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SUBPRIME BAILOUTS AND THE PREDATOR STATE

Steven A. Ramirez

INTRODUCTION

According to Senator Dick Durbin, the Senate Majority Whip, the banking industry is the “most powerful lobby” in Congress and “they frankly own the place.”¹ Congressman Collin C. Peterson, the chair of the House Agriculture Committee, maintains that derivatives regulation is problematic in Congress because “[t]he banks run the place.”² President Obama pledged that his administration would include no lobbyists, and then promptly waived his own new rules so that a former Goldman Sachs lobbyist could be the Chief of Staff for the Secretary of the Treasury.³ In the election of 2008 the banking and investment banking industry contributed to both the Democratic and Republican candidates: according to Opensecrets.org, Senator John McCain’s top five campaign contributors were all large financial institutions.⁴ President Barack Obama received even more contributions, from essentially the same financial firms, totaling more than \$3.5 million.⁵ Financial interests as a whole spent \$450 million to lobby policymakers in 2008.⁶ So it should come as little surprise that when the Obama Administration drafted proposals for the reform of financial regulation, in June of 2009, it included bank executives and lobbyists in its deliberations.⁷ It also raises fundamental questions about the trillions in government commitments lawmakers made in late 2008 and early 2009 to save our financial sector from mass bankruptcy.⁸

The influence of the banks presents a challenge to the legal system.

¹ Frank Rich, *Obama’s Make or Break Summer*, N.Y. TIMES, June 21, 2009, at WK8 (quoting Senator Dick Durbin).

² Gretchen Morgenson & Don Van Natta, Jr., *Even in Crisis, Banks Dig in for Battle Against Regulations*, N.Y. TIMES, June 1, 2009, at A1.

³ Fredreka Schouten, *Exceptions to Ethics Rules Under Scrutiny*, USA TODAY, Jan. 29, 2009, at 4A.

⁴ Opensecrets.org, Top Contributors to John McCain, <http://www.opensecrets.org/pres08/contrib.php?cycle=2008&cid=n00006424> (last visited Nov. 20, 2009).

⁵ Opensecrets.org, Top Contributors to Barack Obama, <http://www.opensecrets.org/pres08/contrib.php?cycle=2008&cid=N00009638> (last visited Nov. 20, 2009).

⁶ Opensecrets.org, Washington Lobbying Grew to \$3.2 Billion Last Year, Despite Economy, <http://www.opensecrets.org/news/2009/01/washington-lobbying-grew-to-32.html> (last visited Dec. 28, 2009).

⁷ Stephen Labaton, *Obama Sought a Range of Views on Finance Rules*, N.Y. TIMES, June 16, 2009, at A1.

⁸ Economists have recognized that corruption, career aspirations, or personal prestige may lead policymakers to bailout financial institutions in times of strife. GARY H. STERN & RON J. FELDMAN, *TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS* 53 (2009).

The legal system as advertised holds that no man (or corporation) is above the law.⁹ Our government is “a government of laws, and not of men.”¹⁰ Among other things, this means that legal rules are announced in advance, with clarity, not changed *ex post*; market actors face the same rules regardless of their wealth or political influence, and no economic actor has the power to change the rule in light of an unpleasant economic outcome.¹¹ Simply stated, if a business enterprise faces insolvency then it must face the legal consequences of insolvency, which should not be averted through a government rescue.¹² Otherwise, economic incentives are distorted as creditors begin to respond to government guarantees (implicit or explicit) with an expanded supply of credit, and management becomes less risk averse in view of the government’s guarantees of failure.¹³ Competitors, in turn, will seek to become too-big-to-fail (“TBTF”) so that they too may enjoy government guarantees and a lower cost of capital.¹⁴ Some competitors will be unable to compete with large subsidized rivals and will fail.¹⁵ This massive distortion of incentives undermines the primary virtue of free markets: the creation of incentives and disincentives for maximum human productivity.¹⁶ Nevertheless, in 2008-2009, the U.S. government expended massive funds and made massive guarantees to the financial sector, which ultimately benefited reckless bank managers and creditors who had not bargained for a government guarantee of the funds they extended to risky financial firms.¹⁷ This practice brazenly violated any

⁹ Scholars have long recognized that interest groups with concentrated members and concentrated wealth have superior incentives to organize and therefore benefit disproportionately from the legislative process. MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 2, 11, 165 (1971) (stating that very large groups will not pursue organizations to influence public goods like law because rational actors will instead assume that they can free ride on the efforts of others).

¹⁰ See *Marbury v. Madison*, 5 U.S. 137, 163 (1803).

¹¹ See BRIAN Z. TAMANAHA, *ON THE RULE OF LAW: HISTORY, POLITICS, THEORY* 65-66 (2004) (noting that stripped of all its technicalities the rule of law means that government acts only in accordance with “rules fixed and announced before-hand [which allows one] to plan one’s individual affairs on the basis of this knowledge”) (quoting Friedrich Hayek).

¹² Until recently, it was thought that banks facing insolvency are put into receivership under the supervision of the Federal Deposit Insurance Corporation (“FDIC”). Robert R. Bliss & George C. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation*, 2 VA. L. & BUS. REV. 143, 145 (2007). Other firms facing insolvency are subject to the federal bankruptcy code. *Id.* at 160.

¹³ STERN & FELDMAN, *supra* note 8, at 2, 17-18, 23-24.

¹⁴ See *id.* at 20-42. Recently, the debt of Goldman Sachs has traded at more narrow credit spreads relative to Treasury debt. *A Tale of Two Bailouts*, WALL ST. J., July 16, 2009, at A13.

¹⁵ See Ricardo J. Caballero et al., *Zombie Lending and Depressed Restructuring in Japan*, 98 AM. ECON. REV. 1943 (2008), available at <http://www.atypon-link.com/doi/abs/10.1257/aer.98.5.1943> (finding that “zombie” firms, that is firms that would be insolvent without assistance, are associated with reduced investment in non-“zombie” competitors).

¹⁶ Indeed, laissez faire enthusiasts have long argued that the maintenance of appropriate incentives was the primary reason society must tolerate high inequality and otherwise unacceptable levels of poverty. Steven A. Ramirez, *Bearing the Costs of Racial Inequality: Brown and the Myth of the Equality/Efficiency Trade-Off*, 44 WASHBURN L.J. 87, 90 (2004).

¹⁷ Banks that are deemed TBTF have an advantage in the capital markets and many bank mergers are apparently pursued to attain TBTF status rather than the operating efficiencies. STERN & FELDMAN, *supra* note 8, at 32-33.

reasonable concept of the rule of law.¹⁸ There was no announced law that the government would save the creditors and managers of particular banks that would be deemed TBTF, only an “inchoate public policy notion that certain institutions are so large or so complex that the government will intervene and prevent their failure by protecting uninsured creditors”¹⁹ Today, this lawlessness creates even more risk, as the TBTF banks are even bigger and thus present even more systemic risk.²⁰

The bailouts of the financial sector of 2008-2009 also do not enjoy support from macroeconomic science. The government faced a variety of means and alternatives to dealing with the financial crisis.²¹ Maintaining “zombie banks”²² at the apex of our financial sector lacked evidence of a reasonable prospect of macroeconomic success because such banks cannot supply the credit needed for growth.²³ Banks faced with the prospect of insolvency will become risk averse and clamp down on lending.²⁴ If they enjoy sufficient market power they will seek to squeeze additional profits from their customers.²⁵ They may seek to postpone their insolvency through various machinations with respect to their balance sheet.²⁶ They may hoard capital to guard against further losses.²⁷ They may reduce their workforce to cut costs.²⁸ All of this is adverse to macroeconomic performance, over the

¹⁸ As Professor Tamanaha suggests the “thinnest” version of the concept of the rule of law would only require that “whatever a government does, it should do through laws.” TAMANAHA, *supra* note 11, at 92 (quoting Noel B. Reynolds). “Understood in this way, the rule of law has no real meaning, for it collapses into the notion of rule by the government.” *Id.* Every government world-wide would satisfy this promiscuous standard for defining the rule of law, and over the course of history such notoriously outlaw states as the southern Confederacy or Nazi Germany would conform to the rule of law. *See id.* In short, the rule of law would be worthless for securing human well-being.

¹⁹ Yomarie Silva, Comment, *The “Too Big to Fail” Doctrine and the Credit Crisis*, 28 REV. BANKING & FIN. L. 115, 115 (2009).

²⁰ David Cho, *Banks ‘Too Big To Fail’ Have Grown Even Bigger*, WASH. POST (Maryland), Aug. 28, 2009, at A01.

²¹ William F. Stutts & Wesley C. Watts, *Of Herring and Sausage: Nordic Responses to Banking Crisis as Examples for the United States*, 44 TEX. INT’L L.J. 577, 626-27 (2009) (outlining major differences between the U.S. efforts to resolve financial crisis in 2008-2009 compared to relatively costless government resolution in Sweden and Norway).

²² Zombie banks are banks that are insolvent but remain in a near life condition due to government subsidies. *See* EDWARD J. KANE, *THE S & L INSURANCE MESS: HOW DID IT HAPPEN?* 4 (Martha Burt et al. eds., 1989).

²³ Paul Krugman, *Banking on the Brink*, N.Y. TIMES, Feb. 23, 2009, at A27.

²⁴ Kelly Evans, *Bank Clampdown Dogs Economy: Lending Standards Keep Tightening, Increasing the Risk of a Prolonged Recession*, WALL ST. J., Nov. 4, 2008, at A3.

²⁵ *See* Julia Kollewe, *George Soros Warns ‘Zombie’ Banks Could Suck Lifeblood out of Economy*, April 7, 2009, <http://www.guardian.co.uk/business/2009/apr/07/george-soros-zombie-banks>.

²⁶ Susan Pulliam & Tim McGinty, *Congress Helped Banks Defang Key Rule*, WALL ST. J., June 3, 2009, at A1.

²⁷ Martin Feldstein, *America’s Mortgage Meltdown*, Aug. 27, 2009, <http://business.smh.com.au/business/americas-mortgage-meltdown-20090826-ezub.html> (“When home owners default, banks lose money, and uncertainty about the extent of future defaults undermines confidence in banks’ capital, making it harder for them to raise funds and causing them to reduce lending to conserve their resources.”).

²⁸ “During the last three months of 2008, the largest banks that received taxpayer loans announced more than 100,000 layoffs.” *Bailout Banks Sought More Foreign Workers*, CBSNEWS.COM, Feb. 2, 2009, <http://www.cbsnews.com/stories/2009/02/02/business/main4768439.shtml>.

short term. Over the longer term, once the zombie banks become accustomed to their privileged status as wards of the state they are apt to gamble for resurrection and undertake very risky lending in vain hope that more risk could pull their firms out of the government's care.²⁹ The government subsidies at the heart of the TBTF approach create industry-wide distortions in incentives and excessive risks.³⁰ Thus, economies burdened with zombie banks frequently suffer adverse economic consequences for years to come.

This article will show that the bailouts of 2008 and 2009 were contrary to the rule of law as well as sound economics, and that the law must respond to this gross injustice by imposing a regime in accordance with notions of the rule of law and rationalizing any future government assistance to failing firms which present systemic risk.³¹ Part I will review the details of the bailouts of 2008-2009, highlighting the many ways in which they violated the rule of law, appropriately conceived. Part II will demonstrate that while the economy required government intervention to avoid a cataclysm, it did not require the subprime bailouts that occurred. Part III will articulate a rationalized legal framework that should govern bailouts, based upon the use of civil and criminal sanctions to impose disincentives upon managers of firms flirting with TBTF status. These proposed sanctions impose costs directly upon the CEOs of firms that have permitted their business to become so large and complex that it imposes fiscal and macroeconomic costs upon society in general. The goal is a match between penalties and costs. The chasm between an optimized approach to government bailouts and the legal reality of the bailouts forms the foundation for the conclusion of this article: the rule of law must govern government assistance going forward to prevent further bailouts driven purely by political power and economic caprice.

I. THE SUBPRIME BAILOUTS OF 2008-2009

In what can only be described as an orgy of reckless financial management, a number of very large financial firms pursued short-term profits without regard to risks borne by their firms in one of the greatest

²⁹ During the late summer of 2009, banks recommenced risky lending. Kristen Haunss & Jody Shenn, *Leverage Rising on Wall Street at Fastest Pace Since '07 Freeze*, BLOOMBERG.COM, Aug. 28, 2009, http://bloomberg.com/apps/news?pid=20601087&sid=a_XpcU5pY0f4.

³⁰ Professor Arthur E. Wilmarth, Jr., warned in 2002 that large financial firms would exploit the "generous subsidies" available to firms deemed TBTF and that both regulatory pressure and market discipline were unlikely to curb "formidable risks" that federal funds would be needed to bailout such firms. Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 476 (2002).

³¹ According to the most sophisticated business observers, "taxpayers can only guess at the specific reasons behind the ad hoc rescues that began with Bear Stearns in March of 2008" and regulators refuse to disclose the underlying facts that may have driven their decisions. *Who's Too Big to Fail?*, WALL ST. J. ONLINE, Sept. 13, 2009, <http://online.wsj.com/article/SB10001424052970204731804574386932897872954.html>.

credit bubbles in history, starting in 2004 and continuing through 2007.³² Much of this excessively risky credit found its way into the U.S. residential real estate market via subprime loans.³³ Managers seemingly lost all concern for the well-being of their firms and their shareholders in the pursuit of obscenely large compensation payments or golden parachute payments.³⁴ Various managers exploited the real estate and credit bubbles in various ways, but essentially, managers ignored clear risks in the vain hope that easy money would keep the party going indefinitely.³⁵ By the spring of 2007, however, the music stopped playing, and with the party winding down the inevitable hangover meant one thing for ordinary Americans: economic crash.³⁶ Moreover, the reckless lending in America soon infected the entire global financial system and ultimately caused a global synchronized recession costing trillions in foregone output.³⁷

The first expenditure of federal funds in support of a failed financial institution involved the collapse of Bear Stearns (a large investment bank) in the spring of 2008. The Federal Reserve System (the “Fed”) initially agreed to lend billions to Bear Stearns through JPMorgan Chase on March 14, 2008.³⁸ Shortly thereafter, Bear Stearns merged with JPMorgan Chase for \$10 a share or less than 10 percent of Bear Stearns’ market value just months before.³⁹ The Fed facilitated the merger through \$30 billion in special financing.⁴⁰ The Fed took control of a portfolio of Bear Stearns assets amounting to \$30 billion.⁴¹ JPMorgan Chase would bear the first \$1 billion of any losses associated with the Bear Stearns assets, and the Fed would

³² See Steven A. Ramirez, *Lessons from the Subprime Debacle: Stress Testing CEO Autonomy*, 54 ST. LOUIS U. L. J. (forthcoming 2009) (manuscript at 6-9, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1364146).

³³ *Home Mortgages: Recent Performance of Nonprime Loans Highlights the Potential for Additional Foreclosures: Hearing Before the J. Econ. Comm.*, 111th Cong. 2-3 (2009) (statement of William B. Shear, Director Financial Markets and Community Investments), available at <http://www.gao.gov/new.items/d09922t.pdf> (“Nonprime mortgage originations grew rapidly from 2000 through 2005 before sharply contracting in mid-2007 . . .”).

³⁴ Ramirez, *supra* note 32, at 66-67.

³⁵ Citigroup CEO Chuck Prince famously stated: “‘When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.’” Michiyo Nakamoto & David Wighton, *Bullish Citigroup Is ‘Still Dancing’ to the Beat of the Buy-Out Boom*, FIN. TIMES, July 10, 2007, at 1 (quoting Citigroup Chief Executive, Chuck Prince). Ultimately, Prince resigned and collected \$38 million in severance pay. James Politi, *Wall Street on Defensive over Pay Packages*, FIN. TIMES, Mar. 8, 2008, at 20.

³⁶ See Feldstein, *supra* note 27.

³⁷ IMF: *Global Recession Worst Since Depression*, CHINA DAILY, April 23, 2009, http://www.chinadaily.com.cn/world/2009-04/23/content_7707566.htm (reporting that forgone GDP worldwide would amount to \$4 trillion in 2009 alone, in addition to \$4 trillion in credit losses).

³⁸ Gretchen Morgenson, *Rescue Me: A Fed Bailout Crosses a Line*, N.Y. TIMES, Mar. 16, 2008, at BU1.

³⁹ Yalman Onaran, *Fed Aided Bear Stearns as Firm Faced Chapter 11, Bernanke Says*, BLOOMBERG.COM, Apr. 2, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&refer=worldwide&sid=a7coicThgEE>.

⁴⁰ Press Release, Fed. Reserve Bank of N.Y., Statement on Financing Arrangement of JPMorgan Chase’s Acquisition of Bear Stearns (Mar. 24, 2008) (available at <http://www.newyorkfed.org/newsevents/news/markets/2008/rp080324.html>).

⁴¹ *Id.*

absorb any losses from the remaining \$29 billion on a non-recourse basis to JPMorgan Chase.⁴² JPMorgan Chase received \$30 billion in cash but was only obligated to repay \$1 billion.⁴³ The Fed received \$30 billion in Bear Stearns assets that it manages today through an entity called Maiden Lane I.⁴⁴ The Fed acted under section 13(3) of the Federal Reserve Act,⁴⁵ a provision the Fed had not used since the Great Depression.⁴⁶ Thus far, it appears that the Fed has lost about \$3.4 billion on the Bear Stearns bailout.⁴⁷

The hope that the Bear Stearns bailout would stabilize the financial system was short-lived. On September 15, 2008, Lehman Brothers (“Lehman”), a large investment bank, declared bankruptcy, in the absence of federal assistance.⁴⁸ The failure of Lehman appeared to quickly deliver a lethal blow to financial stability.⁴⁹ The fall of Lehman was followed by instability in global money markets, and commercial credit subsequently froze.⁵⁰ Some commentators argue that Lehman’s failure did not cause the financial market instability.⁵¹ Nevertheless, the consensus view is that the failure of Lehman led directly to unprecedented financial chaos.⁵² In any event, “the market was . . . bewildered when the Fed rescued certain firms and not others,” and the decision to rescue Bear Stearns and then permit Lehman to fail is often cited as the most prominent example of the ad hoc nature of the government’s bailouts.⁵³ Other commentators suggest that such uncertainty has long been inherent in the current ambiguous and

⁴² Press Release, JPMorgan Chase, JPMorgan Chase and Bear Stearns Announce Amended Agreement (Mar. 24, 2008) (available at http://www.jpmorgan.com/cm/cs?pagename=JPM_redesign/JPM_Content_C/Generic_Detail_Page_Template&cid=1159339104093&c=JPM_Content_C).

⁴³ Andrew Ross Sorkin, *The Hand Behind the Deal*, N.Y. TIMES, Mar. 25, 2008, at C1.

⁴⁴ Federal Reserve Bank of New York, Maiden Lane Transactions, <http://www.newyorkfed.org/markets/maidenlane.html> (last visited Nov. 20, 2009).

⁴⁵ 12 U.S.C. § 343 (2006). “This 1932 emergency authority for discounts ‘in unusual and exigent circumstances’ for individuals, partnerships and corporations was used sparingly, and just 123 loans were made over four years [during the Depression] by all 12 banks, totaling about \$1.5 million; the largest single loan was for \$300,000.” David Fettig, *Lender of More Than Last Resort*, THE REGION, Dec. 2002, at 15, available at <http://www.minneapolisfed.org/pubs/region/02-12/lender.pdf>.

⁴⁶ David Fettig, *The History of a Powerful Paragraph: Section 13(3) Enacted Fed Business Loans 76 Years Ago*, THE REGION, June 2008, at 33, available at <http://www.minneapolisfed.org/pubs/region/08-06/section13.pdf>.

⁴⁷ Alister Bull, *Fed Loss on Bear Stearns, AIG Loans Shrinks a Bit*, REUTERS.COM, Aug. 21, 2009, <http://www.reuters.com/article/businessNews/idUSTRE57K4AX20090821>.

⁴⁸ *Lehman Brothers Files for Bankruptcy*, FIN. TIMES, Sept. 15, 2008, <http://www.ft.com/cms/s/0/52098fa2-82e3-11dd-907e-000077b07658.html>.

⁴⁹ Emily Kaiser, *Lehman Fallout Threatens Deeper, Wider Recession*, REUTERS.COM, Sept. 16, 2008, <http://in.reuters.com/article/businessNews/idINIndia-35488720080915>.

⁵⁰ Bob Ivry et al., *Missing Lehman Lesson of Shakeout Means Too Big Banks May Fail*, BLOOMBERG.COM, Sept. 8, 2009, <http://www.bloomberg.com/apps/news?pid=20601102&sid=aX8D5utKFuGA>.

⁵¹ Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?4* (Univ. of Pa. Law School, Inst. for Law & Econ., Working Paper 09-11, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1362639 (“the ‘Lehman effect’ on the markets stemmed more from the news that a major investment bank was financial distressed than from the news that the bank had filed for bankruptcy. It is not obvious that a rescue loan to Lehman would have prevented the general disruption and crisis of confidence . . .”).

⁵² Evan Thomas & Michael Hirsch, *Paulson’s Complaint*, NEWSWEEK, May 25, 2009, at 52.

⁵³ Anna Jacobson Schwartz, Op-Ed., *Man Without a Plan*, N.Y. TIMES, July 25, 2009, at WK12.

discretionary regime.⁵⁴ One fact is clear: Lehman's failure did immediately precede more financial problems, particularly a run on money market funds, after one such fund, which was holding Lehman debt "broke the buck."⁵⁵

Within a few days of the fall of Lehman, the world's largest insurance company, AIG, teetered on the brink of bankruptcy.⁵⁶ AIG apparently guaranteed the obligations of a number of obligors of other powerful financial firms through an unregulated instrument known as credit default swaps.⁵⁷ If AIG had failed, it could have inflicted up to \$180 billion in losses on its credit-default swap counterparties.⁵⁸ Among those exposed to the failure of AIG was the large investment bank, Goldman Sachs ("Goldman"). Goldman, whose alumni included then Secretary of the Treasury Hank Paulson and his predecessor in the Clinton Administration, Secretary of the Treasury Robert Rubin, apparently would lose \$13 billion if AIG failed.⁵⁹ Goldman was not alone, and if AIG failed there was a substantial prospect that a number of other large financial firms would follow.⁶⁰ Consequently, Fed Chair Ben Bernanke and Secretary of Treasury Hank Paulson engineered a bailout (amounting to a maximum \$182.5 billion) to keep AIG out of liquidation at a cost to the taxpayer, as of fall of 2009, of \$86.8 billion.⁶¹ The statutory basis of the bailout was again section 13(3).⁶²

Bernanke and Paulson were not finished. On September 18, 2008, they gathered Congressional leaders to inform them that unless they funded a massive federal bailout immediately, "we may not have an economy on Monday."⁶³ Within days, the Treasury posted a three page bailout bill on its website that called for a \$700 billion bailout of unnamed financial firms,

⁵⁴ Tyler Cowen, *Bailout of Long-Term Capital: A Bad Precedent?*, N.Y. TIMES, Dec. 26, 2008, at BU5.

⁵⁵ Ayotte & Skeel, *supra* note 51, at 25. Money market funds typically trade at one dollar per share unless they must recognize losses on otherwise safe short term debt. The Reserve Fund lost money on Lehman paper and traded under one dollar precipitating a panic in money market akin to a bank run. *Id.* at 24-25.

⁵⁶ *A Nuclear Winter?*, ECONOMIST, Sept. 20-26, 2008, at 90.

⁵⁷ *Id.*

⁵⁸ Justin Fox, *Why the Government Wouldn't Let AIG Fail*, TIME.COM, Sept. 16, 2008, <http://www.time.com/time/business/article/0,8599,1841699,00.html>.

⁵⁹ Paritosh Bansal, *Goldman's Share of AIG Bailout Money Draws Fire*, REUTERS.COM, Mar. 17, 2009, <http://www.reuters.com/article/ousiv/idUSN1712706420090317>.

⁶⁰ *Id.*

⁶¹ Joshua Zumbrun, *What AIG Really Owes Taxpayers*, FORBES.COM, Sept. 1, 2009, <http://www.forbes.com/2009/09/01/aig-bailouts-fed-business-washington-aig.html>.

⁶² Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 16, 2008) (available at <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm>). Apparently, the government insisted that the CEO of AIG resign as part of the bailout. James B. Stewart, *Eight Days*, NEW YORKER, Sept. 21, 2009, at 59, 73.

⁶³ Joe Nocera, *As Credit Crisis Spiraled, Alarm Led to Action*, N.Y. TIMES, Oct. 1, 2008, at A1 (quoting Federal Reserve Chairman, Ben Bernanke); *Frontline: Inside the Meltdown* (PBS television broadcast Feb. 17, 2009), available at <http://www.pbs.org/wgbh/pages/frontline/meltdown/etc/synopsis.html>.

to be administered solely by the Treasury, free of all oversight.⁶⁴ When asked the basis of the \$700 billion amount, a Treasury official stated that they wanted it to be a “really large number.”⁶⁵ The American people weighed in strongly against such a bill.⁶⁶ This caused the House of Representatives to pause.⁶⁷ But, the Senate loaded the bill with sufficient pork that the House ultimately succumbed and passed the Troubled Asset Relief Program (“TARP”) on October 3, 2008.⁶⁸ The legislation, hastily conceived and passed in a panic, originally contemplated the purchase of “troubled assets” by the Treasury.⁶⁹ This original conception was abandoned in favor of equity injections in banks and other financial firms.⁷⁰ On October 13, 2008, Paulson gathered the CEOs of the nation’s largest financial firms and forced them to accept billions in government aid, whether they desired the aid or not, and whether they needed the aid or not.⁷¹ As of mid-2009, the government’s net investment in the financial sector pursuant to the TARP program exceeded \$248.8 billion.⁷²

Even this proved insufficient. Citigroup continued to flounder even after receiving \$25 billion in TARP funds. On November 23, 2008, the Treasury, the Fed, and the FDIC agreed to inject another \$20 billion from the TARP funds and essentially guaranteed the value of \$306 billion of Citigroup’s assets.⁷³ The Treasury did not negotiate for any changes in management and only received warrants and preferred stock in exchange.⁷⁴ Commentators suggested that “[t]he \$306 billion guarantee was an

⁶⁴ *Treasury’s Bailout Proposal*, CNNMONEY.COM, Sept. 20, 2009, http://money.cnn.com/2008/09/20/news/economy/treasury_proposal/index.htm.

⁶⁵ *Brian Wingfield & Josh Zumbrun*, *Bad News for the Bailout*, FORBES.COM, Sept. 23, 2008, http://www.forbes.com/2008/09/23/bailout-paulson-congress-biz-beltway-cx_jz_bw_0923bailout.html.

⁶⁶ *Matthew Benjamin*, *Americans Oppose Bailouts, Favor Obama to Handle Market Crisis*, BLOOMBERG.COM, Sept. 24, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aYK_5_fV5D4M.

⁶⁷ *A Shock from the House*, ECONOMIST.COM, Sept. 29, 2008, http://www.economist.com/world/unitedstates/displaystory.cfm?story_id=12326538.

⁶⁸ *The Bail-Out Becomes Law, but Will It Work?*, ECONOMIST.COM, Oct. 3, 2008, http://www.economist.com/businessfinance/displayStory.cfm?story_id=12367649. See also Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §§ 101-136, 122 Stat. 3765 (codified at 12 U.S.C. § 5201).

⁶⁹ *Nocera*, *supra* note 63, at A1.

⁷⁰ *More Rabbits from the Hat*, ECONOMIST.COM, Nov. 13, 2008, http://www.economist.com/world/unitedstates/displaystory.cfm?story_id=12597500.

⁷¹ *Paulson Forced Banks to Take TARP Money: Documents*, CNBC.COM, May 9, 2009, <http://www.cnbc.com/id/30745687>. The government did not replace any senior management of the banks receiving federal funds. See Press Release, U.S. Dep’t of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Actions to Protect the U.S. Economy (October 14, 2008) (available at <http://www.treas.gov/press/releases/archives/200810.html>).

⁷² *Jon Hilsenrath*, *Bailouts Yield Returns Amid Risk*, WALL ST. J., Sept. 2, 2009, at A10.

⁷³ Press Release, U.S. Dep’t of Treasury, Joint Statement by Treasury, Federal Reserve and the FDIC on Citigroup (Nov. 23, 2008) (available at <http://www.treas.gov/press/releases/hp1287.htm>). The government did not replace senior management nor negotiate any reduction in their compensation. See *id.*

⁷⁴ Press Release, U.S. Dep’t of Treasury, Summary of Terms: Eligible Asset Guarantee, Nov. 23, 2008, (available at http://www.treas.gov/press/releases/reports/cititermsheet_112308.pdf).

undisguised gift.”⁷⁵ On February 27, 2009, the Treasury further acted to strengthen Citigroup’s capital structure by agreeing to convert \$25 billion in preferred shares to common equity shares.⁷⁶ There is some confusion regarding the cost thus far of bailing out Citigroup.⁷⁷ On one hand, the government is sitting on an \$11 billion profit from its common shares.⁷⁸ On the other hand, the ultimate cost of the government’s guarantee of asset values is uncertain at best.⁷⁹ This constituted the first use of the FDIC insurance funds to bail out a bank during the 2008-2009 crisis and it acted pursuant to its emergency authority to address systemic risk.⁸⁰

Bank of America presented similar problems (particularly after its acquisition of Merrill Lynch in mid-September of 2008), notwithstanding the government’s initial injection of \$25 billion in the fall of 2008.⁸¹ On January 16, 2009, the government announced that it would inject a further \$20 billion into Bank of America and guarantee the value of essentially \$118 billion in loans in exchange for preferred shares.⁸² Bank of America ultimately decided not to take advantage of the asset guarantee program and has resisted paying the fees associated with the program.⁸³ As of early fall of 2009, Bank of America was negotiating to repay part of its TARP money and end the asset guarantee.⁸⁴ Thus, it is impossible to calculate the losses from these additional Bank of America bailouts. The FDIC, which acted in concert with the Fed and the Department of the Treasury, again based its actions on the systemic risk exception to limits on its use of deposit insurance funds.⁸⁵

There were many additional government efforts to bail out the financial sector. For example, the government has expended \$96 billion to

⁷⁵ Michael Lewis & David Einhorn, *How to Repair a Broken Financial World*, N.Y. TIMES, Jan. 4, 2009, at WK10.

⁷⁶ Press Release, U.S. Dep’t of the Treasury, Treasury Announces Participation in Citigroup’s Exchange Offering (Feb. 27, 2009) (available at <http://www.treas.gov/press/releases/tg41.htm>).

⁷⁷ The TARP inspector general recently announced plans to audit the Citigroup bailout. Alister Bull, *TARP Special Inspector to Audit Citi Guarantee*, REUTERS.COM, Aug. 19, 2009, <http://www.reuters.com/article/marketsNews/idUSN194852220090819>.

⁷⁸ Patrick Jenkins & Francesco Guerrero, *Bank Bail-Outs Weigh on Some States*, FIN. TIMES, Aug. 23, 2009, <http://www.ft.com/cms/s/0/88e0d226-901e-11de-bc59-00144feabdc0.html>.

⁷⁹ David Olive, *Bailout Profit Not Adding Up*, THESTAR.COM, Sept. 6, 2009, <http://www.thestar.com/columnists/article/691545>.

⁸⁰ Silva, *supra* note 19, at 129 (noting that under 12 U.S.C. § 1823(c)(4)(G)(i) the FDIC may expend insurance funds to protect other than insured depositors).

⁸¹ Dan Fitzpatrick et al., *Bank of America to Get Billions in U.S. Aid: Sides Finalizing Terms for Fresh Bailout Cash*, WALL ST. J., Jan. 15, 2009, at A1.

⁸² Press Release, U.S. Dep’t of the Treasury, Federal Reserve and the FDIC Provide Assistance to Bank of America (Jan. 16, 2009) (available at <http://www.treas.gov/press/releases/hp1356.htm>). The government did not replace senior management nor reduce their compensation rights. *See id.*

⁸³ David Milkenberg & Rebecca Christie, *Bank of America Said to Balk at Paying Backstop Fee (Update 2)*, BLOOMBERG.COM, July 13, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=agE.cyK752sU>.

⁸⁴ David Milkenberg & Jeran Wittenstein, *Bank of America May Repay U.S. Aid, End Loss-Sharing Accord*, BLOOMBERG.COM, Sept. 1, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=ax2wBt9xSau0>.

⁸⁵ Silva, *supra* note 19, at 129.

prop up Fannie Mae and Freddie Mac, two government sponsored entities that were subject to enhanced government regulation and were always viewed as implicitly backed by the U.S. government.⁸⁶ The failure of these two entities would have destabilized the housing market and led to huge losses to the financial sector.⁸⁷ In fact, it is fair to say that without these two entities the real estate market would cease to function.⁸⁸ Further, the FDIC guaranteed all bank debt (under the “Temporary Liquidity Guarantee Program”), giving banks access to funds at a lower cost.⁸⁹ As of September 4, 2009, the FDIC guaranteed \$304 billion of bank debt.⁹⁰ The Fed also plans to purchase \$1.45 trillion in mortgage-backed securities and has purchased \$740 billion to date.⁹¹ This means the Fed is the largest purchaser of mortgages in the world.⁹² All of this activity effectively protected banks from losses on their holdings of mortgage securities and enhanced bank profitability.

The financial sector also benefited from changes in accounting standards. The Financial Accounting Standards Board (the “FASB”) is responsible for promulgating accounting standards.⁹³ Yet, the FASB’s authority is always subject to Congressional power.⁹⁴ In the heat of the financial crisis the FASB was pressured by Congress and lobbied by the financial industry to revamp market accounting and to allow banks greater discretion in valuing assets.⁹⁵ This materially buoyed profits at financial firms and shored up their capital.⁹⁶ In the first quarter of 2009, experts estimate that bank earnings would have been 42% lower without the changes; in the second quarter bank profitability would have declined 14%.⁹⁷ This amounted to a stealth bailout.

All of this bailout activity concentrated economic power primarily

⁸⁶ Rick Newman, *5 Bailouts That Did Some Good*, US NEWS & WORLD REPORT, Sept. 4, 2009, <http://www.usnews.com/blogs/flowchart/2009/09/04/5-bailouts-that-did-some-good.html>.

⁸⁷ For example, 90% of all home mortgages are currently funded or guaranteed by the government, including Fannie Mae and Freddie Mac. Zachary A. Goldfarb & Dina ElBoghday, *Mortgage Market Bound by Major U.S. Role*, WASH. POST, Sept. 7, 2009, at A01.

⁸⁸ Newman, *supra* note 86.

⁸⁹ Press Release, FDIC, FDIC Announces Plan to Free Up Bank Liquidity (Oct. 14, 2008) (available at <http://www.fdic.gov/news/news/press/2008/pr08100.html>).

⁹⁰ Damien Paletta & Mark Gongloff, *Banks Face Loss of Debt Guarantee*, WALL ST. J., Sept. 10, 2009, at A2.

⁹¹ Mark Gongloff, *MBS—Fed’s Inflation-Fighting Weapon*, WALL ST. J., Sept. 3, 2009, at C1.

⁹² *Id.* In the run-up to the election of 2008, the Federal Home Loan Bank System, which serves as a lender of last resort, injected hundreds of billions into various federally chartered thrifts, an effort which Fannie Mae and Freddie Mac joined. This “shadow bailout” kept the mortgage market afloat, at an unknown future cost. Thomas Ferguson and Robert Johnson, *Too Big to Bail: The “Paulson Put,” President Politics, and the Global Financial Meltdown*, 38 INT’L J. POL. ECON. 3, 25-27 (2009).

⁹³ LAWRENCE A. CUNNINGHAM, LAW & ACCOUNTING: CASES AND MATERIALS 8-12 (2005).

⁹⁴ *Id.*

⁹⁵ Ian Katz & Jesse Westbrook, *Mark-to-Market Lobby Buys Bank Profits 20% as FASB May Say Yes*, BLOOMBERG.COM, Mar. 30, 2009, <http://www.bloomberg.com/apps/news?pid=20601109&sid=awSxPMGzDW38>.

⁹⁶ Michael Rapoport, *A Comprehensive View on Bank Profits*, WALL ST. J., July 29, 2009, at C14.

⁹⁷ *Id.*

in the hands of Secretary of the Treasury, Hank Paulson.⁹⁸ Paulson was the latest of a long line of former Goldman Sachs CEOs to assume high profile government positions, particularly as Treasury Secretary.⁹⁹ Throughout the fall of 2008, he exercised unprecedented power over the economy, largely free of congressional or other oversight.¹⁰⁰ This led to charges of inappropriate political influence and even crony capitalism—particularly with respect to the bailout of AIG which richly benefitted Goldman Sachs.¹⁰¹ *The New York Times* obtained records under the Freedom of Information Act showing that Paulson spoke to the current CEO of Goldman Sachs twenty-four times during the week of the AIG bailout.¹⁰² Closely associated charges of inconsistency and arbitrary action were leveled against Paulson's actions; John Taylor, a Stanford economics professor, argued that the “lack of a predictable framework for intervention” resulted in market uncertainty.¹⁰³ “The pattern of government intervention in the past year is at times bewildering. . . . Creeping uncertainty of this sort would inevitably slow and distort the economy.”¹⁰⁴ In short, the rule of man replaced the rule of law in the American economy during the financial crisis of 2008-2009.

All of this was unprecedented.¹⁰⁵ Yet, Paulson proceeded to disburse hundreds of billions of dollars with few, if any, controls or oversight.¹⁰⁶ The government vastly overpaid for the rights and shares purchased; in fact, the Congressional Oversight Panel that reviewed the initial TARP transactions found that the Treasury received assets worth \$66 for every \$100 spent.¹⁰⁷ The money often went to banks that did not want or need the funds, as well as to unscrupulous banks.¹⁰⁸ There were no requirements imposed on the use of the funds, and little or no effort was made to trace the use of the funds.¹⁰⁹ Banks that received funds subsequently used funds to buy competitors, to host golf junkets, or redecorate their offices.¹¹⁰ The Attorney General of New York issued a report showing that \$32.5 billion was paid out in bonuses to senior executives even while losses mounted and firms took in government

⁹⁸ *President Hank*, *ECONOMIST*, Sept. 25, 2008, at 46.

⁹⁹ *Id.*

¹⁰⁰ For example, Paulson largely decided whether long-time Goldman rivals such as Bear Stearns and Lehman Brothers survived. Gretchen Morgenson & Don Van Natta, Jr., *Paulson's Calls to Goldman Tested Ethics During Crisis*, *N.Y. TIMES*, Aug. 9, 2009, at A1.

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ Krishna Guha, *Paulson Rues Shortage of Firepower as Battle Raged*, *FIN. TIMES*, Dec. 30, 2008, http://www.ft.com/cms/s/0/247f263a-d6aa-11dd-9bf7-000077b07658.html?nclink_check=1 (quoting Stanford professor, John Taylor).

¹⁰⁴ William D. Cohan, *An Offer He Couldn't Refuse*, *ATLANTIC*, Sept. 2009, at 62.

¹⁰⁵ Donald L. Bartlett & James B. Steele, *Good Billions After Bad*, *VANITY FAIR*, Oct. 2009, at 206.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

assistance.¹¹¹ Finally, there was no effort to assure that banks receiving bailout monies could survive; stress-testing was not required until spring of 2009, well after hundreds of billions had been expended.¹¹² The intent of all the bailouts seems lost—the money disbursed did little to free up credit markets.

It is virtually impossible at this date to calculate the final net loss to the taxpayer from these government interventions. There is reason to think that any estimate as of the date of this writing is apt to be too low. The commercial real estate debacle is just getting started.¹¹³ The government has failed to arrest the collapse of the residential real estate market or to materially slow the rate of real estate foreclosures.¹¹⁴ Indeed, while the government expended hundreds of billions in bailout funds for large banks, and still has \$2.2 trillion in bailout loans outstanding, its mortgage relief program disbursed a relatively paltry sum of \$22 billion¹¹⁵ to help stem a flood of foreclosures that some sources estimate at thirteen million over the next five years.¹¹⁶ In the spring of 2009, Harvard economist, Kenneth Rogoff, estimated the hole in the financial system to be \$2 trillion and suggested that taxpayers could pay \$1 trillion without succeeding in recapitalizing the financial sector appropriately.¹¹⁷ Combined with lost GDP, it seems certain the bailouts will be a multi-trillion dollar catastrophe.

The next section will show that macroeconomic science suggested that these programs would ultimately fail to reignite lending, and by extension, economic growth. Moreover, economists and other scholars specifically warned that distorted incentives implicit in TBTF would lead to financial instability, in the first instance, and that the fact that the government extended assistance to firms teetering towards bankruptcy would further distort incentives well into the future.

¹¹¹ Tomoeh Murakami Tse, *Bankers' Bonuses Beat Earnings as Industry Imploded*, WASH. POST, July 31, 2009, at A18.

¹¹² See Fredrick Tung, *The Great Bailout of 2008-2009*, 25 EMORY BANKR. DEV. J. 333, 335 (2009).

¹¹³ Nick Timiraos & Jessica Holzer, *Corus Bank Is the Latest to Be Seized by Regulators*, WALL ST. J., Sept. 12, 2009, at B1.

¹¹⁴ Robert Daniel, *U.S. Aug. Foreclosures Off 1% from July, up 18% vs. Year Ago*, MARKETWATCH, Sept. 10, 2009, <http://www.marketwatch.com/story/us-foreclosures-off-1-vs-july-up-vs-year-ago-2009-09-10>.

¹¹⁵ David Goldman, *Bailout Tracker: What's Going, What's Coming*, CNNMONEY.COM, Sept. 11, 2009, http://money.cnn.com/2009/09/11/news/economy/bailout_repayment_tracker/?postversion=2009091113.

¹¹⁶ Editorial, *After the Fall Our View of the Economic Meltdown One Year Later: How Much Has Changed?*, ST. LOUIS POST-DISPATCH, Sept. 13, 2009, at A14, available at <http://www.stltoday.com/blogzone/the-platform/published-editorials/2009/09/after-the-fall-the-economic-meltdown-one-year-on/>.

¹¹⁷ Kenneth Rogoff, *Rogoff: Stop the Financial Bleeding*, BOSTON.COM, May 10, 2009, http://www.boston.com/business/globe/globe100/globe_100_2009/articles/rogoff_stop_the_financial_bleeding/.

II. THE MACROECONOMICS OF BAILOUTS

Economists greeted the bailouts with intense skepticism.¹¹⁸ According to former Chief Economist of the International Monetary Fund (“IMF”), Simon Johnson, the financial sector has become too politically powerful.¹¹⁹ Their political power contributed to the onset of the subprime crisis and is now impeding a rational government response.¹²⁰ Specifically, Johnson maintains that the terms of the TARP capital infusions were “grossly favorable to the banks themselves.”¹²¹ Johnson claims that this reality mirrors that of many developing nations facing a financial crisis.¹²² Unfortunately, too often, those nations could not wrest control of the financial sector from the reckless financial elites that engineered the crisis due to their political power.¹²³ Johnson maintains that the “economic solution is seldom very hard to work out.”¹²⁴ It requires only the political will to “scale up the standard Federal Deposit Insurance Corporation process” whereby shareholders and unsecured creditors are wiped out, failed management is terminated, and the banks (with deleveraged balance sheets) are sold off (perhaps piecemeal) into the private sector.¹²⁵ “The main advantage is immediate recognition of the problem so that it can be solved before it grows worse.”¹²⁶ Finally, Johnson argues that because “oversize[d] institutions disproportionately influence public policy,” banks must be

¹¹⁸ E.g., Nouriel Roubini, *Public Losses for Private Gain*, GUARDIAN.CO.UK, Sept. 18, 2008, <http://www.guardian.co.uk/commentisfree/2008/sep/18/marketturmoil.creditcrunch> (denouncing “hypocrites who spewed . . . laissez-faire . . . capitalism” and “allowed the biggest debt bubble ever to fester without any control, and have caused the biggest financial crisis since the Great Depression” now overseeing “the biggest government intervention . . . in the recent history of humanity, all for the benefit of the rich and the well connected”).

¹¹⁹ Simon Johnson, *The Quiet Coup*, ATLANTIC, May 2009, at 46.

¹²⁰ Johnson notes that political influence has been central to the crisis:

elite business interests . . . played a central role in creating the crisis, making ever-larger gambles, with the implicit backing of the government, until the inevitable collapse. More alarming, they are now using their influence to prevent precisely the sorts of reforms that are needed, and fast, to pull the economy out of its nosedive. The government seems helpless, or unwilling, to act against them.

Id. at 49.

¹²¹ *Id.* at 53.

¹²² The IMF economists echo former chief IMF economist Simon Johnson:

Typically, these countries are in a desperate economic situation for one simple reason—the powerful elites within them overreached in good times and took too many risks. Emerging-market governments and their private-sector allies commonly form a tight-knit . . . oligarchy, running the country rather like a profit-seeking company in which they are the controlling shareholders They reckon—correctly, in most cases—that their political connections will allow them to push onto the government any substantial problems that arise.

Id. at 47–48.

¹²³ *Id.* at 48.

¹²⁴ *Id.* at 47.

¹²⁵ Johnson, *supra* note 119, at 54.

¹²⁶ *Id.*

prevented from ever again being too-big-to-fail; thus, “banks that remain in private hands must be subject to size limitations.”¹²⁷

Other high profile economists joined the chorus of adverse commentary.¹²⁸ Nobel Laureate, Paul Krugman, bemoaned the policies that allowed the “zombie banks” to continue to operate under impaired capital conditions.¹²⁹ He too argues in favor of FDIC seizure.¹³⁰ Another Nobel Prize winner, Joseph Stiglitz, claims that the bailouts amount to “ersatz capitalism” whereby gains are privatized but losses are socialized.¹³¹ Such a reality will create “perverse incentives, worse even than the ones that got us into the mess.”¹³² He points out that in the past the government, through the FDIC, seized large banks, including Continental Illinois in the 1980s.¹³³ Stiglitz argues that the government could have generated \$7 trillion in loans¹³⁴ if it had diverted the TARP money to the creation of a “good bank,” which would be stripped of the problem bank assets that have proven so troublesome.¹³⁵

Recently, two IMF economists studied financial crises around the world from 1970 through 2007.¹³⁶ They found that the best economic policy for resolving such crises is cognizant of the large costs involved in redirecting a nation’s wealth from taxpayers to financial firms and their creditors.¹³⁷ These costs include the amount transferred to banks plus the misallocations of capital and distorted incentives that can harm GDP for years.¹³⁸ Moreover, they found that any delay in resolving a financial crisis

¹²⁷ *Id.* at 56.

¹²⁸ Jack Willoughby, *Tearing into the Fed and Treasury Plans*, BARRON’S, Oct. 27, 2008, at 52 (interview of pre-eminent economist Anna Schwartz).

¹²⁹ Krugman, *supra* note 23, at A27.

¹³⁰ *Id.*

¹³¹ Joseph E. Stiglitz, *Obama’s Ersatz Capitalism*, N.Y. TIMES, Apr. 1, 2009, at A31.

¹³² *Id.*

¹³³ *Id.*

¹³⁴ Joseph E. Stiglitz, *How to Fail to Recover*, INT’L BUS. TIMES, Mar. 16, 2009, <http://www.ibtimes.com/articles/20090316/how-to-fail-to-recover.htm>.

¹³⁵ Joseph E. Stiglitz, *A Bank Bailout That Works*, THE NATION, Mar. 23, 2009, <http://www.thenation.com/doc/20090323/stiglitz/single>. A good bank has assets and liabilities that have certain value using market prices. Management can therefore be confident the bank’s capital and support new lending. *Id.* Other high profile economists joined in these critiques. See Rogoff, *supra* note 117, at A14 (“We need to put most of the major financial institutions through accelerated bankruptcy. We’re not going to get normal lending until we do that. We also need to lay down a regulatory framework so this doesn’t happen again.”); Paul Romer, *Let’s Start Brand New Banks*, WALL ST. J., Feb. 6, 2009, at A13 (“If the TARP funds go to existing banks, much of them will end up stuck in financial institutions that are still bad after the transfer. We know from the previous round of TARP that giving more capital to bad banks generates very little net new lending.”).

¹³⁶ Luc Laeven & Fabian Valencia, *Systemic Bank Crises: A New Database 3* (Int’l Monetary Fund, Working Paper No. WP/08/224, 2008), available at <http://www.imf.org/external/pubs/ft/wp/2008/wp08224.pdf>.

¹³⁷ *Id.* at 3 (noting that “sound policy approaches to financial crises [include] recognition that policy responses that reallocate wealth toward banks and debtors and away from taxpayers face” costs).

¹³⁸ *Id.* (concluding that costs include the amount of “taxpayers’ wealth that is spent on financial assistance and indirect costs from misallocations of capital and distortions to incentives that may result”).

is often very costly as insolvent firms tend to become more insolvent.¹³⁹ Instead, authorities must act with speed and shutter hopelessly insolvent firms while reserving assistance for those firms that can survive.¹⁴⁰ Forbearance results in greater costs and increased credit contraction.¹⁴¹ Finally, help for distressed borrowers is essential for the successful resolution of bank crises.¹⁴² Those nations that fail to pursue these often politically painful steps frequently suffer prolonged stagnation.¹⁴³

Much of the learning regarding appropriate policy responses to a financial crisis emanates from the experience of Japan over the last twenty years. Japan attempted to bail out its banks and succeeded in creating zombie firms which sapped economic growth.¹⁴⁴ Japan's problems started with a bursting real estate bubble and a bursting stock market bubble leading to large losses for the Japanese financial sector.¹⁴⁵ This led to a typical credit crunch, as banks and other financial institutions pared risk.¹⁴⁶ However, Japan exacerbated the credit crunch by keeping zombie banks afloat; such banks face incentives to continue lending to zombie firms rather than recognizing losses that could tip the banks into insolvency.¹⁴⁷ Zombie firms, in turn, depress investment, employment growth, and productivity sector-wide as even non-zombie firms struggle to compete against the zombie firms.¹⁴⁸ As professors Hoshi and Kashyap conclude: "We believe that the depressed restructuring that accompanied the financial crisis has left Japan with a dysfunctional banking system that misallocates funds and a perverted industrial structure in which subsidized inefficient firms are

¹³⁹ *Id.* at 4 ("Existing empirical research has shown that providing assistance to banks and their borrowers can be counterproductive, resulting in increased losses to banks, which often abuse forbearance to take unproductive risks at government expense.").

¹⁴⁰ *Id.* at 30 ("A successful bank recapitalization program tends to be selective in its financial assistance to banks, specifies clear quantifiable rules that limit access to preferred stock assistance, and enacts capital regulation that establishes meaningful standards for risk-based capital.").

¹⁴¹ *Id.* at 4 ("The typical result of forbearance is a deeper hole in the net worth of banks, crippling tax burdens to finance bank bailouts, and even more severe credit supply contraction and economic decline than would have occurred in the absence of forbearance.").

¹⁴² Laeven & Valencia, *supra* note 136, at 31 ("To relieve indebted [borrowers] . . . from financial stress and restore their balance sheets to health, intervention in the form of targeted debt relief programs to distressed borrowers and corporate restructuring programs appear most successful. Such programs . . . tend to be most successful when they are well-targeted with adequate safeguards attached.").

¹⁴³ *Id.* at 30 ("Above all, speed appears of the essence. As soon as a large part of the financial system is deemed insolvent and has reached systemic crisis proportions, bank losses should be recognized . . . and steps should be taken to ensure that financial institutions are adequately capitalized.").

¹⁴⁴ James Baker, *How Washington Can Prevent 'Zombie Banks'*, FT.COM, Mar. 1, 2009, <http://www.ft.com/cms/s/0/b3f299a6-0697-11de-ab0f-000077b07658.html>.

¹⁴⁵ Takeo Hoshi & Anil K. Kashyap, *Japan's Financial Crisis and Economic Stagnation*, J. ECON. PERSPECTIVES, Winter 2004, at 5-6.

¹⁴⁶ *Id.* at 6-7.

¹⁴⁷ *Id.* at 14-15, 18 (citing Joe Peek & Eric Rosengren, *Unnatural Selection: Perverse Incentives and the Misallocation of Capital in Japan*, 95 AM. ECON. REV. 1144, 1165 (2005) (finding that perverse incentives facing potentially insolvent banks caused a misallocation of credit that exacerbated economic malaise and contributed to Japan's lost decade of economic stagnation)).

¹⁴⁸ See Caballero, *supra* note 14, at 1971-72.

crowding out potentially profitable ones.”¹⁴⁹ In short, the longer the zombie banks operate, the more damage they inflict upon the economy, and the sooner they are “shuttered,” the better for the economy.¹⁵⁰

Strong evidence demonstrates that zombie banks plague the U.S. economy. For example, notwithstanding the prodigious government subsidies discussed above, “[m]ore than 150 publicly traded U.S. lenders own nonperforming loans that equal 5 percent or more of their holdings, a level that former regulators say can wipe out a bank’s equity and threaten its survival.”¹⁵¹ For its part, the FDIC has recently expanded its list of troubled banks to more than 400.¹⁵² In addition, regulators subjected nineteen of the nation’s largest banks to “stress tests” and found that ten of those banks needed to add \$75 billion in new capital to meet \$599 billion in losses projected over the next two years—and that was after the banks negotiated downward adjustments to capital needs of \$68 billion.¹⁵³ Experts suggest that the recent changes in mark-to-market accounting standards, discussed above, are also operating to mask bank insolvency and create illusory profits.¹⁵⁴ An influential business consulting firm, McKinsey & Co., recently reported that while the credit securities crisis is winding down, the bank loan portfolio crisis is just starting—because credit securities were marked to market while loan portfolios are written down only upon actual default.¹⁵⁵ McKinsey’s research suggests that total credit losses from U.S. debt will be between \$2.5 trillion and \$3.5 trillion, of which only \$1 trillion have been recognized.¹⁵⁶ Consequently, by any reasonable measure the nation’s financial sector is deeply troubled.

These troubles have economic impact. McKinsey states that “[e]ven the strongest of the major US banks face a challenging environment for the foreseeable future.”¹⁵⁷ Basically the “entire industry is now dependent on government support of all kinds, ranging from low-cost funding . . . to debt guarantees, asset guarantees, and capital injections.”¹⁵⁸ This means that a significant portion of the industry consists of zombie banks—banks that are

¹⁴⁹ Hoshi & Kashyap, *supra* note 145, at 24.

¹⁵⁰ Caballero, *supra* note 15, at 1972.

¹⁵¹ Ari Levy, *Toxic Loans Topping 5% May Push 150 Banks to Point of No Return*, *Bloomberg.com*, Aug. 14, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aTTT9jivRIWE>.

¹⁵² Damian Paletta & David Enrich, *Banks on Sick List Top 400: Industry’s Health Slides as Bad Loans Pile Up*, *WALL ST. J.*, Aug. 28, 2009, at A1.

¹⁵³ David Enrich et al., *Banks Won Concessions on Tests: Fed Cut Billions off Some Initial Capital-Shortfall Estimates*, *WALL ST. J.*, May 9, 2009, at A1.

¹⁵⁴ Yalman Onaran, *Bank Profits from Accounting Rules Masking Looming Loan Losses*, *BLOOMBERG.COM*, June 5, 2009, <http://www.bloomberg.com/apps/news?pid=20601109&sid=alC3LxSjomZ8>.

¹⁵⁵ Lowell Bryan & Toos Daruvala, *What’s Next for US Banks*, *MCKINSEY QUARTERLY*, June 2009, at 1, available at http://www.mckinseyquarterly.com/Whats_next_for_US_banks_2368.

¹⁵⁶ *Id.* at 3.

¹⁵⁷ *Id.* at 6.

¹⁵⁸ *Id.*

insolvent but for government subsidies and lifelines.¹⁵⁹ Zombie banks harm the entire financial sector, even non-zombie firms, because they will naturally use their government subsidies to support higher deposit rates and lower interest costs, thereby squeezing industry profit margins.¹⁶⁰ Right now zombie banks are “irrationally” risk-averse and are hoarding capital.¹⁶¹ Zombie banks also will rationally fear government restrictions on their operations (especially, in a CEO primacy regime of corporate governance, those relating to executive compensation) and hoard capital in order to repay the government.¹⁶² They will also hoard capital to avert government intervention if they know large losses are imminent.¹⁶³ Thus, these firms become insolvency sponges, sucking in vast capital just to remain viable.

These zombie banks have already harmed the U.S. economy. The money that the government pumped into the financial sector failed to reignite lending.¹⁶⁴ According to a *New York Times* survey of investor conferences, bankers frankly admitted they were more interested in hoarding capital or making acquisitions than expanding lending.¹⁶⁵ Moreover, because the government gave the most money to the most insolvent banks, much of the money went to fill holes in balance sheets to alleviate their insolvency; thus, lending fell by twice the amount at banks that received TARP funds relative to banks that did not receive such funds.¹⁶⁶ The Federal Reserve reports that banks have long been tightening their credit standards, and this has continued unabated since the disbursement of the TARP funds.¹⁶⁷ The FDIC depicts in the following chart the resulting contraction in bank lending:¹⁶⁸

¹⁵⁹ William Safire, *Zombie Banks*, N.Y. TIMES, May 17, 2009, at MM26.

¹⁶⁰ Edward J. Kane, *Dangers of Capital Forbearance: The Case of the FSLIC and “Zombie” S&Ls*, CONTEMP. POL’Y ISSUES, Jan. 1987, at 77, 78.

¹⁶¹ Willem Buiter, *Time to Take Banks into Full Public Ownership*, <http://blogs.ft.com/maverecon/2009/01/time-to-take-the-banks-into-full-public-ownership/> (Jan. 16, 2009, 17:39 EST).

¹⁶² *Id.*

¹⁶³ Feldstein, *supra* note 27.

¹⁶⁴ David Enrich et al., *Bank Lending Keeps Dropping: Analysis of Treasury Data Paints Starker Picture Than Official Government Snapshots*, WALL ST. J., Apr. 20, 2009, at A1.

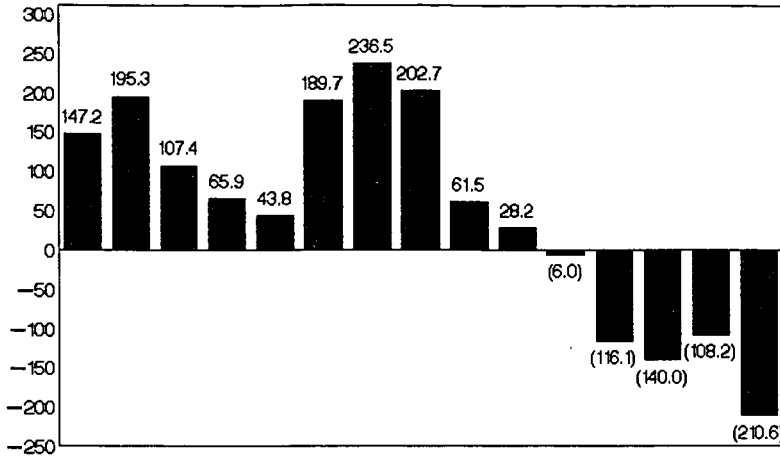
¹⁶⁵ Mike McIntire, *Bailout Is a Windfall to Banks, If Not to Borrowers*, N.Y. TIMES, Jan. 18, 2009, at A1.

¹⁶⁶ Binyamin Appelbaum, *Despite Federal Aid, Many Banks Fail to Revive Lending*, WASH. POST, Feb. 3, 2009, at A1, available at http://www.washingtonpost.com/wp-dyn/content/article/2009/02/02/AR2009020203338_pf.html. It can be difficult to determine if declining loan volume is the result of falling demand for loans or a pullback in supply by newly risk-averse banks seeking to preserve capital, particularly in the context of a general economic contraction. In prior episodes of lending contraction, however, economists have found that capital constrained institutions shrank lending more than well-capitalized banks. Joe Peek & Eric Rosengren, *The Credit Crunch: Neither a Borrower nor a Lender Be*, 27 J. MONEY, CREDIT & BANKING 625, 636-37 (1995).

¹⁶⁷ Press Release, Bd. of Governors of the Fed. Reserve Sys., *The October 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices 1-2* (Nov. 9, 2009) (available at <http://www.federalreserve.gov/boarddocs/snloansurvey/200911/fullreport.pdf>). The Fed also reports that banks raised the cost of capital continuously since late 2007, relative to the bank cost of funds. *Id.* at 6. If declining loan volume were driven by declining demand then loan costs would decrease, no increase.

¹⁶⁸ FDIC, *FDIC QUARTERLY BANKING PROFILE 36* (2nd Quarter 2009), available at <http://www2.fdic.gov/qbp/2009jun/qbp.pdf>.

Quarterly Change In Reported Loans Outstanding
(\$ Billions)



03/06 06/06 09/06 12/06 03/07 06/07 09/07 12/07 03/08 06/08 09/08 12/08 03/09 06/09 09/09

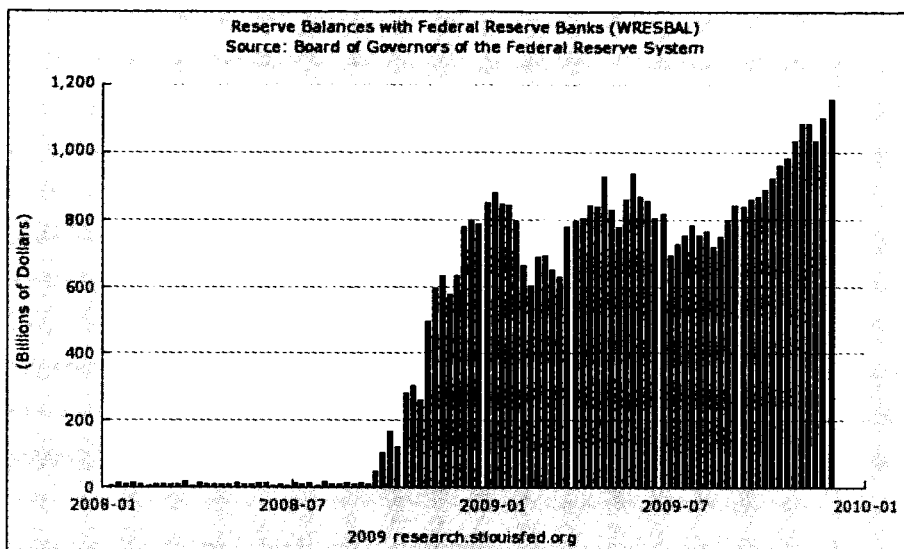
In the third quarter of 2009, real estate loans decreased by \$125 billion, commercial and industrial loans decreased by \$89 billion, and consumer loans increased by \$3 billion.

The above chart demonstrates, that in fact, bank lending sharply contracted immediately following the massive government sponsored bailouts. It is difficult to determine if the contraction of lending led to the contraction in the U.S. economy or if the causation runs in the opposite direction. Nevertheless, the contraction in GDP tracks the contraction in lending very tightly, rather than preceding it: GDP turned negative in third quarter of 2008 and plunged the next two quarters.¹⁶⁹ Therefore, it is probable that the contraction in lending caused the contraction in GDP.

Meanwhile, there is also powerful evidence that the banks have used the funds to hoard capital. According to following Federal Reserve Bank of St. Louis chart, reserves held at the Federal Reserve Banks nationwide exploded at the time the TARP funds were disbursed:¹⁷⁰

¹⁶⁹ Federal Reserve Bank of St. Louis, Real GDP, http://timeline.stlouisfed.org/xcharts/public/popup.cfm?p=chart_detail&rs_id=7 (last visited Oct. 28, 2009).

¹⁷⁰ Federal Reserve Bank of St. Louis, FRED Graph, [http://research.stlouisfed.org/fred2/graph/?s\[1\]\[id\]=WRESBAL](http://research.stlouisfed.org/fred2/graph/?s[1][id]=WRESBAL) (last visited Oct. 28, 2009).



Instead of lending money, the banks are hoarding capital, as reflected in the massive build-up of reserve balances with Federal Reserve Banks. Banks are required to maintain reserve balances; however, excess reserve balances exploded immediately following the government bailout efforts,¹⁷¹ and as of late July of 2009, banks held \$794 billion in excess reserves.¹⁷² As economists Aaron Edlin and Dwight Jaffee put it: “Thars the problem folks.”¹⁷³ Economist Nouriel Roubini argues that this capital hoarding is a material factor slowing the economy today, and in the longer term, threatens to cause higher inflation when banks finally do regain confidence in their balance sheets and the economy.¹⁷⁴

Certainly, policymakers should be credited for averting a repeat of the Great Depression.¹⁷⁵ Yet, the extraordinary efforts of policymakers around the world as well as in the U.S. have not been costless: “governments have been spending and borrowing like never before.”¹⁷⁶ In the U.S. total commitments exceed \$12 trillion, and actual expenditures

¹⁷¹ Aaron S. Edlin & Dwight M. Jaffee, *Show Me the Money*, ECONOMISTS’ VOICE, March 2009, at 1-2.

¹⁷² FEDERAL RESERVE, AGGREGATE RESERVES OF DEPOSITORY INSTITUTIONS & THE MONETARY BASE 1 (2009), available at <http://www.federalreserve.gov/releases/h3/current/h3.pdf>.

¹⁷³ Edlin & Jaffe, *supra* note 171, at 2.

¹⁷⁴ Nouriel Roubini, *The Spend-and-Borrow Economy*, FORBES.COM, Aug. 27, 2009, <http://www.forbes.com/2009/08/26/stimulus-recession-fiscal-monetary-liquidity-taxes-opinions-columnists-nouriel-roubini.html>.

¹⁷⁵ *Id.* (“In the last few months the world economy has been saved from a near-depression. That feat has been achieved by a range of extraordinary government stimulus measures . . . governments have pumped liquidity, slashed policy rates, cut taxes, primed demand and ring-fenced and back-stopped the financial system.”).

¹⁷⁶ *Id.*

amount to \$4 trillion.¹⁷⁷ Governments have also resorted to printing money, which is never costless.¹⁷⁸ Without this massive government intervention the economy would have suffered “headlong GDP contraction.”¹⁷⁹ Not even the U.S. government can afford to accumulate debt and expand its monetary base (which includes the reserve balances held at the Federal Reserve Banks) at such a furious rate without adverse consequences.¹⁸⁰ The debt burden of the U.S. is now projected to double, to 80% of GDP by 2014, which “amounts to a fiscal train wreck” that could cause creditors to demand higher risk premia on U.S. obligations.¹⁸¹ Additionally, when banks cease to hoard capital and make loans, the money supply will expand rapidly and therefore threaten inflation.¹⁸² In other words, the U.S. faces the potential of higher interest rates and higher inflation as a result of the excessively costly and ill-tailored bailouts of 2008-2009.

Economists suggested other alternatives to the subprime bailouts. As mentioned, a number of economists have suggested the creation of a well-capitalized “good bank” rather than government efforts to plug the vast insolvency holes now plaguing the bailed-out banks.¹⁸³ Others suggest that instead of trying to keep fundamentally insolvent financial institutions afloat with government money (saving their unsecured creditors and their managers the horrors of bankruptcy or FDIC reorganization), the government create a streamlined bankruptcy regime.¹⁸⁴ Creditors would swap into equity positions and be denied government funds.¹⁸⁵ The government could provide prepackaged bankruptcy terms aimed at achieving a rapid resolution of the bank’s insolvency.¹⁸⁶ The result would be recapitalized banks, ready to lend, at no cost to the taxpayer.¹⁸⁷ The overarching point is that lending could have been restored without stuffing billions, even trillions, into the pockets of creditors who never bargained for a government guarantee.

Thus, the bailouts of 2008-2009 suffer from numerous and serious macroeconomic flaws. First, the bailouts failed to reignite lending and stabilize the economy and instead led to a historic capital hoarding of U.S. government funds. Second, the bailouts left current management of banks largely intact and protected their compensation agreements, creating incentives for managers to conceal losses and keep their firms afloat so that

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ Roubini, *supra* note 174.

¹⁸¹ *Id.*

¹⁸² *Id.*

¹⁸³ See sources cited *supra* notes 134, 135.

¹⁸⁴ Luigi Zingales, *Plan B*, *ECONOMIST’S VOICE*, 1446, Nov. 3, 2008, at 1, 3-4.

¹⁸⁵ *Id.* at 4.

¹⁸⁶ *Id.* at 4-5.

¹⁸⁷ *Id.* at 5.

more compensation payments will be forthcoming. Third, the bailouts did not shutter hopelessly insolvent firms, which means that at some firms, losses are likely to expand. Fourth, the bailouts did not materially assist distressed borrowers so as to contain future losses. Fifth, and most importantly, the government clearly affirmed it would rescue certain financial firms, and thereby, created powerful incentives for both managers and creditors to gorge on risk and propagate new financial crises. The bailouts of 2008-2009 simply do not enjoy much support from the world of macroeconomics.¹⁸⁸ In the end, this may be the most massive misallocation of social wealth in history, particularly in light of the obvious social needs of our citizenry—ranging from education to healthcare.¹⁸⁹

Nor have economists and business commentators greeted the Obama Administration's reform efforts with much warmth.¹⁹⁰ The President of the Federal Reserve Bank of Minneapolis, Gary Stern, states that "the [Obama Administration's] proposal fails to come to grips with TBTF and therefore leaves the financial system considerably more vulnerable than it needs to be to future bouts of instability."¹⁹¹ The core problem with the Administration's proposal is that "there is nothing in the . . . proposal designed to put creditors of large, systemically important financial institutions at risk of loss."¹⁹² According to the *Wall Street Journal*: "Team Obama seeks to codify the bailout policies of the last 18 months."¹⁹³ Columbia University Professor Joseph Stiglitz suggests: "the too-big-to-fail banks have become even bigger. . . . [and] [t]he problems are worse than they were in 2007 before the crisis."¹⁹⁴ He argues that the political power of the financial sector is the cause of this "outrage."¹⁹⁵

¹⁸⁸ The Congressional Oversight Panel also found that successful resolution of financial crises required swift action, the termination of managers, transparency, and the willingness to let hopelessly insolvent banks to fail. CONG. OVERSIGHT PANEL, APRIL OVERSIGHT, ASSESSING TREASURY'S STRATEGY: SIX MONTHS OF TARP 5, 70 (2009), available at <http://cop.senate.gov/documents/cop-040709-report.pdf>.

¹⁸⁹ The Congressional Oversight Panel found that while the government's bailout efforts succeeded in averting a calamity, it did so at the risk of a "significant long run cost to the . . . economy." Moreover, the government's prodigious efforts failed to reignite lending, finding that credit availability, the "lifeblood of the economy, remains low." CONG. OVERSIGHT PANEL, DECEMBER OVERSIGHT REPORT, TAKING STOCK: WHAT HAS THE TROUBLED ASSET RELIEF PROGRAM ACHIEVED? 112-113 (2009), available at <http://cop.senate.gov/documents/cop-120909-report.pdf>.

¹⁹⁰ The Obama Treasury Department released a white paper explaining the full breadth of their reform efforts. U.S. DEPT. OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 2-5 (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. In addition it has proposed legislation. U.S. Department of the Treasury, Financial Regulatory Reform: A New Foundation, <http://www.ustreas.gov/initiatives/regulatoryreform/> (last visited Oct. 26, 2009) [hereinafter *Proposed Legislation*] (listing the proposed legislation).

¹⁹¹ Gary Stern, President, Fed. Reserve Bank of Minneapolis, Remarks to Helena Business Leaders 7 (July 9, 2009) (available at http://www.minneapolisfed.org/news_events/pres/Stern07-09-09.pdf).

¹⁹² *Id.*

¹⁹³ *Who's Too Big to Fail*, *supra* note 31.

¹⁹⁴ Mark Deen & David Tweed, *Stiglitz Says Bank Problems Bigger Than Pre-Lehman*, BLOOMBERG.COM, Sept. 14, 2009, <http://www.bloomberg.com/apps/news?pid=20601085&sid=aSBt8GZjdKI>.

¹⁹⁵ *Id.*

Former Fed Chair Paul Volcker, among others, advised the Administration to reduce the size of TBTF banks.¹⁹⁶ Nevertheless, the Administration's proposal simply identifies banks that are deemed TBTF and subjects them to enhanced regulation, while explicitly expanding the TBTF subsidy to more and larger financial institutions.¹⁹⁷

III. SUBPRIME BAILOUT LAW

On many levels the entire subprime fiasco resulted from a failure of law. One key example is the perverse incentives the law created under the auspices of the pseudo-legal doctrine of TBTF.¹⁹⁸ This legal monstrosity, which always relied on political extortion over formal law, held that major firms (or at least some undefined set of major firms) would be effectively guaranteed against insolvency by the U.S. government.¹⁹⁹

American law had long provided two insolvency regimes: one for banks and another for ordinary commercial enterprises.²⁰⁰ If a bank fails (or becomes "critically undercapitalized"), then the FDIC seizes control and ousts management.²⁰¹ Typically, the FDIC pays off insured depositors and therefore enjoys priority in the distribution of assets with uninsured depositors.²⁰² General unsecured creditors and shareholders are typically last in priority and are thus not likely to fare well.²⁰³ However, Congress has authorized the FDIC to make payments to unsecured claimants based upon estimated recoveries in order to provide liquidity for such claims.²⁰⁴ The failure of Washington Mutual in September of 2008 illustrates the soundness of this resolution regime.²⁰⁵ Although it was the largest bank failure in history, it cost the government insurance fund nothing, and its assets were immediately transferred to another bank.²⁰⁶ While general unsecured creditors took large losses, there is little evidence that its failure

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ Stern, *supra* note 191, at 5 (claiming credit for recognizing "in a timely way that TBTF was a severe and growing problem, that it had not been addressed effectively by the FDICIA legislation of 1991, and that it would eventually and inevitably lead to excessive risk-taking, turmoil in financial markets, and disruption in the economy," unlike most regulators and scholars).

¹⁹⁹ Experts typically define the doctrine of TBTF to mean that certain firms will be guaranteed against failure by government lifelines because policy makers find such firms too important economically to permit failure. STERN & FELDMAN, *supra* note 8, at 1. The September 18, 2009 meeting with Congressional leaders may be a historic example of political extortion—when in the heat of the election the Fed Chair told the Congress that unless a massive bailout was passed immediately "we may not have an economy on Monday." Nocera, *supra* note 63, at A1.

²⁰⁰ Bliss & Kaufman, *supra* note 12, at 144.

²⁰¹ *Id.* at 156 (citing 12 U.S.C. § 1831o (b)(1)(E) (2004)).

²⁰² *Id.* at 161-62.

²⁰³ *Id.* General unsecured creditors may receive protection in cases where the failure to provide such protection results in systemic risk. *Id.* at 161, 165.

²⁰⁴ *Id.* at 167.

²⁰⁵ *JPMorgan Buys Failed WaMu Assets for \$1.9 Billion*, CNBC.COM, Sept. 25, 2008, <http://www.cnbc.com/id/26893741>.

²⁰⁶ *Id.*

led to more widespread instability.²⁰⁷

A second regime for managing insolvency is bankruptcy, which applies to all firms other than banks. Bankruptcy can be triggered at the instance of creditors or the firm itself.²⁰⁸ Unsecured creditors typically fare poorly in bankruptcy--their claims are subject to an automatic stay and are usually paid out in the form of newly issued securities by the reorganized firm.²⁰⁹ Thus, bankruptcy proceedings eliminate issues of moral hazard as unsecured creditors are put at risk of loss, and management contracts are treated as just another creditor claim.²¹⁰ On the other hand, bankruptcy should not be confused with liquidation; in fact, Chapter 11 reorganization specifically promotes the ongoing operations of the firm by staying collection activity (which may otherwise prove disruptive) and making special financing available.²¹¹ Neither bankruptcy nor FDIC receivership law contemplated the massive bailouts of 2008-2009.

In 1991, Congress enacted the Federal Deposit Insurance Corporation Improvement Act ("FDICIA").²¹² At the time, legislative history showed that Congress "strongly intends that the too-big-to-fail policy is hereby abolished."²¹³ The FDICIA did apparently narrow the circumstances under which the FDIC and the Fed could extend assistance to open banks--or at least many commentators so concluded.²¹⁴ Nevertheless, even after the FDICIA, the FDIC retained power to protect uninsured creditors to avert "serious adverse effects on economic conditions or financial stability."²¹⁵ The Fed also still had the power to open the discount window to non-banks.²¹⁶ This is the provision that the Fed relied upon in extending \$30 billion in assistance in connection with the bailout and sale of Bear Stearns to JPMorgan Chase,²¹⁷ as well as the bailout of AIG.²¹⁸ The

²⁰⁷ *Id.*

²⁰⁸ Bliss & Kaufman, *supra* note 12, at 157.

²⁰⁹ *Id.* at 157, 160-61.

²¹⁰ See Ayotte & Skeel, *supra* note 51, at 20.

²¹¹ *Id.* at 8-9.

²¹² Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified in scattered sections of 12 U.S.C.).

²¹³ H.R. REP. NO. 102-330, at 104 (1991).

²¹⁴ See STERN & FELDMAN, *supra* note 8, at 77-78 (reporting on scholarly comments lauding the elimination of TBTF under FDICIA).

²¹⁵ 12 U.S.C. § 1823(c)(4)(G)(i) (2006). In 1984, in connection with the bailout of Continental Illinois Bank, the FDIC extended \$6 billion in loans, cash and capital injections. Silva, *supra* note 19, at 121.

²¹⁶ 12 U.S.C. § 343 ("In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank" to lend to "any individual, partnership, or corporation" if the "Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions.").

²¹⁷ Bd. of Governors of the Fed. Reserve Sys., Minutes 1 (Mar. 14, 2008), <http://www.federalreserve.gov/newsevents/press/other/other20080627a1.pdf>.

²¹⁸ Press Release, Bd. of Governors of the Fed. Reserve Sys., Authorization to the Federal Reserve Bank of New York to Lend up to \$85 billion to the AIG (Sept. 16, 2008) (available at <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm>).

regulatory agencies simply wielded their power in historically unprecedented ways to achieve results without regard to legal expectations. The Fed had never used its power to open the discount window to non-banks on the scale of the AIG or Bear Stearns bailouts.²¹⁹ The primary antecedent for the FDIC's use of deposit insurance funds for other than insured deposits similarly lacked precedent in frequency as well as scope—the bailout of Continental Illinois was relatively puny compared to the bailouts of 2008-2009.²²⁰ Thus, although Congressional abolition of TBTF seems to have always been overstated, the bailouts of 2008-2009 were nevertheless nearly inconceivable under law.

Of course, Congress could bail out banks simply by changing the law, which they did with the enactment of the Emergency Economic Stabilization Act of 2008 (“EESA”).²²¹ This permitted far vaster bailouts with an enhanced veneer of legitimacy than the bailouts that had occurred before October of 2008. More than any other government action, this huge bailout bill—which exceeded \$700 billion—demonstrated that when political leaders are faced with either the risk of economic catastrophe or massive government support for teetering financial giants, they will choose to spend rather than try to explain later.²²² The role of campaign contributions cannot be ignored.²²³ Moreover, the CEOs of the nation's largest financial firms are a small group which commands vast wealth; theories of collective action in the political realm would predict they would hold powerful sway over policy.²²⁴ Perhaps bailouts of large firms, especially financial firms, are inevitable.²²⁵

Nevertheless, the bailouts of 2008-2009 were unprecedented, in scope as well as cost. This suggests that previously the law operated to minimize the TBTF problem relative to today. In fact, as I have argued elsewhere, CEO power within the public corporation has expanded over recent decades. Much of this can be credited to corporate tort reform combined with longstanding power imbalances that CEOs enjoy over the

²¹⁹ See Fettig, *supra* note 45, at 15.

²²⁰ 12 U.S.C. § 1823(c)(4)(G)(i).

²²¹ Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 101(a), 122 Stat. 3765 (codified in 12 U.S.C. §§ 5211-5261).

²²² According to at least one account calls from constituents were overwhelmingly against the EESA. Stewart, *supra* note 62, at 79.

²²³ See sources cited *supra* notes 1-6.

²²⁴ See OLSON, *supra* note 9, at 22-36 (arguing that smaller groups seeking concentrated legislative benefits will face lower costs to organizing and will therefore be more effective than diffused groups which face free riding problems); Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. REV. 1159, 1233 (2006) (stating that special interest negotiation taking place between lawmakers and organized groups with wealth can be “well-hidden”).

²²⁵ In the aftermath of the bankruptcy of Lehman Brothers, there was a general run on the money market mutual fund industry that in turn led to a freeze in short term commercial credit markets that necessitated a \$4 trillion government guarantee of money market funds. Stewart, *supra* note 62, at 75.

composition of the board, their nominal supervisors.²²⁶ Further, the law clearly permits larger financial firms than in decades past as well as more complex business activities. This operated to make financial firms more interconnected as well as larger, raising the systemic risk of large failures. Changes in law, such as the repeal of the Glass-Steagall Act²²⁷ and the Financial Modernization Act of 2000, contributed to these trends.²²⁸ These legal developments appear to have increased the stakes of the TBTF doctrine.

I posit that reforming the TBTF issue requires a durable legal framework that imposes appropriate incentives for the key agents of the creation of TBTF firms—CEOs.²²⁹ Efforts to regulate the risks taken by firms that are TBTF lead to regulatory forbearance and indulgences.²³⁰ In the current crisis, we have seen Congress itself apply pressure to relax accounting rules.²³¹ Once firms become TBTF, it seems unlikely that policymakers will risk the wrath of the public if they permit the real economy to follow the financial sector into an abyss.²³² This political reality is compounded by the access bankers enjoy as a result of their prodigious campaign contributions.²³³ Moreover, many of the key regulators are likely to be at least cognitively and culturally captured by their colleagues in the banking industry.²³⁴ Commentators predicted that firms that were TBTF would in fact be bailed out—and in fact they were.²³⁵ Thus relying upon wise regulation, regulatory ambiguity, or effective regulators to spare the costs of bailouts, financial crises, credit crunches, liquidity traps, and distorted incentives is not likely to work.

This reality highlights the problems with current proposals for dealing with the TBTF problem. Formalizing incentives for becoming TBTF will simply create clearer, more powerful distortions.²³⁶ Relying on

²²⁶ Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, YALE J. ON REG., Summer 2007, at 313, 334 (“CEO primacy is the direct outcome of the system of corporate governance law that devolved in the 1980s and 1990s into a dictatorship of management, by management and for management.”).

²²⁷ Wilmarth, *supra* note 30, at 219-20 nn. 5-7.

²²⁸ Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended at 15 U.S.C §§ 6801-6827 (1999)).

²²⁹ As previously mentioned, usually a bailout under TBTF means the CEO can stay atop a major firm even in the face of catastrophic losses and attain a de facto government guarantee of employment contracts. See source cited *supra* notes 73-82.

²³⁰ STERN & FELDMAN, *supra* note 8, at 53-54.

²³¹ Sources cited *supra* notes 93-97.

²³² See STERN & FELDMAN, *supra* note 8, at 47-56.

²³³ Sources cited *supra* notes 1-7.

²³⁴ Posting of Willem Buiter to Willem Buiter’s Mavercon, <http://blogs.ft.com/maverecon/2009/07/should-fed-chairmen-go-around-kissing-babies/> (July 28, 2009, 18:15 EST).

²³⁵ STERN & FELDMAN, *supra* note 8, at 20.

²³⁶ In fact, the failure of Lehman proved the TBTF doctrine to be false, insofar as Lehman’s failure gave lie to assumption that the government would never allow a major financial firm to enter bankruptcy. Formalization of TBTF thus clarifies the presence of the government guarantee. See sources cited *supra* notes 48-55.

enhanced regulation cannot be effective if regulators forbear.²³⁷ Recent scholarship also suggests that identifying firms that are TBTF in advance is very difficult.²³⁸ The problem is that the temptation to bail out large financial firms is apt to differ from any set of firms identified in advance.²³⁹ Thus, any policy that attempts to pre-identify firms that would be rescued (and impose enhanced regulation) is not likely to be successful.²⁴⁰ Finally, there is a complete absence of empirical evidence that the disincentives from regulatory penalties, such as enhanced capital requirements, leverage limits, or other detriments, outweighs the cheaper capital and government guaranteed compensation payments that attract managers to TBTF in the first instance.²⁴¹

Consequently, the key to controlling costs from firms that are TBTF is to create the proper incentives for those who control the decisions leading to TBTF status—the firm’s CEO who typically controls the firm’s destiny.²⁴² We have seen that these CEOs do not appreciate federal input into their compensation.²⁴³ They are therefore likely to abhor having their compensation agreements discharged as they would be in bankruptcy and FDIC receivership.²⁴⁴ Under 12 U.S.C. Section 1821(e), the FDIC has the power to set aside certain agreements.²⁴⁵ Compensation agreements for

²³⁷ As former St. Louis Fed President William Poole states: “Regulation itself cannot be the solution because if regulators make mistakes, as they have in the past and will in the future, the government is likely to again bail out banks deemed too big to fail.” William Poole, Senior Fellow at Cato Inst., *Moral Hazard: The Long-Lasting Legacy of Bailouts* Address at the 27th Annual Monetary and Trade Conference 3 (Apr. 29, 2009), (available at <http://www.interdependence.org/docs/Bill-Poole-Speech.pdf>).

²³⁸ James B. Thompson, *On Systemically Important Financial Institutions and Progressive Systemic Mitigation 5*, (Fed. Reserve Bank of Cleveland, Policy Discussion Paper No. 27, 2009), available at <http://www.clevelandfed.org/research/policydis/pdp27.pdf>.

²³⁹ *Id.* (noting that “regulators are reluctant to allow the official failure (closure) of a distressed financial institution under particular economic or financial market conditions if its solvency could have been resolved under more normal conditions. Hence, conditions/context are sources of systemic importance”).

²⁴⁰ *Id.*

²⁴¹ In fact, none of these putative regulatory burdens would seem to affect the supply of capital to a firm at all. See STERN & FELDMAN, *supra* note 8, at 19.

²⁴² Fredrick Tung proposes that banks issue subordinated debt and mandate that managers be paid with such instruments to reduce their risk appetite. Tung, *supra* note 112, at 340-41. That concept is entirely consistent with the proposal herein. Similarly, William Poole urges that deductibility of interest be curtailed to discourage excessive leverage and that banks issue subordinated debt to impose market-based discipline upon bank managers. Poole, *supra* note 237, at 17 (“These two reforms—phasing out the deductibility of interest on business tax returns and requiring banks to maintain subordinated debt in their capital structure—would change the incentives under which firms operate. Firms would be more stable individually and the economy would be more stable.”).

²⁴³ Since 2005, I have argued that corporate governance in the U.S. has devolved from a shareholder primacy model to a CEO primacy model. Steven A. Ramirez, *People of Color, Women, and the Public Corporation: Rethinking the Corporation (and Race) in America; Can Law (and Professionalization) Fix “Minor” Problems of Externalization, Internalization, and Governance?*, 79 ST. JOHN’S L. REV. 977, 982 n.24 (2005) (“The CEO typically holds ultimate control over management and decisive control over the selection of directors.”).

²⁴⁴ For example, Treasury Secretary Paulson assumed that CEOs would decline to participate in any federal bailout if it meant that their compensation may be compromised. Stewart, *supra* note 62, at 77.

²⁴⁵ 12 U.S.C. § 1821 (e) (2006).

senior executives at firms that are bailed out because they are TBTF should be similarly dischargeable. First, their own misconduct likely contributed to the insolvency of their firms. Second, but for the government assistance, their compensation agreements would have been worthless. Thus, there are policy considerations at least as powerful as those supporting section 1821(e), supporting the discharge of such agreements. Most importantly, the very existence of such a provision would powerfully deter senior executives from seeking TBTF status.

Second, given the centrality of government subsidies to firms that are TBTF, there is no reason that such instrumentalities of the state, with access to vast sums of federal funding, should ever be shielded in any way from the perpetration of securities fraud.²⁴⁶ Thus, the protections for those committing securities fraud in the Private Securities Litigation Reform Act of 1995²⁴⁷ and the Securities Litigation Uniform Standards Act of 1998²⁴⁸ should be eliminated for the senior officers and directors of firms that are TBTF when they receive government funds or other assistance.²⁴⁹ This would do no more than expose miscreants to the full brunt of the federal securities laws as they existed from 1934 through 1995, when, as I have previously pointed out, the federal securities laws seemed to operate to minimize scandals and lower the cost of capital.²⁵⁰ Amending these acts is therefore a costless means of averting the full macroeconomic horrors of bailouts for dysfunctional firms. This is particularly so given that the onset of federal protection of securities “fraudfeasors” has generally been associated with corporate scandals upon corporate scandals with extraordinarily negative macroeconomic costs.²⁵¹ Simply put, the PSLRA was a bad idea in 1995, which is particularly heinous when it operates to protect those raiding the federal fisc.

Third, there is little reason why managers with proven track records of crashing their firms to the point of requiring a federal bailout should

²⁴⁶ See *In re Citigroup Inc. Shareholder Derivative Litig.*, No. 07 Civ. 9841, 2009 WL 2610746, at *9 (S.D.N.Y. Aug. 25, 2009) (dismissing securities fraud action against directors and officers of Citigroup for failing to disclose extent of subprime exposure under the heightened pleading standards which protect securities fraudfeasors under the Private Securities Litigation Reform Act).

²⁴⁷ Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).

²⁴⁸ Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, § 1260, 112 Stat. 3227 (codified in 15 U.S.C. § 78a (1998)).

²⁴⁹ I have argued that the PSLRA suffered from a lack of policy basis since its enactment. Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious As Well As the Frivolous*, 40 WM. & MARY L. REV. 1055, 1082 (1999) (stating that the PSLRA “is a further move toward the risky strategy of financial deregulation. The original conception of federal securities regulation—that the nation needed federal regulation to create more stringent standards of conduct than those prevailing under state law—seems to have been lost in the shuffle”).

²⁵⁰ *Id.* at 1085.

²⁵¹ Since the passage of the PSLRA American capital markets have suffered through the Enron calamity and related scandals, the options backdating scandals, and the subprime debacle. Ramirez, *supra* note 32, at 3-4.

retain control over such firms. Almost always managers of firms that are TBTF only turn to the government for bailouts in the wake of excessive risk. The bailouts of 2008-2009 were precipitated by pathetically promiscuous risk management.²⁵² Moreover, new management would have incentives to recognize losses immediately, which economists recognize is the key to reigniting new lending.²⁵³ On the other hand, there may be a need for some managerial continuity, and it is possible that some managers are merely in the wrong firm at the wrong time. Thus, any expenditure of government support for firms that are TBTF should be conditioned upon the presumptive termination of all of the senior managers and board of the failed firm. Only senior managers that are vital to the firm's business should be retained in extraordinary circumstances. Certainly, the norm would be to discharge virtually all of the inept managers that crashed the firm. In FDIC receiverships, the FDIC legally accedes to all the powers of the board and management.²⁵⁴

Fourth, regulators (weak as they may be) should be empowered to order prudential divestitures of operations anytime a firm approaches TBTF status.²⁵⁵ I do not propose this reform because of faith in regulators. Instead, if operations can be subject to divestiture, there is less incentive for such acquisitions in the first instance.²⁵⁶ Creditors will see that such acquisitions are exposing firms to the penalties of being TBTF. Thus, they will naturally view such divestitures as imposing a real risk of non-payment because managers would react to divestitures by slimming down their firms or facing sanctions.²⁵⁷ Meanwhile, if given the power to order divestitures, regulators will almost certainly exercise the power or risk public rebuke if firms are bailed out.²⁵⁸ Again, this creates disincentives for firms to become TBTF. Divestiture has long been an available remedy to counter excessive power in the context of antitrust law. Indeed, famous examples include the

²⁵² Ramirez, *supra* note 32, at 52 (“The subprime fiasco rose from one of the ‘worst miscalculations in the annals of risk management.’”) (citing Shawn Tully, *Wall Street's Money Machine Breaks Down*, FORTUNE, Nov. 12, 2007, available at http://money.cnn.com/magazines/fortune/fortune_archive/2007/11/26/101232838/index.htm).

²⁵³ See sources cited *supra* notes 26, 125, and 188.

²⁵⁴ 12 U.S.C. § 1821 (d)(2)(A)(i).

²⁵⁵ On December 11, 2009, the House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009. Section 1105 of this proposed legislation included regulatory power to order prudential divestitures of bank divisions or assets to reduce systemic risk. Posting of Steven Ramirez to Corporate Justice Blog, <http://corporatejusticeblog.blogspot.com/2009/12/prudential-divestitures-ii-or-iii-or-iv.html> (Dec. 14, 2009, 8:57 EST).

²⁵⁶ There is strong empirical evidence that CEOs frequently lead their firms into value destroying mergers, which is consistent with the idea that many such mergers are specifically intended to lead to TBTF status. See STERN & FELDMAN, *supra* note 8, at 32-33, 66.

²⁵⁷ Exposing creditors to the risk of nonpayment is central to eliminating the distorted incentives of TBTF. *Id.* at 2.

²⁵⁸ Gary Stern has proposed a similar approach focusing on a more stringent merger review. Bill McConnell, *Big, Bigger and Too Big*, DEAL MAGAZINE, May 15, 2009, <http://www.thedeal.com/http://www.thedeal.com/newsweekly/features/big,-bigger-and-too-big.php>. Legally, my proposal to empower regulators to order prudential divestiture anytime a firm becomes TBTF focuses the reform upon the core problem without interfering in general antitrust policy.

break-up of Standard Oil Co. and AT&T, neither of which triggered the kind of macroeconomic costs associated with TBTF.²⁵⁹

Fifth, harsh criminal and administrative penalties should follow reckless conduct leading to bailouts. Currently, the FDIC retains broad power to assess civil penalties to those exposing banks to unsafe or unsound practices.²⁶⁰ There are also broad criminal prohibitions against bank fraud.²⁶¹ The FDIC routinely investigates claims against every manager of a failed bank.²⁶² Given the social costs implicit in TBTF, every disbursement of government funds or assistance under systemic risk provisions should trigger an automatic investigation of civil or criminal misconduct, as well as claims that can lead to recoverable assets to defray bailout costs.²⁶³ Because TBTF banks impose disproportionately large social costs, the penalties for causing losses to such institutions should be more severe than the penalties facing managers of ordinary banks—and should provide substantial administrative fines (commensurate with the compensation earned by the manager) to those managers causing loss through unsafe and unsound practices. Further, any person causing a loss to a TBTF firm through reckless misconduct should face incarceration akin to those convicted of bank fraud. Managers have proven that the temptation to boost profits through excessive risk can be irresistible.²⁶⁴ Knowledge that bailouts mean subpoenas or worse may give pause to managers who may otherwise fall prey to distorted incentives. Scholars have proposed dedicating Department of Justice personnel to the pursuit of white collar criminals, and this proposal would dovetail with such innovations.²⁶⁵

It would be hard to imagine managers that would expose themselves to this battery of penalties. Capital requirements, leverage limitations, and other prudential limitations, as the Obama Administration has proposed,

²⁵⁹ Spencer Weber Waller, *The Past, Present, and Future of Monopolization Remedies*, 76 ANTITRUST L.J. 11, 26 (2009).

²⁶⁰ Steven A. Ramirez, *The Chaos of 12 U.S.C. Section 1821 (k): Congressional Subsidizing of Negligent Bank Directors and Officers?*, 65 FORDHAM L. REV. 625, 645-46, 658 (1996). An unsafe or unsound practice is anything that results in an abnormal risk of loss to a financial institution. *Id.* at 658 n.183. Banking regulators have broad authority to sanction unsafe and unsound practices. *Id.* at 658 (citing 12 U.S.C. § 1818 (1994)).

²⁶¹ See *U.S. v. Weidner*, 437 F.3d 1023, 1031-32 (10th Cir. 2006) (upholding bank fraud convictions against borrower and bank officer even though loan was repaid in full).

²⁶² *Federal and State Enforcement of Consumer and Investor Protection Laws: Hearing Before the H. Finance Servs. Comm.*, 111th Cong. 10 (2009) (statement of Martin J. Gruenberg, Vice Chairman, Fed. Deposit Ins. Corp.), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/fdic_-_gruenberg.pdf.

²⁶³ During the 1980s and 1990s, the FDIC, acting as receiver of failed banks recovered over \$5 billion from the pursuit of professional liability claims, such as claims against directors and officers. FDIC, MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 1980-1994, at 266 (1998), available at <http://www.fdic.gov/bank/historical/managing/history1-11.pdf>.

²⁶⁴ Ramirez, *supra* note 32, at 64-67.

²⁶⁵ See Mary Kreiner Ramirez, *Prioritizing Justice: Combating Corporate Crime from Task Force to Top Priority*, 93 MARQ. L. REV. (forthcoming 2010).

would complement these proposed reforms.²⁶⁶ Similarly, these proposed sanctions contemplate that TBTF bailouts may well occur in the future under a more formalized legal regime, such as that proposed by the Obama Administration.²⁶⁷ Still, given the costs and the economic catastrophe inherent in the TBTF doctrine, more needs to be done than the meager disincentives currently proposed by the Obama Administration. Given these costs, it is crucial that disincentives for managers be clear: CEO wealth, and even liberty, is at stake should firms flirt with TBTF status. CEOs can be expected to respond to these incentives just as they have exploited incentives to dominate their firms and incur excessive risk in the cause of short term profit. In sum, CEOs would be well advised to avoid becoming TBTF in light of the sanctions proposed herein. This should operate to minimize the TBTF problem.

Economist James Galbraith writes in *The Predator State* that our system of government is rotting from the “systemic abuse of public institutions for private profit.”²⁶⁸ In particular, he argues that corporate elites constitute a “predator class” that subverted the rule of law.²⁶⁹ According to Galbraith, this class seized control of the state itself and “set out to run . . . it—not for any ideological project but simply in a way that would bring to them, individually and as a group, the most money.”²⁷⁰ Prophetically, Galbraith suggested these interests would seek government rescues in times of trouble.²⁷¹ More recently, Galbraith argued that insolvent banks be rapidly shuttered and their managers terminated.²⁷² New managers will have proper incentives to write off toxic assets and sell the remains into the market where the remaining capital can support lending.²⁷³ Going forward he suggests that large financial firms be fragmented into smaller firms so that their failure can no longer propagate global financial

²⁶⁶ The Administration’s proposals include positive innovations, such as more expansive regulatory net and more prudential limitations on TBTF financial institutions—defined as “Tier 1 Financial Holding Companies.” See *Proposed Legislation*, *supra* note 190 (proposed legislation, Tit. II, § 204). The proposals herein complement my previous proposals relating to corporate governance reforms. See Ramirez, *supra* note 32, at 52–66.

²⁶⁷ *Proposed Legislation*, *supra* note 190, at §§1203–1204; see also *id.* § 1301 (formalizing Fed authority under section 13(3)). Another laudable virtue of the Obama Administration’s proposal is that it vests bailout authority in a depoliticized entity, specifically the Fed. *Id.* at § 1203(a). Bailout power, if recognized at all, certainly should be vested in a depoliticized regulatory authority like the Fed. See Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503, 591–93 (2000) (arguing for further depoliticization of financial regulation and suggesting the Fed as the model for depoliticized regulatory agencies).

²⁶⁸ JAMES K. GALBRAITH, *THE PREDATOR STATE: HOW CONSERVATIVES ABANDONED THE FREE MARKET AND WHY LIBERALS SHOULD TOO* xiii (2008).

²⁶⁹ *Id.* at 125.

²⁷⁰ *Id.* at 126.

²⁷¹ *Id.*

²⁷² *Economist James Galbraith: Bailed-Out Banks Should Be Declared Insolvent*, (Democracy Now broadcast Feb. 10, 2009), available at http://www.democracynow.org/2009/2/10/economist_james_galbraith_bailed_out_banks.

²⁷³ See *id.*

meltdown.²⁷⁴ This he suggests is “common sense.”²⁷⁵ The current regime of TBTF is simply an “affront to our democracy.”²⁷⁶ As such, continuation of the TBTF regime will subvert the confidence of citizens in an evenhanded legal framework governing economic activity and ultimately, in the rule of law itself.²⁷⁷

CONCLUSION

The law can adjust incentives and disincentives facing managers of firms flirting with TBTF status. Creating appropriate disincentives and destroying destructive incentives for such managers should greatly mitigate the huge costs implicit in implied government guarantees. Any tally of such costs suggests that strong disincentives and greatly reduced incentives, under a clear rule of law, are urgently needed. Indeed, financial firms are exiting the current crisis bigger than ever while benefitting from greater government commitments. Elites outside the financial system must exercise their influence to weigh against this continued abuse of government resources. Indeed, even elites within the financial system should demand that the gross distortions that caused this crisis be deconstructed, as they themselves suffered great damage from subsidies to a small handful of their competitors. This article argues that a combination of privatized, administrative, and criminal sanctions can reset and rationalize incentives. If the political heft of the financial sector prevails in securing more certain government guarantees of failure, without legal penalties, the law will have failed to prevent future financial meltdowns.

Moreover, given the huge economic stakes implicit in a continuation of TBTF, as essentially formalized in the Obama Administration’s proposal, our legal system will have devolved in large measure into a political free for all insofar as economic law and regulation is concerned. Such an outcome is too bitter to contemplate. For at time when

²⁷⁴ McConnell, *supra* note 258.

²⁷⁵ *Id.*

²⁷⁶ As former St. Louis Fed President William Poole states:

Our current bailout world is an affront to democracy. There is much anger in our society. People who were responsible in their use of debt, many of whom are struggling to stay current on their obligations, will eventually be taxed to cover losses incurred by irresponsible borrowers and lenders. We know that many executives of financial firms, despite huge losses, have larger fortunes remaining than most of us can ever dream of enjoying. Taxpayers, in general, will pay for losses incurred by the insolvent, or nearly insolvent, firms these executives left behind. These bitter attitudes in our society today tend to be dismissed as “populist.” That is a mischaracterization; no one, whatever his political persuasion, should be willing to accept without complaint wealth transfers of the sort now taking place.

Poole, *supra* note 237, at 7.

²⁷⁷ TAMANAHA, *supra* note 11, at 141 (stating that an “indispensible element” of the rule of law is that the “general populace” accepts the “propriety of” the legal system).

the rule of law is revered as a source of macroeconomic growth, it will mean that the U.S. has essentially devolved from a system where elites were deprived of the ability to rig the economic system in their favor to a system where economic and political power renders sound policy irrelevant. This devolution in law is inconsistent with continued American economic leadership. Perhaps some new economic power will see fit to minimize costs implicit in the TBTF issue through the rule of law.