserve.[157] The proposal is notable for the lack of a consistent definition of excessive risk; indeed, it seems to explicitly authorize hindsight bias as a regulatory approach. It does, however, provide some measure of guidance as to how banks should determine risky compensation policies and the general strategy that banks should take in matching risk to returns.

To the extent that banks attempting to comply with these risk-based assessments find overwhelming uncertainty in determining which assets and investing strategies are excessively risky, purchasing Treasuries would seem to be a safe choice to invest the bank's portfolio rather than purchasing more risky assets. If the Treasury's capital ownership in banks offers additional leverage over existing regulation, then one might anticipate that it would be used to encourage private bankers to buy Treasury bonds rather than invest in other assets. This would stimulate artificial demand for Treasuries and keep interest rates on Treasury debt artificially low. As such, artificial demand for Treasuries would forestall politically unpopular deficit cuts or tax increases. The government-controlled firm's political rents could be a source of financing for its increased purchases of government obligations.

As one explanation for why bureaucrats may seek to maximize the value of their agency's budget despite not sharing in those funds directly, Stearns and Zywicki note that employees may work at the agency out of an attraction to the agency's mission and a desire to expand the reach of its authority that offers non-monetary utility.[158] For example, Treasury employees and other regulators of government firms may feel that facilitating rent seeking at those firms will increase the chances that they will be able to repay the taxpayer's investment. This may be true despite potential harm to other firms and the fact that the rents may eventually be transferred in full to interest groups in the end, thereby ultimately threatening the value of the taxpayer's investment. Alternatively, they may feel a desire to facili-

http://blogs.law.harvard.edu/corpgov/2009/11/03/fed-proposes-incentive-compensation-policies-for-banking-organizations/.

[156] *Id.*

[157] *Id.*

[158] STEARNS & ZYWICKI, *supra* note 51, at 364.

tate off-budget transfers, focusing only on the benefits transferred without considering their costs.

A few additional and unique observations charge the incentives of government as shareholder. First, the rents that interest groups enjoy and share with political actors and bureaucrats managing the Treasury's investment are experienced immediately, but the costs are time-discounted, particularly to the extent that the rent being transferred is an implicit guarantee of the firm's debt. This is supported in part by the difference between the life cycle of the typical Schedule C appointee like the Assistant Secretary for Financial Stability, which is roughly two years,[159] and the typical lifespan of a government-sponsored or government-controlled enterprise, which the limited sample of Fannie Mae and Freddie Mac suggests can range to forty or fifty years before the firm becomes insolvent.

Second, when interest groups encourage subsidizing activity, such as subsidized interest rates at TARP banks, those activities will become a net benefit to the individual bureaucrat managing the government's investment. This effect is seriously magnified by the issues discussed in Part II.[160]

Third, an indirect cost of the rent-transfer properties of the government-controlled firm, although difficult to quantify, is that the culture and infrastructure of the firm will be built around that guarantee. The institutional knowledge of the firm will be based around the existence of a government guarantee and in the service of the non-financial objectives that will typically come with government control and ownership. This, in turn, may make later re-privatization difficult.

A public choice model for government bank lending versus private bank lending might be sketched as follows. Consider two marginal variables: L, which equals the net present value from future losses on unpaid loans in a bank's portfolio, and P, which is the net present value of expected aggregate future interest payments on those loans. For a private bank, the decision metric is fairly simple: lend when the marginal loan's value is described as $L < P$. An executive whose compensation is tied to the bank's profitability would look to that equation in directing corporate policy, and a shareholder interest in maximizing the health of the bank would do the same. This model would be complicated by executive compensation that was im-

[159] *See generally* DAVID E. LEWIS, THE POLITICS OF PRESIDENTIAL APPOINTMENTS: POLITICAL CONTROL AND BUREAUCRATIC PERFORMANCE (2008) (examining presidential appointments and their influence on public policy).

[160] *See supra* Part II.

properly linked to performance, but as government pay is in no way linked to performance, this concern is irrelevant for this comparison.

The decision process for a government shareholder is complicated by a number of marginal variables that are not included for executives, namely interest-group rents from groups affected by company policies who vote for members of Congress and administrations. Consider the following simple illustration of a few marginal variables: *GB* represents interest-group rents, the benefits interest groups obtain from the corporation, such as subsidized lending; *GB2* represents the political benefits to administering efficient government, which might in some way enhance the administration's reelection prospects and result in higher opinion poll numbers or decreased deficits; *GD1* represents the probability of being in office when a government-owned bank fails or significantly appreciates in value or other event in the representation below occurs; *GD2* represents the share of political reward/blame that political actors get for effects on the banks viability, or for other decisions, taking into account the fact that political actors are able to share blame among the political appointees in their department, appointees in other financial regulatory agencies, their predecessors, and members of Congress; *GD3* represents the share of rents to interest groups that are shared with political actors, such as political donations, political support, or jobs after retirement from government; *GC1* represents the net present value of future expenditures under subsequent bailouts due to inefficient lending; and *GC2* represents the cost of exercising equity control over banks. For government-controlled banks, the decision by an administrator overseeing the government's investment, and the decision metric used by other political actors who might be able to use political leverage to influence that administrator's decision, will be to lend when

$$L + GC2 + [GC1 \times GD2 \times GD1] < P + [GB2 \times GD2 \times GD1] + [GB \times GD3].$$

As the right side of the equation gets larger from the additional variables, then, all else remaining equal, a lower interest rate is required (a component of *P*) to make the right side of the equation exceed the left. This will result in subsidized lending through a lower interest rate on loans. This representation might also be considered in a dynamic way in the sense that subsidized interest rates are part of the rent extracted by interest groups and shared with the TARP administrator and those overseeing the TARP administrator, thus the decrease in interest rates will also itself increase *GB* and *GD1*. As government-controlling interest increases, increasing shares of ownership decrease the cost of control. To the extent that incentives are distorted by increasing share ownership in banks, this is supported by previously explored evidence that increases in a government's percentage ownership in a bank correlates with decreases in bank profitability.[161] This representation is compiled with a government-controlled bank in mind, but a government-controlled automotive or insurance company would have its own version as well.

Rents tend to come before costs for government officials because they may be gone before the costs are experienced, magnifying the importance of those rents to them. Thus their discount rate would be much higher than would otherwise be the case, and their discount rate would be much higher than that of a taxpayer with perfect information about the problem. This is evidenced by a comparison of the average tenure of financial regulators and congressional banking committee chairmen to the time it took government subsidies of lending to blow up in the cases of India, Italy, and Fannie Mae explored in the author's prior work.[162] The typical assistant secretary at the Treasury or HUD serves for two to three years, but it took nearly thirty years for Fannie Mae and Freddie Mac to explode. The fact that rents come before costs alters the net present value analysis, as the costs are time discounted at a high rate but the rents effectively are not, which pushes the decision toward excessive lending.

Another indirect cost of the government guarantee accompanying government ownership, which would be difficult to account for in this simplistic representation, is that the culture and infrastructure of the firm will be built around the guarantee. The institutional knowledge of the firm will be based around the existence of a government guarantee and in the service of the nonfinancial objectives that will typically come with government control and ownership.[163] This will make later re-privatization difficult, as the market may not have an in-

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[161] *See, e.g.*, Alexander Muravyev, *Federal State Shareholdings in Russian Companies: Origin, Forms and Consequences For Enterprise Performance* 25 (Bank of Finland Inst. for Economies in Transition, Discussion Paper No. 12, 2002), *available at* http://ssrn.com/abstract=1015707 (suggesting that each x% increase in government ownership correlates with a result y% decrease in bank earnings).

[162] Verret, *Separation of Bank and State*, *supra* note 50.

[163] *See id.* Some argued that the best way to deal with the moral hazard problems of guaranteeing Fannie Mae and Freddie Mac debt was simply to increase regulation of the GSEs. Peter Wallison, *Moral Hazard on Steroids: The OFHEO Report Shows that Regulation Cannot Protect U.S. Taxpayers* 2 (American Enterprise Institute for Public Policy Research, AEI Outlook Series, 2006), *available at* http://www.aei.org/outlook/24591. And yet, as Chairman Greenspan observed at the time, increased regulation of an implicitly government guaranteed enterprise only enhances the market's perception that the government is all the more willing to guarantee their debt. *Id.*

terest in buying into a firm whose instincts have been dulled by public-sector backing and control and who may not be able to survive on their own outside the nest.[164] An additional incentive that bureaucrats may face is an increase in their post-employment value at government-controlled firms. Existing public choice literature already has considered the effect of incentives for bureaucrats to increase regulatory complexity to add to their own employment prospects subsequent to their government career.[165] This will still be in effect in their case, but even more powerful will be their incentive to enhance the government's control over the captured firm to enhance their value to government-controlled firms for consulting purposes.

C. The Power of Interest Groups in Public Choice Analysis

One potential interest-group criticism of the Treasury's TARP holdings amounts to a suggestion that labor, management, and government will collectively conspire against the interests of taxpayers and, at times, the interest of shareholders, as well as the long-term interests of a firm's constituents.[166] A similar type of collaboration is evident in Roe's interest-group theory on the development of financial regulation discouraging the intermediation of capital in the United States during the nineteenth and twentieth centuries, and so may be considered by way of analogy for the purposes of this Article.[167] Otherwise profitable nationalized firms create rents that can

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[164] *See* Verret, *Separation of Bank and State*, *supra* note 50. As a particularly egregious example of how Fannie Mae and Freddie Mac's operational risks were ignored by private markets due to the government's backing, Fannie Mae and Freddie Mac were forbidden from filing financial statements with the SEC starting in 2003 due to revelations of earnings manipulations and accounting fraud. Wallison, *supra* note 163, at 2. And yet, during the years that investors had no access to filed financial statements, their demand for Fannie and Freddie debt continued unabated. *Id.*

[165] *See supra* Part III.B.

[166] *See generally* Ellen M. Pint, *Nationalization and Privatization: A Rational-Choice Perspective on Efficiency*, 10 J. PUB. POL'Y 267, 268 (1990). Rational choice theory stands for the proposition that small and well-organized groups will tend to gain benefits over larger and less homogenous groups in the political process. *Id.* For example, one study indicates a negative correlation between labor productivity and residual government ownership in Russian privatized firms. Alexander Muravyev, *supra* note 161, at 25. This study found that a 10% increase in government ownership was associated with a 6.5% drop in labor productivity and a 1.2% drop in profitability. *Id.*

[167] *See* J.W. Verret, *Economics Makes Strange Bedfellows: Hedge Funds, Pension Funds in an Era of Financial Re-Intermediation* 10 U. PA. J. BUS. & EMP. L. 63, 65 (2007) for a summary of Roe's theory. Roe's theory for how labor and management interest groups helped to determine the shape of American finance in the 20th Century is instructive. The political process Roe describes is as follows: the source of laws that restrict the power of intermediaries comes from both public opinion and interest group power. *Id.* Where the general public has even a weak preference, that prefe-

be redistributed by liberal and conservative governments alike, effectively making even profitable firms merely break even once the rents are distributed.[168] The difference in which ideology holds power, then, would be merely to which constituency the rents would be distributed.

Though the United States has tended to historically avoid government ownership in most economic firms, many other global economies are characterized by extensive government ownership in firms. At times these governments nationalize private industries, and at times they privatize nationalized industries, all of which offers an opportunity to consider the interest-group forces that shape a government's conduct as holder of a residual stake in firms in practice. The consequences of a government agency holding voting equity in a private firm can be costly. Constituent directors tend to gain power when governments have equity and debt leverage over private firms. Labor is the primary constituent of the corporation that seeks influence over the corporation, but local constituencies seeking to block cross-border flows of capital and services, consumer rights activists,

rence cannot be outweighed by that of a smaller, more interested group. *See* Arthur T. Denzau & Michael C. Munger, *Legislators and Interest Groups: How Unorganized Interests Get Represented*, 80 AM. POL. SCI. REV. 89, 96–99 (1986). The American public has always been suspicious of consolidated economic power. *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 48 (1994). The flow of funds, though, is essential to economic stability. Thus a choice was inevitable: either intense regulation of one consolidated entity, or fragmentation with light regulation. *See id.* at 41. The American government chose the latter. *See generally id.* These two forces are magnified by federalism, which serves to enhance the effects of fragmentation and path dependency, both of which make institutions evolve in response to political choices. *See* Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 163 (2000). Institutions that might have served as powerful intermediaries, namely, mutual funds, pension funds, banks, and insurers, were all constrained by a series of political reactions and rulemaking that constrained their economic influence over firms through some version of the political model described in Roe's thesis. *See, e.g.*, David Langer, *Protector Becomes the Threat to Pensions,* PENSIONS & INVESTMENTS, Sept. 14, 1992, at 15, *available at* http://www.davidlanger.com/article_c46.html (describing how United Steelworkers and the United Auto Workers were key lobbyists for ERISA). The political interest group theory is that managers and labor join together to oppose the rise of institutional investor power. ROE, *supra* at 42–45. Management does not want an intermediary that can monitor its extraction of rents in the form of excessive compensation, and labor is convinced that intermediaries will squeeze the employment rolls to maximize investor returns. *Id.*

[168] *See* Pint, *supra* note 166, at 275. For instance, Britain's nationalized railway and coal industries were directed to simply "break even," and otherwise control prices to minimize consumer costs. *Id.* An exception to this challenge would be nationalization as liquidation, which would effectively re-privatize the firm through a wind up procedure before interest groups have an opportunity to capture control over the firm through the government. *See id.*

and environmental activists also seek a role. A significant element of tension between shareholder wealth maximization and constituent directors is inescapable. Stephen Bainbridge observes that shareholders as a group have far less power as political interest groups than do non-shareholder constituencies of the corporation.[169]

Michael Jensen and William Meckling examined the related issue of labor-managed firms, which they define as presupposing the existence of laws restricting the rights of residual equity owners in favor of transfers to labor groups.[170] They characterize this system as a pure-rental system because although individuals are permitted to own property, they are forbidden from having distinct property rights.[171] Instead, workers share the risk and returns to output, using average return per worker as their metric of success.[172] Firms are permitted to rent from workers, but otherwise workers hold residual claims on the outputs since those outputs are dependent on future work for which Jensen and Meckling assert there is no legal market.[173] Armen Alchian and Harold Demsetz argue that such a system is inefficient compared to one with firm ownership of productive assets and residual shareholder claimants.[174] Jensen and Meckling note the monitoring cost angle to rental of productive assets because the lessee has reduced incentive to maintain the asset and guard it from theft and misuse, and if such behavior cannot be costlessly monitored, the cost of that monitoring will explain why firms are often the most cost effective owner / monitor of productive assets.[175]

[169] *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 559–61 (2003). For a further summary of the shareholder power debate in this context, see J.W. Verret, *Pandora's Ballot Box, or a Proxy with Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-examined*, 62 BUS. LAW. 1007, 1021–35 (2007).

[170] Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 J. BUS. 469, 475 (1979).

[171] *Id.* at 476–77.

[172] *Id.* at 476.

[173] *Id.* at 477.

[174] Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 792–93 (1972).

[175] Jensen & Meckling, *supra* note 170, at 480. Jensen and Meckling close by explaining five distinct flaws with the labor managed firm. *Id.* at 481. First, firms must at some point acquire intangible assets which by their nature cannot be rented such as goodwill, and thus the limitation on firm ownership cannot hold. *Id.* Second, there are different horizons for employees' claims on cash flows that cannot be compensated without cost and could lead workers to select negative net present value projects that maximize their individual return. *Id.* Third, such firms could see common property problems with equal sharing of cash flows among employees. *Id.* Fourth, because workers claims are contingent on their continued employment,

This Article is an investigation of government ownership in private firms, and the attendant consequences for the legal constraints on state action that are intended to limit public choice problems. As such, a look at employee-managed firms may seem to be a detour. It becomes directly relevant, however, when it is considered that one of the strongest constituencies who will seek to influence the government in its exercise of shareholder powers is the employee representative groups. Indeed, the automotive sector in particular is characterized by high union membership. This could also apply equally to investment banking activities by bank sector TARP recipients, as investment banks in part finance consolidation activity that tends to lead to layoffs. As such, this analysis is particularly relevant for this case. Only by understanding the inefficiencies of employee self-governance can the costs of their ability to influence their managers through the intermediary of government as shareholder be grasped.

D. Fannie Mae and Freddie Mac: A Direct Example of Government-Controlled Firms and Rent Transfer

Fannie Mae and Freddie Mac are unique organizations among publicly traded companies. They were initially government entities and subsequently spun off to private investors, with the government retaining substantial charter powers but no shareholding. As part of the 2008 response to the financial crisis, they were both taken under government conservatorship, and the government also took a controlling equity position in both firms. While Fannie Mae and Freddie Mac are examples of firms that this Article's analysis will apply to going forward, they also provide instructive examples for how government-controlled firms operate based on their history prior to the bailout.

Fannie Mae and Freddie Mac were originally chartered by the federal government and spun off as government-sponsored enterprises. As evidence of the fact that bailed-out companies can easily become captive institutions used by the government to facilitate subsidy, Michael Froomkin observes that many federally chartered companies were created for that express purpose.[176] Fannie Mae and Freddie Mac are the most recent examples of government-controlled companies that became insolvent due to the political pressures of government ownership, but the Farm Credit System also experienced

their ability to diversify capital investments is limited. *Id.* Finally, workers will not be expected to manage in a way that minimizes residual losses, but will otherwise arrive at decisions and control managers in ways predicted by public choice theory. *Id.*

[176] Froomkin, *supra* note 6, at 558–59.

insolvency due to the rent transfers it was pressured to give.[177] Many federally created corporations are characterized by mixed ownership.[178] Mixed ownership is an arrangement in which the government owns a significant stake in the company but many of the shares may be publicly traded, and the President of the United States frequently obtains the right to appoint directors whether or not the government actually owns shares.[179] In such companies, private market prices reflect obligations as though the company's debt is supported by an implicit government guarantee, despite the presence of express disclaimers from the government that this is not the case.[180]

The cases of Fannie Mae and Freddie Mac are therefore instructive. Although they were not owned by the government until the government took them under conservatorship in 2008, the control the government exercised over these firms prior to the bailout demonstrates how the government will use its controlling equity powers in bailed-out TARP firms. Fannie Mae and Freddie Mac issue debt to investors and then create mortgage-backed securities based on pools of mortgages obtained primarily from lenders at banks that actually originate the mortgages.[181] The public has always assumed that Fannie Mae and Freddie Mac's obligations are backed by the federal government.[182]

Other writers have observed that Fannie Mae's enjoyment of an implicit federal subsidy operates as a rent because Fannie Mae's access to capital at a resultantly discounted rate affords Fannie Mae a politically-created competitive advantage.[183] Some regulatory benefits that are frequently given to governmentally created corporations, and which Fannie Mae and Freddie Mac enjoyed, include immunity from state taxes, immunity from antitrust laws, immunity from SEC disclosure laws, and more generous capital requirements.[184] These benefits may come in the form of explicit statutory protections or in the form of implicit benefits through lax enforcement or implicit guarantees. For most of its existence, the dedicated regulator overseeing Fannie Mae and Freddie Mac had few strong enforcement or regulatory

[177] *Id.* at 586.
[178] *Id.* at 555.
[179] *Id.*
[180] *See id.*
[181] Carrie Stradley Lavargna, *Government Sponsored Enterprises are Too Big to Fail: Balancing Public and Private Interests*, 44 HASTINGS L.J. 991, 1002 (1993).
[182] *Id.* at 1011.
[183] Froomkin, *supra* note 6, at 580.
[184] *Id.* at 584, 604.

powers.[185] Another way that government-controlled companies can exert influence is through their ability to hire former government officials directly. This was a particularly strong technique for Fannie Mae and Freddie Mac.[186] The singular exception to the regulatory benefits that government-controlled firms receive, particularly in the area of disclosure, may be that when the firm comes closer to the edge of insolvency, the problem may eventually become too large to hide. For example, although Fannie Mae and Freddie Mac long enjoyed securities disclosure exemptions,[187] they came under pressure to register with the SEC in 2002 and soon became embroiled in a scandal in 2003 lasting through 2005, which grew as the companies neared insolvency in 2007 and 2008.[188]

Treasury officials repeatedly expressed that the Treasury did not stand behind Fannie Mae's debt.[189] Yet the market's assumption that this was not true became something of a self-fulfilling prophecy, as the government eventually bailed out Fannie Mae and Freddie Mac. The implicit guarantee permitted Fannie Mae and Freddie Mac to borrow more cheaply than their risk profile should have allowed, and that access to cheap capital permitted them to expand their portfolio even further. By statute, securities of Fannie Mae and Freddie Mac must include a disclaimer that the securities are not guaranteed by the United States.[190] Yet in December 2009, the Treasury, in its most recent announcement regarding the government guarantee of Fannie Mae and Freddie Mac, announced that it was willing to provide an explicit and unlimited guaranty of Fannie Mae and Freddie Mac's debt because it determined that the guaranty of $400 billion, offered at the time of conservatorship in 2008, was insufficient.[191] The presence of this implicit federal guaranty distorted the price of the firm's securities.[192]

Estimates of the rents Fannie Mae obtained from its implicit Treasury guaranty range from up to 0.75% on its borrowing, and estimates of the subsidy transferred through to consumers as an interest

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185 Reiss, *supra* note 76, at 1033–35.
186 Koppell, *supra* note 95, at 101.
187 *Id.* at 1056.
188 *Id.* at 1036–38.
189 Reiss, *supra* note 76, at 1045.
190 *Id.* at 1023.
191 Davis et al., *supra* note 8, at A1.
192 *See* Benjamin A. Templin, *The Public Trust In Private Hands: Social Security and the Politics of Government Investment*, 96 KY. L.J. 369, 411 (2008).

group center around roughly 0.25%.[193] Thus Fannie Mae passed through its rents but did not permit the government to extract its full rents. This is consistent with McChesney's view of rent extraction because he does not argue that governments will be able to extract all rents but will be limited in their ability to do so.[194] It is possible that Fannie Mae's market power partially permitted greater bargaining leverage, and the more competitive field of 600 TARP financial firm recipients will compete for government-conferred rents in such a way as the government will be able to extract the full amount of politically created rents, and possibly even assets, of the companies privately obtained.

Some may argue that the passage of financial reform legislation through the Dodd-Frank Wall Street Reform and Consumer Protection Act will make it more difficult for the government to bail out firms, even those in which it holds an ownership interest. This is an inaccurate reading of the Act. The Act will not be able to limit the government's ability to bail out firms. In fact, it explicitly permits the Financial Stability Oversight Council the authority to relax bailout restrictions in the bill.[195] In any case, the executive branch would be free to ignore any remaining restrictions because no party would have the standing to obtain an injunction to stop the bailout.[196] Furthermore, a bailout like that passed through Congress in 2008 is also possible because Congress can amend prior law to facilitate a future bailout. Indeed, a constitutional amendment is likely the only constraint that might limit the prospect of government bailout, as the express statutory restrictions on the bailout of Fannie Mae and Freddie Mac turned out to be little more than empty promises in 2008.

The rent transfer system at Fannie Mae and Freddie Mac was explicitly written into its charter, with each interest group that obtained rents represented by a director from their groups among the President's nominees.[197] The President was given the authority to appoint five of the eighteen directors on the board, one of which had to be from the home-building industry, one from the mortgage-lending industry, and one from an organization representing low-income borrowers.[198]

193 Froomkin, *supra* note 6, at 600.

194 McChesney, *supra* note 61, at 109.

195 *See The New Lords of Finance*, WALL ST. J., May 24, 2010, at A16.

196 *See* Verret, *Treasury Inc.*, *supra* note 4, at 311.

197 *See* Reiss, *supra* note 76, at 1054–55.

198 *Id.*

Another rent that government-controlled entities may enjoy is that their securities are given preferences when the government regulates the investments of other entities that purchase the debt or equity of the government-controlled firm. For example, Fannie Mae and Freddie Mac debt was granted the same status by statute as Treasury bonds under fiduciary investor laws and the Federal Reserve regulation of lenders through capital requirements.[199] In much the same way, to give government-backed firms a hand, the Federal Reserve, the OCC, and the FDIC could easily use their supervisory powers to make inappropriately low assumptions about the risk of investments in the assets of bailed-out firms to give institutions investing in those assets a lower capital requirement. This system of preferences has continued into 2010, as the Dodd-Frank Act has exempted securities issued by Fannie and Freddie from the Volcker Rule's bank proprietary trading restrictions.[200]

Some have observed that Fannie Mae and Freddie Mac have used their market power to force firms with which they did business to agree to include in their own contracts with customers terms that were considered by political actors to be pro-consumer.[201] Similarly, a government-controlled entity like GM could use its leverage over suppliers to force their cooperation with emission requirements or employment policies in excess of regulatory requirements and beyond the equilibrium outcomes of that market.

Another concept that some have addressed in this context is whether the state action doctrine would apply to bailout recipients by virtue of the government's controlling interest.[202] For Fannie Mae and Freddie Mac, the state action doctrine has been determined to apply in some respects.[203] If the state action doctrine applies, then the constraints of the Constitution will apply to that entity, so that, for instance, the anti-discrimination strictures of the Bill of Rights will apply. In that case, for example, Citigroup would have to meet the enhanced Constitutional requirements such as not disciplining employees without the opportunity for a hearing, guaranteeing freedom of speech for employees, and respecting privacy rights of em-

[199] *Id.* at 1060–64.

[200] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 619 (2010).

[201] Reiss, *supra* note 76, at 1079.

[202] *See, e.g.*, Stefan Padfield, *Finding State Action when Corporations Govern*, 82 TEMP. L. REV. 703 (2009); *see also* Templin, *supra* note 192, at 381.

[203] *See* Templin, *supra* note 192, at 388–89.

ployees.[204] State action doctrine application would represent a significant cost for the bailed-out entities. This, however, would do little to limit rent-seeking behavior because rent seeking is not unconstitutional. If it were, the field of public choice may never have been necessary in the first place. Thus state action doctrine application is not particularly relevant in the context of the problems explored in this Article.

In some ways the government's control over bailed-out firms is even greater than the control it enjoyed over government-sponsored enterprises like Fannie Mae and Freddie Mac. In the case of Fannie Mae, the President did not have unfettered authority to replace a majority of the board, but merely the right to appoint a minority of Fannie Mae directors subject to restrictions on their backgrounds.[205] This right, combined with the regulatory authority exercised by both the Office of Federal Housing Enterprise Oversight (OFHEO) and the Treasury and the implicit guarantee, did provide the government with a significant measure of control.[206] In contrast, with respect to many TARP recipients, the government does have the ability to elect a majority of the board who can unilaterally replace executives.[207] This equity power in the bailed-out entities facilitates the government's ability to make binding rent-seeking and rent-transfer bargains with the bailed-out firms because the government has the assurance that firm executives will keep to the bargain out of fear of replacement. Indeed, it also gives the government greater discretion to increase the demands of original bargains and push for further rent transfers. The government's implicit guarantee may also be easier at a firm that the government has already bailed out because the justification that the taxpayer's investment will be lost otherwise may resonate more powerfully with the public. Analysis from Moody's credit rating service in fact indicates the market's understanding that when the government exercises a heightened level of control over a company, its implied obligation to guarantee that company's debt is assumed to similarly increase.[208]

Administrative law and private causes of action against the government are one solution to rent seeking. The hope behind those reforms is that interest groups who may otherwise be unable to affect the political process may be represented through counsel or may at

[204] *See id.*
[205] See Reiss *supra* note 76, at 1054–55.
[206] *See id.* at 1035.
[207] *See* Verret, *Treasury Inc.*, *supra* note 4, at 300–01.
[208] Reiss, *supra* note 76, at 1052.

least have an incentive to submit comment letters in the rule-making process. As will be discussed, many of the controls put into place to limit the public choice challenges to agency and legislative action like administrative law, White House Office of Management and Budget (OMB) review of agency rules, and judicial challenges, are evaded by the government's exercise of power through its TARP holdings as an alternative to formal regulatory action. The observations in the next Part will help support this Article's consideration of an alternative method for limiting the reach of government power into the business decisions of bailout recipients in the form of ownership trusts.

IV. THE LIMITS OF ADMINISTRATIVE LAW

This Part will consider how the bailout bill and the Treasury and the Federal Reserve's execution of the bailout under the new legislation, as well as other programs these two bureaus initiated, interact with the restrictions of administrative law and other limits on agency action.

The Emergency Economic Stabilization Act of 2008 (EESA) created several new entities. First, the EESA established the Office of Financial Stability within the Treasury[209] and granted this office the authority to implement the programs described within the EESA subject to the approval of the Secretary of the Treasury.[210] The EESA then established three new entities to oversee the Treasury's implementation of the EESA: the Financial Stability Oversight Board (FSOB),[211] the Congressional Oversight Panel,[212] and the Special Inspector General for TARP (SIG TARP).[213] Additionally, the EESA vested oversight power in the existing office of the Comptroller General,[214] who is the director of the Government Accountability Office.

The threshold inquiry in analyzing the policymaking responsibilities of these entities is whether their actions fall under the mandates of the Administrative Procedure Act (APA). The EESA provided that any actions of the Secretary of the Treasury, and through him, the Office of Financial Stability, would be subject to judicial review under the APA.[215] In creating and empowering the entities above, however,

[209] Emergency Economic Stabilization Act of 2008, H.R. 1424, 110th Cong. §101 (2008).
[210] *Id.*
[211] *Id.* § 104.
[212] *Id.* § 125.
[213] *Id.* § 121.
[214] *Id.* § 116.
[215] H.R. 1424 § 119.

the EESA did not specifically subject *their rulemaking* actions to the APA.

In *Citizens to Preserve Overton Park, Inc. v. Volpe*, the Supreme Court held that the APA applies to the actions of any agency of the federal government unless clear and convincing evidence exists to show that Congress sought to exclude the actions of that agency from the APA.[216] The Court affirmed this holding in *Heckler v. Chaney*, when it held that, despite the presumption of APA applicability, Congress may affirmatively preclude APA applicability if Congress expressed such intent.[217] The EESA contains no such affirmative preclusion, and therefore the APA applies to any rulemaking authorized by the EESA. Additionally, the only practical manner through which to challenge such a rulemaking would be through a judicial challenge under the APA, which the EESA technically authorizes subject to the wide exceptions below.

The focus of this Part is on the Treasury, since the EESA's only authorization for direct action applies to the Treasury. Any dictate from the Treasury that is considered a "rule" is subject to the APA and must provide for notice and comment procedures. Any informal directive or suggestion from the Treasury that is not a "rule" is not subject to administrative constraints.

The next question is which Treasury actions are "rulemakings" under the APA. The APA defines a "rule" as "an agency statement of general or particular applicability and future effect" either "designed to implement, interpret, or prescribe law or policy" or "describing the organization, procedure, or practice requirements of an agency."[218] According to *Sugar Cane Growers Cooperative of Florida v. Veneman*, a leading administrative law case, the key concept is that a rule must be of "future effect."[219] So, for example, if the Treasury merely exercises its power under the EESA to buy stock warrants in Goldman Sachs, this can be considered a one-time action without future effect and therefore not a rule. On the other hand, if the Treasury announces that only institutions with a market capitalization of ten billion dollars will be eligible for federal support through TARP, this has future effect on policy and would be considered a rule. This is why the Treasury's purchases of stock warrants in individual companies, such as its initial purchases from ten institutions on October 28, 2008, are not rulemakings and therefore not subject to notice and comment.

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[216] 401 U.S. 402, 410 (1971).
[217] 470 U.S. 821, 830 (1985).
[218] Administrative Procedure Act, 5 U.S.C. § 551(4) (2006).
[219] *See* 289 F.3d 89, 95–96 (D.C. Cir. 2002).

Whether or not one of the Treasury's actions is in fact considered "rulemaking," if the Treasury's exercise of power through its equity holdings is implicit and based on the threat of replacing the board of directors or executives at a bailed-out firm, there may be little basis to review the Treasury's exercise of authority. Indeed, the Treasury may not always need to actually exercise that authority but instead could indicate its preferences and rely on the firm's executives to compete to meet those preferences without the need for official communication or action from the Treasury. In addition, the exercise of power at a particular firm may not necessarily meet the "future effect" requirement for administrative review. Finally, the restrictions on equitable action in the EESA would limit administrative law review even if Treasury's exercise of power were held to be a "rulemaking."

The empowering language of the EESA is broad. Specifically, it authorizes the Treasury to "purchase, and to make and fund commitments to purchase, troubled assets from any financial institution."[220] But the initial concept of the EESA was for the Treasury to insure "troubled" assets of major financial firms, not purchase equity in those firms.[221] Nevertheless, only eleven days after the EESA was passed, the Treasury announced the Capital Purchase Program (CPP),[222] which rather than ensuring or purchasing troubled assets, involved direct purchases of equity. The other major program instituted by the Treasury under its EESA powers is the Systemically Significant Failing Institutions (SSFI) Program; on November 25, 2008, the Treasury issued guidelines for the program, which is "designed to provide stability and to prevent disruption to financial markets from the failure of a systemically significant institution."[223] The Treasury used the SSFI program to purchase stock and stock warrants in AIG.[224]

Although informal directives or policy suggestions from the Treasury to TARP recipients are not subject to the constraints of the APA, this is not to say, however, that such communication is without significance. In their article "Regulation by Deal: The Government's Response to the Financial Crisis," Steven Davidoff and David Zaring argue that, rather than regulating through the rulemaking process, the government has used the financial crisis to regulate the financial

[220] H.R. 1424 § 101(a).
[221] *See id.* § 102.
[222] U.S. DEP'T OF THE TREASURY, FIRST TRANCHE REPORT TO CONGRESS 2–3 (2008).
[223] U.S. DEP'T OF THE TREASURY, THIRD TRANCHE REPORT TO CONGRESS 2 (2008).
[224] *Id.*

industry through deal making.[225] The authors point to the interventions authorized by the EESA, as well as to the government-brokered purchases of Bear Stearns by J.P. Morgan-Chase and Wachovia by Bank of America, as the means by which the government has set new rules for the financial sector, most notably the introduction of the "too-big-to-fail" doctrine and the preference for bondholders over shareholders.[226] Davidoff and Zaring identify flexibility and speed as the benefits of the deal-making approach but note that replacing rulemaking with deal making avoids the open government policies of administrative law, including notice, comment, judicial review, and measured action.[227]

Existing scholarship and precedent suggests that if the United States owns more than half of the outstanding common equity of a corporation, or has the power to appoint a majority of that company's board of directors, that company is a state actor for purposes of the Constitution and the APA.[228] This would apply to AIG and Fannie Mae in particular. But there is also countervailing scholarship and precedent suggesting that unless the actions of the corporation fulfill a traditionally governmental objective, that corporation should not be considered a state actor.[229] Given the applicable law, it is unlikely that the Supreme Court would find that AIG is a state actor. Even if the state actor doctrine is in effect, it would do little to limit the problems examined in this article. As a general matter, rent seeking is not

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[225] Steven Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 466–67 (2009).

[226] *Id.* at 474.

[227] *Id.* at 468.

[228] *See* Froomkin, *supra* note 6, at 561. Early nineteenth century cases set the doctrine for when a federal corporation is an agency. The Court set forth the modern statement for the doctrine in *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374 (1995). *Id.* The basic test to determine whether a federal corporation is an agency is the finding of a "sufficiently close nexus" between the government and the challenged action—based on whether the actor was relying on government assistance, whether the actor was performing a traditional government function, or whether the injury was incident to government authority. *Id.* at 564; Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1033 n.378 (2005) (citing Horvath v. Westport Library Ass'n, 362 F.3d 147, 153 (2d Cir. 2004)). Some courts use a more flexible approach, looking for indicia of control, such as a majority of government appointees on the board, government funding, government approval of rules or policies, or government supervision. Nagy, *supra*, at 1041. Where the government has taken a temporary debt or equity position in a company, a weaker case for calling the entity part of the state exists. Froomkin, *supra* note 6, at 569 n.132–33. But *Lebron* suggests that in a mixed-ownership federal corporation, if the United States owns more than half of the shares, or otherwise has control, the entity should be considered a state actor. *See id.* at 572.

[229] *See* discussion and sources cited *supra* note 228.

actionable under constitutional restrictions on government power. Indeed, if that were the case, rent seeking would not be as prevalent as it is and the public choice literature may never have developed in the first place.

The question of whether action by the Treasury constitutes rulemaking is part of the analysis, but the ability to challenge those rules is significantly modified by the immunity provisions of the EESA. The EESA's judicial review provision is somewhat schizophrenic. On one hand, the EESA provides that "actions by the Secretary [of the Treasury] pursuant to the authority of this Act shall be subject to chapter 7 of title 5, United States Code [the APA judicial review provision]."[230] The EESA then states that "such final actions shall be held unlawful and set aside if found to be arbitrary, capricious, an abuse of discretion, or not in accordance with law,"[231] mirroring the standard of judicial review found in the APA.[232] The EESA, however, then provides that "no injunction or other form of equitable relief shall be issued against the Secretary for actions pursuant to section 101, 102, 106, and 109, other than to remedy a violation of the Constitution."[233] The sections referenced are the primary sections empowering the bailout.[234] Since the most important aspects of relief under the APA are equitable,[235] this latter provision seems to invalidate the first provision.

The notes of the drafters of the legislation in the House seem to suggest that the House intended judicial review to be available, stating that the relevant EESA section "[p]rovides standards for judicial review, including injunctive and other relief, to ensure that the actions of the Secretary are not arbitrary, capricious, or not in accordance with law."[236] On the other hand, when considered in light of the broad exemptions, the EESA reporting requirements and provisions for oversight of the Treasury's actions by the SIG TARP, the FSOB, the Congressional Oversight Panel, and the Comptroller General seems to indicate that the EESA was designed to rely on over-

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[230] Emergency Economic Stabilization Act of 2008, H.R. 1424, 110th Cong. § 119(a)(1) (2008).

[231] *Id.*

[232] 5 U.S.C. § 706(2)(a) (2006).

[233] H.R. 1424 § 119(a)(2)(A).

[234] *See id.* §§ 101, 102, 106, 109.

[235] *See* 5 U.S.C. § 706.

[236] H. COMM. ON FIN. SERVS., 111TH CONG, SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION 4 (2009), *available at* http://financialservices.house.gov/EESABill_section-by-section.pdf.

sight, rather than judicial review, to constrain the Treasury's actions. The Treasury's need for speed also reflects Davidoff and Zaring's concept of regulation by deal making—in which the government must be able to negotiate deals without the specter of judicial review of the final product. It is worth mentioning here that the entire financial crisis and federal bailout has transpired without a single major judicial decision. Suits have been brought to enjoin mergers between corporations such as the Wachovia, Bank of America, and Wells Fargo, but there have been no challenges to the Treasury's actions.

It is unclear how government positions and agencies like the Congressional Oversight Panel or the SIG TARP will alter the public choice dynamic in place. Their only power stems from their ability to issue reports. Assuming their interests do not become captive to the incentives of the bureaucrats and political actors with whom they coordinate, and who nominate them, the reports may serve to minimize informational asymmetries about the performance of government-controlled corporations. If, however, the Congressional Oversight Panel and the SIG TARP do become captivated by those dynamics, then the reports may simply serve to facilitate political actors' ability to force firms to transfer rents to interest groups.

In sum, administrative law and legal challenges to government decisions as a controlling investor offer little in the way of substantive constraints on the government's discretion. There may be a way to limit some, though not all, of the drawbacks to government control of companies through the use of ownership trusts as intermediary buffers between the government investor and the bailed-out company. The next Part will examine that possibility.

V. OWNERSHIP TRUSTS AS A PARTIAL REMEDY

The EESA not only authorizes the Treasury to purchase assets, it also grants the "authority to manage troubled assets purchased under this Act, including revenues and portfolio risks therefrom."[237] Congress introduced bipartisan legislation in both the Senate[238] and the House[239] to amend the EESA management provision to allow the Treasury to delegate management of TARP assets to a trust managed on behalf of U.S. taxpayers. Entitled the TARP Recipient Ownership Trust Act ("TARP ROTA"), the legislation would require the Presi-

[237] H.R. 1424 § 106(b).
[238] S. 1723, 111th Cong. (2009).
[239] H.R. 3594, 111th Cong. (2009).

dent to "appoint 3 independent trustees to manage the equity held in trust, separate and apart from the United States government."[240] It also provides that the trustees "have a fiduciary duty to the American taxpayer for the maximization of the return on the investment of the taxpayer made under the [EESA] in the same manner and to the same extent that any director of an issuer of securities has with respect to its shareholders under the securities laws and all applications of State law"[241] and that the trustees "shall serve at the pleasure of the President, and may be removed for just cause in violation of their fiduciary responsibilities only."[242] The TARP ROTA also sets an exit date of December 2011 for all TARP investments, with the exception of AIG.[243] The legislation is novel from a corporate law perspective because it subjects federal trustees to state corporate law doctrines of fiduciary duty. The provisions are novel from an administrative law perspective because of their constraint on the President's power to remove his appointed trustees.

Many of the provisions in the TARP ROTA are designed to minimize the public choice incentives that both political actors and agency bureaucrats face. For one, having an explicit exit date for the trustees' investments seems intended to limit the disparity in timing for benefits and costs that leads successive government regulators to discount the costs of transfers and evade accountability for those costs after their term. The independent nature of the trust is also intended to reduce the trustees' interests in sharing rent-seeking incentives of interest groups and political actors. This article will consider whether that is actually achievable, but first, it will consider the constitutionality of the trust provisions.

The starting point for analysis of congressionally imposed restrictions on the President's ability to remove his appointees is administrative law's presumption of the unitary executive—that in order for the President to be able to fairly perform his executive function, the power to appoint officers must include the power to remove them at the President's discretion. Indeed, the early twentieth-century case of *Myers v. United States* stands for this proposition.[244] But the growth of the administrative state included the creation of "independent" federal agencies, such as the Federal Reserve, designed to be somewhat immune from presidential coercion. In 1988, the Supreme Court

[240] *Id.* § 3(b)(1).
[241] *Id.* § 3(c)(3).
[242] *Id.* § 3(b)(2)(B).
[243] *Id.* § 3(d)(1).
[244] *See* 272 U.S. 52, 115 (1926).

held in *Morrison v. Olson* that Congress could limit the President's ability to remove an appointee for "good cause," so long as the independence thereby conferred on that appointee did not impermissibly interfere with the President's constitutional duty to execute the law.[245] But the Supreme Court has never ruled on or upheld a removal limitation that is any more restrictive than "good cause."[246] Thus an open question exists as to the constitutionality of the TARP ROTA's limitation of removal to violations of fiduciary duty only. Under *Morrison*, the provision is presumably unconstitutional if it impermissibly interferes with the President's constitutional duty to execute the law.[247]

Agency statutes are typically silent about the grounds for removal of officers.[248] Those statutes that do provide grounds for removal, including the statutes creating the FTC[249] and SEC,[250] typically copy the language of the Act to Regulate Commerce of 1887, which states that officers can be removed for "inefficiency, neglect of duty, or malfeasance in office."[251] The concept of removal for breach of duty, therefore, has a long history. But the Court has not defined the terms "neglect of duty," "malfeasance in office," or "inefficiency."[252] Additionally, the presumably more limiting provision of removal only "for cause" has never been defined[253] or even been challenged in court.[254]

What, then, are the bounds of the President's discretion? In *Wiener v. United States*, the Court suggested that removal "for cause" had to involve the "rectitude" of an official, not merely a policy disagreement with the President.[255] But leading administrative law scho-

[245] 487 U.S. 654, 689–90 (1988).

[246] Michael A. Carvin et al., *Massive, Unchecked Power by Design: The Unconstitutional Exercise of Executive Authority by the Public Company Accounting Oversight Board*, 4 N.Y.U. J. L. & BUS. 199, 220 (2007).

[247] 487 U.S. at 689–90.

[248] Marshall J. Berger & Gary J. Edles, *Established by Practice: The Theory and Operation of Independent Federal Agencies*, 52 ADMIN. L. REV. 1111, 1144 (2000).

[249] 15 U.S.C. § 41 (2006).

[250] 15 U.S.C. §78d (2006). *See also* MFS Secs. Corp. v. S.E.C., 380 F.3d 611, 619 (2d Cir. 2004).

[251] Interstate Commerce Act, ch. 104 § 11, 24 Stat. 379, 383 (1887); Berger & Edles, *supra* note 248, at 1144.

[252] Lawrence Lessig & Cass Sunstein, *The President and the Administration*, 94 COLUM. L. REV. 1, 110 (1994).

[253] *Id.*

[254] Tracy A. Hardin, *Rethinking Independence: The Lack of an Effective Remedy for Improper For-Cause Removals*, 50 VAND. L. REV. 197, 199 (1997).

[255] 357 U.S. 349, 356 (1958).

lars argue that "for cause" removal offers the President significant discretion. Lawrence Lessig and Cass Sunstein contend that removal "for cause" as well as "neglect of duty" or "malfeasance in office" allows the President "substantive supervision" and the ability to discharge officers who "acted in ways inconsistent with the President's wishes with respect to what is required by sound policy."[256] Peter Strauss argues that under a "for cause" standard, a court could sustain removal of an independent agency officer for refusing to follow a presidential directive.[257] If the President's removal power truly is this broad, even under the "for cause" standard that *Morrison* blessed, then the removal limitation in the TARP ROTA may be unconstitutional. If, however, "for cause" restricts the President to grounds based on "failure in trust," rather than "breach of discipline,"[258] then the Constitution may allow room for the TARP ROTA provision.

During the execution of the bailout, the government actually created an ownership trust to house its investment for one bailout recipient, demonstrating some of the pitfalls to a poorly designed trust structure. The Federal Reserve established an ownership trust to manage its investment in AIG.[259] Recent news reports have highlighted the Treasury's delegation of authority to an independent trust that manages the government's interest in AIG.[260] In the deal documents authorizing the exchange of Citigroup preferred shares for the government's voting equity, the Treasury highlighted a plan for a similar trust arrangement for management of the government's interest in Citigroup.[261] Over two years later, that trust still has yet to be created.

When he was still the president of the Federal Reserve Bank of New York (FRBNY), Secretary Timothy Geithner established the AIG Credit Facility Trust Agreement ("AIG Trust").[262] This trust gives

[256] Lessig & Sunstein, *supra* note 252, at 111.

[257] Peter Strauss, *The Place of Agencies in Government: Separation of Powers and the Fourth Branch*, 84 COLUM. L. REV. 573, 667 n.402 (1984).

[258] *Id.* at 615.

[259] *See* J.W. Verret, *Testimony Before the House Oversight Committee Concerning the AIG Trust* 1 (George Mason L.& Econ. Research Paper Series, Paper No. 09-27, 2009), *available at* http://ssrn.com/abstract=1408188.

[260] *See e.g.* Edmund L. Andrews, *3 Trustees of A.I.G. Are Quiet, Perhaps to a Fault*, N.Y. TIMES, Apr. 20, 2009, at B1.

[261] *Id.*

[262] *See* FED. RESERVE BANK OF N.Y., AIG CREDIT FACILITY TRUST AGREEMENT § 2.03 (Jan. 16, 2009), *available at* http://www.newyorkfed.org/newsevents/AIGCFTAgreement.pdf.

three trustees ("AIG Trustees") the power and responsibility for managing and disposing of the federal government's shares in AIG.[263]

A number of provisions in the AIG Trust are controversial. The AIG Trust protects the AIG Trustees from liability if they act lawfully and in "the best interests of the Treasury."[264] It further indemnifies the AIG Trustees "for any loss, cost or expense of any kind or character whatsoever," so long as the AIG Trustees had no reasonable cause to believe their actions were unlawful.[265] Finally, the AIG Trust removes standard fiduciary duties the AIG Trustees have to the other shareholders.[266] For example, the AIG Trust does not employ the standard practice of prohibiting company directors from taking advantage of business opportunities that may be of use to the company they serve for private benefit. The AIG Trust states that no trustee will be obligated to "present any business activity, investment opportunity (or so called corporate opportunity) or prospective economic advantage to the FRBNY, the Treasury or [AIG], even if the opportunity is of the character that, if presented to the FRBNY, the Treasury or [AIG], could be taken by it."[267] The annual compensation for each of the trustees is $100,000 a year.[268] Removal provisions restrict the Federal Reserve's ability to remove the trustees only "for cause."[269]

The removal limitations in the TARP ROTA might help to eliminate some of the public choice constraints on trustees. And yet the bureaucrats at independent agencies have the same removal limitation, but are still the focus of much of the public choice evidence cited above. The term limits in the TARP ROTA are a good first step to limit the ability of trustees to create rent-seeking and rent-transfer networks. The provision in the TARP ROTA providing for an explicit exit date may minimize some of the term-related issues analyzed in this article with respect to bureaucrat's incentives in controlling and guaranteeing firms, particularly if the term limit coincides with the term of the administrative official overseeing the program, or at the very least the term of a President.

One of the issues underlying the analysis in McChesney, Tullock, Stearns and Zywicki, and other scholars' views on rent seeking which deserves further thought, and which would inform this analysis,

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[263] *Id.*
[264] *Id.* § 2.05(a).
[265] *Id.* § 3.03(d).
[266] *Id.*
[267] *Id.* § 3.05(b).
[268] FED. RESERVE BANK OF N.Y., § 3.04(a).
[269] *Id.* § 3.02.

would be the time period required for rent-seeking networks to develop. For instance, McChesney mentions that newly elected politicians can more easily threaten to vitiate prior bargains with rent-seeking firms,[270] and Tullock notes that firms will compete for rents in ways that actually dissipate those rents for the firms.[271] But the length of time required for the individuals involved to develop reputational capital with each other, commitment mechanisms, specialization, and learning will affect the time period necessary for rent-seeking networks to develop.

In the midst of unverifiable information or information asymmetries about the value of rents to firms, or the absence of the quantifiable threat that a rent-extraction attempt by a legislator actually poses to a firms' earnings, networks of relationships between firms, interest groups, lobbying groups, and elected officials develop through which all of the rent seekers and rent providers negotiate over the value of the rents provided. As such, trust becomes an inherent part of those negotiation networks and the development of mutual trust takes time. One simple explanation is the game theory example of repeat competitions in the absence of external bonds as vital to establishing trust between players. But the question is how long it takes for those networks to establish. Although a TARP recipient may have lobbied the government prior to its taking government backing, the precise dynamic of its interaction with government and interest groups would be entirely novel at the point of bailout. As such, establishing the trust necessary to facilitate rent-seeking and transfer activities may take time even if established networks existed prior to the bailout. Some analysis of the time window for those activities may shed more light into the time limits for full privatization of the government's ownership, which may be advisable. For instance, it may be the case that Fannie Mae's rent-seeking networks are so deeply established at this point that no form of trust holdings will solve the problem, whereas, the government did not own Bank of America long enough to establish networks, it was able to exit TARP and repay its bailout funding more easily and therefore would have been an ideal bailout recipient for which ownership through an intermediary trust could have served to limit rent seeking costs.

A limited term for the trust written into its authorizing charter is one of the best options to limit political conflicts for trustees. The TARP ROTA sets a specific date by which the government must liqui-

[270] McChesney, *supra* note 61, at 102.

[271] Tullock, *Efficient Rent Seeking*, *supra* note 57, at 103–07.

date its positions in many firms, with the exception of AIG.[272] Another approach for future trusts could be to set the expiration date as coinciding with the National Bureau of Economic Research Business Cycle Dating Committee's determination at the National Bureau of Economic Research that a recession has ended, something to the effect that the government's position will need to be "sold out one year after the next determination by the Business Cycle Dating Committee that the economy is no longer in recession."

Another method to try and evade the public choice problems of government ownership is to require that members of the government-ownership trust be high net-asset individuals who have finished their careers in the private sector. If assertions about the diminishing marginal utility of wealth are credible, nominees might be expected to be at the high end of that curve.[273] As such, private rent-seeking behavior is not likely to motivate their decision to volunteer for service as a trustee, as the benefits to them may not measure up in their individual work or leisure-indifference curves.[274] The question then remains, why would they serve as a trustee? Two incentives are readily apparent, neither of which are readily quantifiable. One rests on notions of public service—giving back to the community after the accretion of wealth, which seems to be a bedrock principle of many high net-worth individuals informing their philanthropy. The other would be reputational benefits—that the challenge of managing the taxpayer's investment, and turning around the failed institutions bailed-out by the government, presents a unique opportunity for bragging rights for retired Wall Street executives.

The indemnification provisions in the U.K. Limited Trust[275] established to manage its bank bailout and the Federal Reserve's AIG Trust for trustees is highly relevant to this motivation. Trustees motivated to serve by reputational or public-service goals may nevertheless remain concerned about placing their private wealth, as well as wealth similarly budgeted toward social philanthropy causes, at risk through their service. In the absence of a clear indemnification provision in the ownership trust documents, the candidates for service

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[272] H.R. 3594, 111th Cong. § 3 (2009).

[273] *See* Richard A. Easterlin, *Income and Happiness: Towards a Unified Theory*, 11 ECON. J. 465, 473 (2001).

[274] *See id.*

[275] *See* OFFICE FOR NATIONAL STATISTICS, PUBLIC SECTOR INTERVENTIONS IN THE FINANCIAL CRISIS 40 (July 2009), *available at* http://www.statistics.gov.uk/articles/nojournal/Financial-crisis.pdf. *See also* Verret, *Separation of Bank and State, supra* note 50.

may face a tradeoff between use of funds toward philanthropy goals and use of funds to underwrite the costs of legal defense. What is clear, however, is that if the indemnification is contingent on abiding by a fiduciary duty to the best interests of the Treasury, as is the case with the AIG trust, then the government can threaten to withhold indemnification of trustees to exert leverage over them and vitiate the intent of the trust.

That is not to say that the generous indemnification provisions included in both the AIG Trust and the U.K. Limited Trust are required to achieve that end. A restriction on indemnification, similar to that required in Delaware corporations, to permit indemnification only for actions taken in a good faith decision to advance the interests of the entity could serve the same purpose.[276] Such a provision might streamline the incentives of the trustees toward maximizing the value of the taxpayer's investment while at the same time ignoring political pressure from the Treasury and the Congress to accede to political pressure to facilitate rent seeking or off-budget transfer activity.

One question apparent in the issue of using liability rules to narrow the interests of trustees would be determining which parties have standing to sue the trustees. The question of trustee indemnification is moot unless someone can sue the trustees. It is unclear who might have standing and the desire to do so if the trustees are bending to the political will of the government actors who appointed them. This could overburden the trust with a torrent of litigation. Taxpayer standing to challenge policy decisions in the spending and stewardship of the taxpayer's interest has been severely constrained for that very reason.

Taxpayer standing is fraught with problems, and though it might be an option to grant by statute it is typically otherwise strongly limited in the courts.[277] One method that may be workable would be to grant standing to the Attorney General of the United States, but again, his interest in punishing trustees for bending to the political will of the executive branch may be limited because of conflicts he faces as a political appointee. An alternative method may be to grant standing to the fifty state attorneys general to sue on behalf of their state pension funds in the event that their pension funds invest in

[276] Karl E. Stauss, *Indemnification in Delaware: Balancing Policy Goals and Liabilities*, 29 DEL. J. CORP. L. 143, 155 (2004).

[277] *See* Templin, *supra* note 192, at 417.

TARP recipients under shareholder-control-person liability.[278] Another option is to provide standing for *qui tam* actions that relate to shareholder-control-person liability for employees at bailout recipients.[279] Some have argued that courts are not subject to the same public choice challenges as the legislative and executive branches, and as such could be in a better position to stop actionable rent-seeking behavior.[280]

Legislation can provide a very narrow set of plaintiffs with standing to sue the trustees for violation of their fiduciary duties. State pension funds have vast holdings, and one might expect that the majority of TARP recipients have state pension funds as investors. The TARP trustees, as controlling shareholders of many of the TARP recipients, will have fiduciary duties to the other shareholders in the TARP recipients that are also publicly traded, as most of them are. If the bailout bill were amended to give standing to state attorneys general to sue the trustees of the TARP trust for violations of the fiduciary duty to their fellow shareholders and if it were alleged that those trustees were acceding to political pressure, those facts may limit the universe of plaintiffs such that the accountability method would be more manageable and cost-effective. State pension funds face political conflicts of their own in their exercise of shareholder power.[281] But where that power is constrained in its application to merely fiduciary duty lawsuits, the political conflicts may be less important.

A limitation on the President's ability to remove the trustees seems advisable to break the rent-seeking cycle in this context. Several of the independent agencies, such as the SEC, the FBI, and the CIA, have a similar limitation on the President's power to remove where it has been deemed advisable to maintain an independent agency.[282] A financial industry work-experience requirement, similar to that required for members of the Canadian Pension Plan Board, may also be advisable.[283] A prohibition against any member of the government, or anyone who has worked in government in the recent

[278] For a thorough analysis of controlling shareholder liability in the context of TARP recipients, see generally Verret, *Treasury Inc.*, *supra* note 4.

[279] *See* Templin, *supra* note 192, at 420.

[280] *See* Donald Boudreaux & A.C. Pritchard, *Reassessing the Role of the Independent Judiciary in Enforcing Interest Group Bargains*, 5 CONST. POL. ECON. 1, 2 (1994).

[281] *See generally* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993) (discussing political influence on public pension funds).

[282] Templin, *supra* note 192, at 391.

[283] *Id.* at 400.

past, should apply to membership on the board of trustees.[284] Although a limited term for the trust is still this Article's primary recommendation, in the event that the trust has an indefinite life it should, at the very least, contain staggered terms for members so that no single President can stack the board.[285] This, in combination with a limitation on removal powers, will limit rent seeking because even if trustees entered into bargains with legislators in advance they could not be held to those bargains. Or, the board of trustees can be set up such that its membership is half nominated by each party, similar to the FEC.

Another provision in the AIG Trust that should be replicated in future trusts is the provision that the expenses of the trust should be covered by the firms themselves rather than by budgets approved by the government. This will limit any budget growth incentives the trustees may otherwise have.

At first blush, compensating the trustees in a manner commensurate with compensation for managers of private wealth might seem consistent, as it may give them incentives to maximize the value of the taxpayer's investment. But where the presence of an implicit guarantee and where the other politically-conferred rents can be capitalized into the value of the firm's securities, it would give the trustees an incentive to facilitate that behavior. It might also encourage them to facilitate use of the bailed-out firm as a vehicle for rent transfer of a percentage of those rents, if it was part of the bargain. Alternatively, it may lead the government to agree to sever the link between compensation and performance as part of the rent-seeking bargain. Both of these problems were, and continue to be, present at Fannie Mae and at Freddie Mac.[286]

An alternative method explored in this Article may simply be mandating that the trustees only vote in accordance with a proportional voting policy. The government's securities would then be voted in proportion to the percentages of votes of all other shareholders in the firm. If sixty percent of the non-government shareholders voted in favor of board incumbents and forty percent voted against them, the government trustees would be required to also vote sixty percent of the government's shares in favor of management nominees and forty percent of the shares against them. This voting

[284] *Id.*

[285] *See id.* at 402.

[286] *See* Lucian A. Bebchuk & Jesse Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Non-Performance Pay, and Camouflage*, 30 J. CORP. L. 807, 807 (2004).

method has similarly been recommended in the analogous area of broker-street voting.[287]

In her recent paper, Professor Emma Coleman Jordan argues for an approach diametrically opposed to the approach offered in this Article.[288] Jordan argues in favor of placing public directors onto the boards of TARP recipients.[289] She would place solely individuals with public sector careers onto the boards of directors of TARP recipients.[290] She justifies her approach in part on the basis of the need to restore the "trust of the American public."[291] She also justifies it on the basis of maintaining corporate accountability to taxpayer shareholders.[292] Throughout the paper the analysis shifts between a profit-maximization focus of stopping bailout recipients from taking imprudent risks and a social-welfare focus of making the business community more diverse.[293]

She also argues that the representation of government appointees on bailout-recipient boards should be in proportion to the funding received by the firm as a percentage of its market capitalization.[294] This ignores the state corporate law structure under which bailout recipients are organized, which do not provide for proportional representation as a default, and the proxy machinery under which companies solicit votes, which also does not provide for proportional voting and instead mandates that shareholders in most circumstances have the opportunity to vote in proportion to their voting equity holdings for all board of directors candidates.

Jordan also argues that these public directors should be required to display a history of public service and show intellectual and background diversity, including a mandate that the public directors have a

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[287] U.S. S.E.C. BRIEFING PAPER: ROUNDTABLE ON PROXY VOTING MECHANICS (May 23, 2007), http://www.sec.gov/spotlight/proxyprocess/proxyvotingbrief.htm. The United States Thrift Savings Fund, a government run pension plan, also has a shareholder voting restriction which limits the government's flexibility to vote its shares. *See* Deborah Weiss, *The Regulation of Funded Social Security*, 64 BROOK. L. REV. 993, 1000 (1998).

[288] *See* EMMA COLEMAN JORDAN, CTR. FOR AM. PROGRESS, A FAIR DEAL FOR TAXPAYER INVESTMENTS: PUBLIC DIRECTORS ARE NECESSARY TO RESTORE TRUST AND ACCOUNTABILITY AT COMPANIES RESCUED BY THE U.S. GOVERNMENT 1–3 (Sept. 2009), *available at* http://www.americanprogress.org/issues/2009/09/pdf/public_directors.pdf.

[289] *Id.* at 1.

[290] *Id.* at 2.

[291] *Id.* at 1.

[292] *Id.*

[293] *See, e.g.*, *id.* at 2, 15.

[294] JORDAN, *supra* note 288, at 2.

history of experience outside of the economic sector.[295] But aside from a general allegation that private sector directors engage in "groupthink," she fails to link her assertion with any evidence that the public directors will enhance the earnings prospects of the TARP recipients.[296] She also makes a faulty assumption common to many supporters of the corporate social-responsibility movement that "socially responsible goals," which are often poorly defined, are congruent with the wealth-maximization norm and offer the accountability advantages of the wealth-maximization norm, both of which are often lacking in support.[297]

A primary criticism of her view is that, without some kind of reliable buffer between political actors and TARP recipients, the public choice challenges examined in this Article would remain. A secondary, and far more powerful, critique of her argument is that her suggestion would, by a significant order of magnitude, exacerbate the public choice problems of government-controlled firms as it would add new rent seekers to the dynamic, potentially increasing the competition for rents and increasing rent-dissipation costs.

First, public interest careerists are the most highly prone to the bureaucratic careerism issues examined previously. Jordan assumes that the taxpayer's interest and the interest of directors appointed by political actors coincide,[298] but this faulty assumption must at least address the public choice critiques of government decision making to have any resonance. Public interest careerists would be the most motivated individuals to use their position to facilitate post-exit opportunities for employment. Second, public directors would be the appointees with the most experience in coordinating with elected officials to facilitate expropriation of rents as well as coordinating with elected officials to coordinate their granting of politically conferred rents through exchange.

Professor Jordan's proposal would only increase rent-seeking costs. The verdict on ownership trusts appears to be mixed. If properly designed, they may be able to minimize some of the drawbacks to government ownership of firms if properly designed. And though

[295] *Id.*

[296] *Id.*

[297] *See id.* at 2; *see also* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1430 (1993); Robert B. Reich, *The Case Against Corporate Social Responsibility* (Goldman Sch. of Pub. Policy Working Paper Series, Paper No. 08-003, 2008), *available at* http://ssrn.com/abstract=1213129.

[298] *See* JORDAN, *supra* note 288, at 6.

some tweaks may be required to the TARP ROTA, it appears to be a step in the right direction.

VI. CONCLUSION

The government's ownership stakes in bailout recipients is the result of a predictable political calculation. Where the government has offered injections of capital on terms as generous as the bailout of 2008, politicians may have felt that the political backlash would be untenable without creating instruments sufficient to give the taxpayer an opportunity to reap the benefits of share-price appreciation once the financial crisis receded and the government's backing allowed the bailout recipients to return to profitability. This Article does not endorse the decision to bail out firms in 2008, nor does it endorse the government's decision to take equity stakes in bailed-out firms. The question it has attempted to address is how to manage the aftermath of those decisions from an ownership and governance perspective in light of the public choice dynamics that can be expected to develop.

The consequence of the Treasury's decision to take equity stakes in bailed-out firms is that government political actors and bureaucrats now have an unprecedented level of control over the productive resources of the American economy. The instances of government pressure addressed by various media outlets hint at the costs that control could mean for taxpayer returns and economic efficiency. The insights of public choice theory, particularly as they are adapted in this Article to the unique circumstance of government ownership of equity, provide an even stronger basis for concern.

The threat on the horizon is that many of the bailed-out firms will settle into a dynamic similar to that seen in Fannie Mae and Freddie Mac, and use their politically conferred rents to subsidize transfers of resources off of the federal budget to politically powerful interest groups. Even worse, they may become so strongly captured by their government owners that they become vehicles for transfer of their privately held rents and other assets, and thereby become fully dependant on the government's implicit backing to remain solvent. This Article's analysis of bureaucratic and political actor incentives reveals that the implicit guarantee, though it is unlikely to endure, can do so long enough to give multiple presidential administrations and Congresses an incentive to continue the feedback loop. That is not to say that all bailed-out firms will inevitably go the way of Fannie Mae and Freddie Mac, but the threat is nevertheless too great to ignore in light of this Article's analysis.

Independent trusts, similar to those intended by the TARP ROTA, have some limited potential to serve as a buffer between the government and private firms and alleviate the public choice conflicts of direct government ownership. This will require a careful construction of the trusts, as well as careful consideration of the incentives of those who serve as trustees. This analysis stands in marked contrast to the contrary suggestion of Professor Jordan that bailout recipients should be required to have "public directors" that the government controls.