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GOVERNMENTAL INTERVENTION IN AN ECONOMIC CRISIS

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INTRODUCTION

Optimists about the efficacy of the 2010 financial reforms, known as the Dodd-Frank Act, sometimes claim that the reforms have permanently ended bailouts.¹ Pessimists retort that the Dodd-Frank Act did not end

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1. For instance, when he signed the Dodd-Frank Act into law, President Obama proclaimed that the reforms had ended taxpayer-funded bailouts forever. Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act, 1

bailouts at all—some insisting it actually enshrines them in law—and that bailouts could truly be ended if lawmakers rolled back the legislation and enacted a different set of reforms.² The two camps find common ground in the belief that, with the right set of government policies, bailouts will be a thing of the past.

We reject such aspirations as both fanciful and destructive. We count ourselves among the bailout realists who believe that bailouts could never be eliminated unless lawmakers banned debt finance and required banks and other firms to finance themselves entirely with equity.³ In this country, at least, debt will always be with us and so too will the prospect of bailouts. It may be possible to make bailouts less likely, but we cannot make them disappear altogether.

Despite the unrealistic claims made by both sides, the debate between Dodd-Frank optimists and pessimists has raised two important questions that are relevant not just to financial institutions, but also to government intervention in an economic crisis generally. First, and most basic, what exactly is a bailout? The term seems intuitive, but it is used in very different ways in both the public press and the academic literature. For example, the recent effort to tar the Puerto Rico debt adjustment scheme as a “bailout” attempted to label the proposed legislation, which one group of investors did not support, as a bailout regardless of whether there would be good reason to invoke that term.⁴ Second, if bailouts have not been

PUB. PAPERS 1087 (July 21, 2010). A former Federal Reserve governor recently made a similar claim. Alan S. Blinder, *Why Trump, the 'King of Debt,' Hates Dodd-Frank*, WALL ST. J. (June 6, 2016), <http://www.wsj.com/articles/why-trump-the-king-of-debt-hates-dodd-frank-1465254435> [<https://perma.cc/2ZUZ-3HG3>].

2. See, e.g., Peter J. Wallison, Letter to the Editor, *Dodd-Frank Hasn't Eliminated TBTF Banks*, WALL ST. J. (June 14, 2016), <http://www.wsj.com/articles/dodd-frank-hasnt-eliminated-tbtf-banks-1465937932> [<https://perma.cc/T36F-X4FK>] (“[T]he only recourse [when faced with a failing trillion-dollar bank] under Dodd-Frank is a taxpayer bailout.”); Representative Jeb Hensarling, Remarks of Chairman Jeb Hensarling to the Economic Club of New York As Prepared for Delivery (June 7, 2016) (transcript available at http://financialservices.house.gov/uploadedfiles/hensarling_ny_econ_club_speech_june_7_2016.pdf) [<https://perma.cc/98N7-TWP4>] (“Dodd-Frank codified into law Too Big to Fail and taxpayer-funded bailouts”).

3. Such a ban would have to extend to all promises to pay money in the future and would sweep defined benefit pension plans within its orbit, at least where such plans are not fully funded in advance. Indeed, the financial distress that afflicts many cities and states today has been caused in large part by unfunded promises to pay retirement benefits. See, e.g., Robert Novy-Marx & Joshua D. Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, 23 J. ECON. PERSP. 191, 204 (2009) (calculating various possible outcomes and estimating the median outcome for underfunded pension obligations at approximately \$3 trillion).

4. See Jonathan Mahler & Nicholas Confessore, *Inside the Billion-Dollar Battle for Puerto Rico's Future*, N.Y. TIMES (Dec. 19, 2015),

eliminated, how should they be managed? When should the government intervene, what are the ground rules for effective intervention, and when should the government exit the scene? Rather than engaging in the snipe hunt of eliminating all possibility of a bailout, we should work to reduce bailouts to the lowest level practical and embrace principles to guide the inevitable bailouts that will occur.

The first question, what-is-a-bailout, turns out to be a key point of contention in the Dodd-Frank debate, although the debate usually is not framed in these terms. Title II, the Dodd-Frank Act's resolution provisions, gives regulators a vast source of U.S. Treasury funding to finance the resolution of troubled, systemically important financial institutions.⁵ For many Dodd-Frank pessimists, this automatic (or nearly automatic) governmental funding is a bailout, plain and simple. Not so fast, say the optimists. If the resolution works as intended, the troubled institution will repay the government in full and American taxpayers will be entirely unharmed. And if the institution cannot repay what it owes, the Dodd-Frank Act requires that the difference be collected through an assessment on other large financial institutions, thus sparing the general fisc.⁶

These two perspectives reflect different conceptions of what constitutes a bailout.⁷ The Dodd-Frank pessimists tend to assume that, any time the government steps in with funding and does not let the market run its course, it has provided a bailout. The optimists assume that, if the government is acting solely as a lender of last resort and honors traditional lender of last resort principles, its funding does not constitute a bailout. According to the classic test, which is associated with nineteenth century economic journalist Walter Bagehot, the lender of last resort should lend money if the institution is illiquid, but not if it is insolvent.⁸ To solve a

<http://www.nytimes.com/2015/12/20/us/politics/puerto-rico-money-debt.html> [<https://perma.cc/KW75-243A>] (noting that hedge funds had mobilized opposition to Puerto Rico's debt restructuring plan by casting it as a taxpayer-funded bailout).

5. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(n), 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act] (codified as amended at 12 U.S.C. § 5390(n) (2016) (effective Oct. 8, 2016)) (permitting the FDIC to borrow ten percent of the pre-resolution value of a financial institution placed in receivership under Title II, and ninety percent of its post-intervention value).

6. Dodd-Frank Act § 210(o) (codified at 12 U.S.C. § 5390(o) (2015)).

7. The arguments of a more sophisticated version of bailout pessimism reflect a conception of bailouts that is closer to the optimists' view. Sophisticated pessimists argue that regulators may fail to recoup losses from the other firms in the industry, and that even if they do, the assessments are an indirect tax.

8. Anthony J. Casey & Eric A. Posner, *A Framework for Bailout Regulation*, 91 NOTRE DAME L. REV. 479, 522 (2015) (citing WALTER BAGEHOT, *LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET* 188-89 (Hartley Withers ed., E. P. Dutton & Co.

liquidity crisis, Bagehot argued, the lender of last resort should provide large amounts of funding, but should obtain enough collateral to fully secure the loan and should charge a high interest rate to ensure the institution has an incentive to repay the loan promptly.⁹ If things go as planned, the lender eliminates the crisis at no long-term cost to the taxpayer.

Although we find the Bagehot test persuasive, it is notoriously difficult to distinguish between insolvency and illiquidity in the heat of the moment, and pure liquidity crises are uncommon. We will therefore use a somewhat broader definition of bailout, a conception that is closer to pessimists' view in practice. If the government provides funding, and this funding protects creditors or shareholders from losses that they would otherwise suffer, we will call the intervention a bailout, regardless of whether the government actually loses any money in the effort.¹⁰ This definition is much easier to apply than the liquidity/insolvency distinction and focuses more directly on the principal concern with bailouts: the risk that investors will lend too cheaply and will fail to monitor the institution if they expect to be bailed out in a crisis.¹¹

Under our definition of what constitutes a bailout, most of the government's interventions in 2008 and 2009 were bailouts. Some were good bailouts and others were bad,¹² but nearly all were bailouts of one flavor or another. The government stepped in, put money on the table, and prevented losses to some, if not all, of the investors of the bailed-out entity.

By contrast, and contrary to the vehement claims of hedge funds that hold Puerto Rico debt, enacting a bankruptcy-like restructuring framework for Puerto Rico and its municipalities was not a bailout. If the framework is used, Puerto Rico's creditors will bear losses, and no class of investors will be rescued. The restructuring framework is in some respects precisely

1920)).

9. *Id.*

10. For a similar definition, *see id.* at 48 (stating that a "bailout occurs when the government makes payments (including loans, loan guarantees, cash, and other types of consideration) to a liquidity-constrained private agent in order to enable that agent to pay its creditors and counterparties, when the agent is not entitled to those payments under a statutory scheme.").

11. From this perspective, it remains debatable whether the Title II resolution will lead to bailouts. Under the single point of entry approach, which the Federal Deposit Insurance Corporation has signaled that it intends to use, derivatives and other short-term debt will be protected, whereas bond debt will be restructured. Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614 (proposed Dec. 18, 2013). In a sense, the short-term debt will be bailed out. But if the FDIC fully commits to this treatment in advance, the approach gives a pre-defined priority to short term debt and is not necessarily a bailout.

12. A view we will defend later. *See infra* Part II(A).

the opposite of a bailout, since it may reduce the pressure for Congress to provide a genuine bailout. Indeed, failing to give Puerto Rico a debt restructuring option would have made it more likely that the federal government would have had to inject funds into the Commonwealth to prevent a complete collapse.¹³ The desire for a true bailout appears to have been the principal reason some bondholders tried to thwart the restructuring law by calling *it* a bailout.

If future bailouts are inevitable, as we and many others believe, the second question raised by the recent debate—how best to manage bailouts—becomes critically important. A bailout is like a military or rescue operation. When a crisis looms, the government needs to determine whether to intervene, how to structure its bailout investment, how to manage the investment, and when to exit. Things are likely to go better if there is agreement on broad principles in advance rather than an assiduous effort to deny the risks of future bailouts until they are actually upon us.

In this article, we focus on the management question and consider the full range of bailout management issues. Quite surprisingly in our view, this Article seems to be one of the first to do so. The debate between Dodd-Frank optimists and pessimists considers many of these issues in the context of resolution under the Dodd-Frank Act's resolution rules, but it has less to say about bailouts outside of that context. Scholars have addressed particular features of governmental intervention, such as the potential distortions introduced by government control, more extensively.¹⁴ However, they have not offered a full account of government

13. The dire situation on the Commonwealth may well demand an infusion of federal funds to stave off a collapse of the island's basic operations. One of us has argued that restructuring debt, standing alone, is probably not sufficient to solve the territory's woes. See Robert K. Rasmussen, *Puerto Rico: Of Capital Structures, Control Rights and Liquidity*, 11 CAP. MKTS. L.J. 228, 243 (2016) (suggesting that structural changes such as the development and enforcement of pro-growth policies are necessary as well).

14. See generally, e.g., Marcel Kahan & Edward Rock, *When the Government is the Controlling Shareholder: Implications for Delaware*, 35 DEL. J. CORP. L. 409 (2010) (discussing the implications of sovereign immunity on Delaware law); Matthew R. Shahabian, Note, *The Government as Shareholder and Political Risk: Procedural Protections in the Bailout*, 86 N.Y.U. L. REV. 351 (2011) (discussing the political risks for shareholders emanating from the government's status as a major shareholder of firms); J.W. Verret, *The Bailout Through a Public Choice Lens: Government-Controlled Corporations as a Mechanism for Rent Transfer*, 40 SETON HALL L. REV. 1521 (2010) [hereinafter Verret, *Government-Controlled Corporations*] (arguing that the government, in its capacity as a shareholder, will be able to put political pressure on firms to cater to political constituencies); J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. REG. 283 (2010) [hereinafter Verret, *Treasury Inc.*] (arguing that the Troubled Asset Relief Program (TARP) bailout and government shareholding will reshape many facets of the practice of corporate law).

intervention.¹⁵

In our effort to fill this gap, we divide the bailout process into three general stages: the decision to intervene, the implementation of the bailout, and the exit. With the initial bailout decision, we argue that political accountability is the key feature, which requires that the bailout be transparent and that the government articulate the reasons for intervening. By this yardstick, the \$700 billion TARP legislation in 2008 was successful, and the car company bailouts less so. At the implementation stage, we argue that the government should honor investors' priorities to the extent possible, and we propose a simple, transparency-based standard for distinguishing between legitimate and illegitimate exercise of governmental control. Although forcing an executive to step down may seem heavy-handed, it is transparent and consistent with the power wielded by private lenders in other contexts, and therefore should be in the government toolbox. Intervention in a company's operations, by contrast, is far less transparent and therefore should be viewed as illegitimate. With exit, we argue that the government should begin easing out of its investment as soon as conditions stabilize, since the primary objective of a bailout is containment.

Given the extraordinary nature of bailouts, it is of course always possible that regulators will intervene in problematic ways, even if the bailout is otherwise defensible. On multiple occasions, the 2008 and 2009 bailouts seemed to take liberties with existing law. This raises the question of whether government intervention should be subject to judicial review. We argue that it should, but that the scope of review should be considerably narrower than it is for transactions between private parties in order to minimize interference with emergency interventions.¹⁶ It is essential that courts identify deviations from existing law, however, even if they ultimately conclude that liability is not appropriate. Judicial candor can reduce the risk that extraordinary governmental interventions will distort the legal framework that applies to similar transactions in more ordinary circumstances. By this yardstick, courts' performance during and after the crisis has been quite mixed.

This article proceeds as follows. In Part I, we briefly review the major governmental interventions in 2008 and 2009 and identify some of the

15. *But see* Casey & Posner, *supra* note 8, at 481 (offering a relatively complete account, though focusing primarily on the threshold decision whether to affect a bailout and less on its implementation).

16. David Zaring recently reached a similar conclusion about the need for review. *See* David Zaring, *Litigating the Financial Crisis*, 100 VA. L. REV. 1405, 1431-32 (2014) (advocating for judicial review of government emergency actions in light of standing issues and emergency limitations not equally applicable in private litigation).

apparent departures from ordinary law in the transactions that the government arranged. In Part II, we develop our framework for well-designed governmental intervention. In Part III, we consider the appropriate scope of judicial review of bailouts. We briefly sum up in the conclusion.

I. THE GOVERNMENT'S ROLE IN 2008 AND 2009

Nearly a decade after the 2008 crisis, the government's intervention remains almost as contested and controversial as it was at the time. Much of the debate centers on the question of when, if ever, it is appropriate for the government to provide rescue financing to major institutions during a financial crisis, and we too will devote considerable attention to this issue. But there is another, closely related issue as well: to what extent should government intervention be constrained by existing law? Several of the biggest bailouts of 2008 and 2009 seemed to take liberties with the laws that applied to the transactions in question. Is this simply inevitable, or should the government's actions be subject to challenge during or after a crisis?

We begin this part by briefly describing the debate over the 2008 and 2009 bailouts. We then note the questionable features of several of the key interventions, and the efforts by interested parties to challenge the transactions. Our objective at this point is primarily descriptive. We will offer a normative perspective on the issues in the parts that follow.

A. *The Bailout Debate*

A little less than a year after the first tremors of the financial crisis began, bank regulators bailed out the investment bank Bear Stearns in March 2008, providing a \$29 billion guarantee to facilitate Bear's sale to JPMorgan Chase.¹⁷ In August 2008, the U.S. Treasury took over Fannie Mae and Freddie Mac, eventually giving them \$187.5 billion of rescue financing and putting them in conservatorship pursuant to legislation that had been enacted several weeks earlier.¹⁸ Several days after letting Lehman

17. For a brief case study of the Bear Stearns bailout, see David A. Skeel, Jr., *Governance in the Ruins*, 122 HARV. L. REV. 696, 733-42 (2008) (reviewing CURTIS J. MILHAUPT & KATHARINA PISTOR, *LAW AND CAPITALISM* (2008)). This and the other governmental interventions are chronicled in the many books that came out of the crisis, the best known of which is ANDREW ROSS SORKIN, *TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES* (2009).

18. Housing and Economic Recovery Act of 2008 (HERA), Pub. L. No. 110-289, 122