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Government Ownership of Banks: A Curse or a Blessing for the United States?

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GOVERNMENT OWNERSHIP OF BANKS: A CURSE OR A BLESSING FOR THE UNITED STATES?

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ABSTRACT

During the Financial Crisis of 2007–2008, the Treasury injected an enormous amount of capital and held equity in 707 financial institutions to stabilize the U.S. financial system. The government's large-scale ownership of banks alarmed the U.S. banking sector. The mainstream opinion in the United States strongly opposed this practice, mostly due to the distrust of the government and the fear that government intervention would jeopardize private shareholders' interests. Later developments, including the Treasury's quick exit from its holdings and the Dodd-Frank Act's declaration of the end of bailouts, suggest that the U.S. government eventually succumbed to the mainstream opinion.

Such sentiment against government ownership appears to be no more than a myth. In this Article, I provide a balanced view of government ownership in the U.S. context. By tracing the experience of government ownership of private corporations throughout U.S. history, I find that the United States not only is familiar with this practice, but also has developed a set of governance rules to constrain the government's potential abuse of its power derived from the ownership. Empirical evidence based on cross-country data also suggests that a competitive financial market, a developed financial system, and advanced political institutions may control

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the downsides of government ownership of banks; the United States possesses all of these institutions. In fact, in this post–Financial Crisis era, where risk management has become a pillar of good bank governance, government ownership of banks can bring benefits to the U.S. banking sector. Specifically, government directors appointed by the government owner can better represent creditors' interests, supplement incomplete banking regulation and supervision, and reduce informational asymmetry between the banking regulator and banks. This, in turn, can improve poor risk management of banks and lead to greater financial stability. What the United States needs is not a complete rejection of government ownership, but proper legal designs to control the government's exercise of its ownership, such as a conditional and temporary adoption of government ownership, a minority-based governance structure, clear roles and duties of government directors, statutory access to fiduciary claims against government directors, and disclosure rules. The balanced views provided in this Article can allow the United States to be more comfortable with the prospective use of government ownership in the banking sector.

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INTRODUCTION

Unlike governments in most jurisdictions, the U.S. government generally resists owning firms.[1] The financial crisis of 2007–2008 (Financial Crisis), however, challenged such resistance.[2] To stabilize the financial system, the U.S. government injected an enormous amount of capital into financial institutions, mostly banks, to maintain liquidity and protect against insolvency.[3] As a result, the Treasury held equity in 707 U.S. financial institutions, including the American International Group, Inc. (AIG), Citigroup, Inc. (Citigroup), and Bank of America (BoA), etc.[4] In some instances, the Treasury even appointed its representatives to the board of the financial institutions.[5] In effect, it became a giant bank-holding entity: the "Treasury Inc."[6]

Unsurprisingly, the Treasury Inc. incurred strong and widespread opposition within the United States. The opposition came from three major concerns.[7] The first concern relates to the

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[1] Catherine C. Eckel & Theo Vermaelen, *Internal Regulation: The Effects of Government Ownership on the Value of the Firm*, 29 J.L. & ECON. 381, 382 (1986); Mariana Pargendler, *State Ownership and Corporate Governance*, 80 FORDHAM L. REV. 2917, 2925 (2012). As a definitional matter, throughout this Article, the term "government ownership" refers to any level of a government's equities in private firms, either in the form of common stock, preferred stock, or equity warranty, be it majority or minority, voting or non-voting.

[2] Throughout this Article, the term "Financial Crisis" refers to the global financial crisis that started in the summer of 2007. It originated from increasing subprime mortgage defaults and the reverse of decades-long increases in home prices (the so-called "subprime crisis"). The subprime crisis, in turn, froze up the credit market and then threatened the liquidity and solvency of the largest global financial institutions, which eventually harmed the whole financial system. For a brief introduction to the Financial Crisis, as well as its impact, see generally HAL S. SCOTT & ANNA GELPERN, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 41–52 (21st ed. 2016).

[3] *See id.* at 82–83.

[4] *See infra* Section I.C.

[5] *Id.*

[6] *See generally* J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283, 283 (2010) [hereinafter Verret, *Treasury Inc.*].

[7] Other concerns include the fear that the market might perceive the banks receiving government funds as backed by the government and thus, less likely to fail, and that government ownership is inherently incompatible with the U.S. corporate and securities laws. *See* J.W. Verret, *The Bailout Through a Public*

taxpayers' interest.[8] Critics were concerned that, in rescuing the too-big-to-fail financial institutions, the government might overpay the price for their equity and end up wasting the taxpayers' money.[9] The second concern relates to the incumbent shareholders' interest. Critics were concerned that, in the bailout process, the government would nationalize the banks and thus effectively appropriate the equity interest of incumbent shareholders in these banks.[10] The third concern relates to the general shareholders' interest. Critics were concerned that, after acquiring the financial institutions' ownership, the government might use their control derived therefrom to inefficiently intervene into the corporate interests[11] or even pursue the politicians' political agendas rather than shareholders' interests.[12]

Choice Lens: Government-Controlled Corporations as a Mechanism for Rent Transfer, 40 SETON HALL L. REV. 1521, 1521 (2010) [hereinafter Verret, *The Bailout Through a Public Choice Lens*]. S*ee generally* Verrett*, Treasury Inc.*, *supra* note 6, at 283.

[8] *See, e.g.*, Peter Conti-Brown, *Elective Shareholder Liability*, 64 STAN. L. REV. 409, 409 (2012); Steven M. Davidoff, *Uncomfortable Embrace: Federal Corporate Ownership in the Midst of the Financial Crisis*, 95 MINN. L. REV. 1733, 1756 (2011); Jeffrey Manns, *Building Better Bailouts: The Case for a Long-Term Investment Approach*, 63 FLA. L. REV. 1349, 1349 (2011).

[9] For instance, the Congressional Oversight Panel studied the Treasury's investment during the Financial Crisis and found that the Treasury generally overpaid for all of the assets in the study. *See* CONG. OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: VALUING TREASURY'S ACQUISITIONS (2009), http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT47178/pdf/CPRT-111JPRT47178.pdf [https://perma.cc/5E9V-QG44].

[10] *See, e.g.*, Julia D. Mahoney, *Takings, Legitimacy, and Emergency Action: Lessons from the Financial Crisis of 2008*, 23 GEO. MASON L. REV. 299, 304 (2016); Andrew J. Morris, *When a Bailout is a Taking: Can Takings Solve the Problem of the Government as Controlling Shareholder?*, 16 U. PA. J. BUS. L. 897, 898 (2014).

[11] For instance, it was reported that Citigroup repaid its TARP funds earlier than expected in order to extricate itself from the Treasury's control and influence, particularly with respect to the restriction on its executive compensation policy. Matthew R. Shahabian, *The Government as Shareholder and Political Risk: Procedural Protections in the Bailout*, 86 N.Y.U. L. REV. 351, 362 (2011).

[12] *See, e.g.*, Barbara Black, *The U.S. as "Reluctant Shareholder:" Government, Business, and the Law*, 5 ENTREPRENEURIAL BUS. L.J. 561, 583 (2010); Marcel Kahan & Edward B. Rock, *When the Government Is the Controlling Shareholder*, 89 TEX. L. REV. 1293, 1306 (2011) [hereinafter Kahan & Rock, *When the Government Is the Controlling Shareholder*]; Marcel Kahan & Edward B. Rock, *When the Government is the Controlling Shareholder: Implications for Delaware*, 35 DEL. J. CORP. L. 409, 412 (2010) [hereinafter Kahan & Rock, *Implications for Delaware*]; Shahabian, *supra* note 11, at 352; Benjamin A. Templin, *The Government*

To alleviate these concerns, the Treasury tried its best to assure Americans that it was reluctant to take ownership of banks. It declared that it would hold equities only on a short-term basis.[13] During this period, it also promised that it would act as passively as possible to minimize intervention in the corporate decisions of banks.[14] In general, the Treasury kept its promise: it exited from most of its equity holdings within two years after the Financial Crisis.[15] Moreover, in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Congress further declared the policy goal of "ending bailouts" in the United States.[16] In this way, the U.S. government and Congress eventually succumbed to the opponents of government ownership. Accordingly, even though the Financial Crisis on its face challenged the U.S. government's resistance to owning financial institutions, the developments during and after the Financial Crisis in fact affirmed, and even intensified, such resistance.

It is worth noting that, amidst these critics, their ways of addressing government ownership of banks diverge. While the mainstream view proposes to simply reject this practice, an unneglectable number of studies take a moderate stance.[17] Although these studies also acknowledge that the government may abuse its power, they propose to discipline it by imposing institutional constraints on the exercise of government ownership. For instance, to address the first concern identified above, i.e., the taxpayers' interest, a number of studies have brought forward various proposals to ensure that the government bails out financial institutions at a fair price.[18] To address the second concern, i.e., the incumbent shareholders' interest, the Court of Federal Claims in *Starr International Company v. United States*[19] has also attempted to

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Shareholder: Regulating Public Ownership of Private Enterprise, 62 ADMIN. L. REV. 1127, 1164 (2010); Verret, *Treasury Inc.*, *supra* note 6, at 287.

[13] *See* Verret, *Treasury Inc.*, *supra* note 6, at 331.

[14] *See id.* at 295–96.

[15] *See infra* Section I.C.

[16] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[17] *See* Conti-Brown, *supra* note 8, at 427.

[18] *See, e.g.*, *id.* at 409; Manns, *supra* note 8, at 1369.

[19] Starr Int'l Co. v. United States, 121 Fed. Cl. 428, 434 (2015). For related comments, see generally Mahoney, *supra* note 10, at 311.

clarify the government's rules of conduct to discipline the government's use of bailout power.[20]

Interestingly, as to the third concern, i.e., the general shareholders' interest under government ownership, relatively fewer studies propose practical institutional constraints to safeguard private shareholders.[21] The mainstream studies in this aspect simply emphasize the draconian effect of government ownership on private shareholders' interest.[22] They hypothesize that the government is untrustworthy, and thus, any form of government ownership, a tool representing egregious market intervention from the government, is undesirable.[23] This mainstream view, however, requires some re-evaluation from at least the following three aspects. First, the ingrained distrust of government ownership might be a myth. The overall empirical evidence, as will be demonstrated in this Article, suggests that with adequate institutional safeguards, government ownership of banks would not jeopardize shareholders' interests or social welfare.[24] Second, government ownership of banks can also produce advantages. Specifically, corporate governance of banks after the Financial Crisis calls for strong vehicles to prevent mismanagement of business directors, while government ownership could serve as this vehicle. Third, institutional designs, instead of wholesale rejection, might be a better way to control the potential disadvantages of government ownership of banks. Proper institutional designs can safeguard taxpayers' interests and incumbent shareholders' interests when the government bails out banks, and they should be able to work in the case of general shareholders' interests.

In reality, the U.S. government cannot rule out the possibility of future ownership of banks. The "too-big-to-fail" problem

[20] In 2017, however, the Court of Appeals for the Federal Circuit vacated the decision of the Court of Federal Claims and declared part of the decision moot. *See* Starr Int'l Co. v. United States, 856 F.3d 953, 957 (Fed. Cir. 2017).

[21] For the minority opinion, see, e.g., Black, *supra* note 12, at 565.

[22] *See, e.g.*, Kahan & Rock, *When the Government Is the Controlling Shareholder, supra* note 12, at 1297–98; Shahabian, *supra* note 11, at 351–52; Verret, *Treasury Inc.*, *supra* note 6, at 287; Verret, *The Bailout Through a Public Choice Lens, supra* note 7, at 1524.

[23] *See* Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1308.

[24] *See infra* Part II.

inherent in the U.S. banking sector remains, rendering the Dodd-Frank Act's efforts in restricting the government's future bailout of insolvent banks[25] less credible. Therefore, government ownership of banks, though undesirable, might remain inevitable.[26] The U.S. banking sector should at least learn how to handle this practice. This post–Financial Crisis era, when we still have fresh memories about the fragility of financial systems as well as government ownership of banks, offers an appropriate time to ascertain how to harmonize government ownership of banks with the U.S. financial system.

In light of the above, I revisit the practice of government ownership in the United States, with a focus on the banking sector. This Article is structured as follows: Part I begins by reviewing the evolution of government ownership in the United States and demonstrates that such practice, to the United States, is in fact not that unfamiliar. To lay down foundations for further discussion, this Part also reviews associated debates over this practice and briefs the mainstream opinion against this practice in the United States.

Part II addresses the perceived downsides of government ownership of banks, particularly the fear of heightened agency costs and political interference. I argue that, for a regulated sector like

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[25] The preamble of the Dodd-Frank Act declares that one of the Act's objectives is "to protect the American taxpayer by ending bailouts." Dodd-Frank Act, section 1101 further amends the Federal Reserve Act, section 13(3), thereby restricting the Federal Reserve's use of its emergency authority to programs with "broad-based eligibility" and requiring the Federal Reserve to design rules for ensuring that its emergency lending is "not to aid a failing financial company." Dodd Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 716, 124 Stat. 1376 (2010). This amendment aimed at foreclosing the support of individual insolvent banks (such as Bear Stearns and AIG during the Financial Crisis). SCOTT & GELPERN, *supra* note 2, at 93–94. President Obama also stated that, "because of this law, the American people will never again be asked to foot the bill for Wall Street's mistakes." *Remarks on Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act*, WHITE HOUSE (July 21, 2010), https://obamawhitehouse.archives.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act [http://perma.cc/MAE6-G2XW].

[26] For literature suspecting that the Dodd-Frank Act can end future bailouts, see generally Anthony J. Casey & Eric A. Posner, *A Framework for Bailout Regulation*, 91 NOTRE DAME L. REV. 479, 536 (2015); Conti-Brown, *supra* note 8, at 431; Manns, *supra* note 8, at 1382.

the banking sector, the negative effects associated with the government could be marginal and should not be exaggerated. After all, heavy regulation might have imposed a considerable amount of cost. In addition, although government ownership of banks appears to harm individual firm performance and overall economic development in a general sense, the United States may possess institutional infrastructures that can mitigate these downsides, including: (1) a competitive financial market; (2) a well-developed financial system; and (3) transparent and accountable political institutions. Accordingly, I advocate a U.S. exception to the perceived downsides of government ownership of banks.

Part III turns to the bright sides of government ownership. I argue that through its ownership, the government may appoint directors to the boards of the bailed-out banks, thereby improving poor risk management and contributing to financial stability. Current studies of bank governance widely acknowledge that banks require robust risk management to protect creditors' interests as well as their own stability and survival. The practice entrusts this task mainly to the boards of directors of banks. The Financial Crisis, however, exposed the failure of current board practice in the United States. Business directors turned out to have neither the capacity to manage risks nor adequate incentive to resist pursuing short-term profits in order to mitigate long-term risks. To address this dilemma of corporate governance, government owners, and their appointed government directors, could be an answer. They may have better incentives. They may supplement incomplete financial supervision and thus serve as another channel for the financial regulator to implement its regulatory policies. They may further reduce the informational asymmetries between banks and the regulator. Accordingly, I argue that the benefits of government directorship of banks should not be obscured. At the very least, when an individual bank goes insolvent and calls for the government's bailout, that bank's board failure should be well inferred, which justifies the introduction of government directors.

Based on the above analyses, in Part IV, I advocate that U.S. society should be more positive toward government ownership of banks. I specifically discuss a model employing government ownership and government directors, under which the regulator has the authority to appoint a small number of directors for a specified period of time when a bank fails to properly perform its risk management. I also discuss some practical considerations related to government ownership of banks, including the source of talents of government directors, the ownership and directorship structure, the role and mission of government directors, access to fiduciary claims against government owners and directors, and disclosures. This Article concludes in the last section.

Throughout this Article, I will provide a different lens for the United States to reflect on government ownership of banks. The downsides of this practice are certainly real but should not be exaggerated, while the bright sides should not be ignored. With proper legal design, government ownership of banks could be a blessing instead of a curse in the United States. I anticipate that the analysis of this Article provides some balanced views and allows U.S. society to be more comfortable with the prospective use of government ownership.

I. Government Ownership in the United States and the Resistance to It

Opponents of government ownership believe a myth that this governmental act is extraordinary. Indeed, compared with most jurisdictions around the world, this practice is relatively uncommon in the United States.[27] It is, however, by no means absent. The U.S. government adopted this practice from time to time. In this Part, I will review the evolution of government ownership practice in the United States first, and then explore the grounds adopted by the mainstream opinion in the United States for opposing such practice.

A. The Evolution of Government Ownership in the United States Before the Financial Crisis

There are two major types of government ownership in the United States: government corporations and government ownership of private corporations.[28]

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[27] Pargendler, *supra* note 1, at 2925.

[28] *See id.* at 2926.

1. The Evolution of Government Corporations

"Government corporations" refers to corporations chartered by Congress or states to achieve governmental objectives.[29] They behave like governmental agencies dressed in corporate form.[30] While I do not intend to address the practices and challenges associated with government corporations in this Article, a brief review of their evolution is helpful for understanding the whole picture of government ownership in the United States.

Before World War II, government corporations were common in the United States.[31] The first government corporation was the Bank of the United States: in 1791, Congress authorized the U.S. government to subscribe 20 percent of its stock.[32] After its expiration, Congress chartered another government corporation, i.e., the Second Bank of the United States in 1816, and again authorized the U.S. government to subscribe 20 percent of its stock.[33] Congress also authorized the President to appoint five of the twenty-five directors of the Second Bank of the United States, with the Senate's advice, while leaving the rest of the directors elected annually by shareholders other than the U.S. government.[34] Other examples of government corporations in early ages included the Union Pacific Railroad[35] and the Panama Railroad Company.[36] During World War I, the United States further commenced a "large-scale use of government-controlled corporations" by incorporating

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[29] *See* Verret, *Treasury Inc., supra* note 6, at 291.

[30] *See* Pargendler, *supra* note 1, at 2931.

[31] For some summaries of government corporation practice in the U.S., see Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 386–89 (1995). *See also* Lloyd D. Musolf, *American Mixed Enterprise and Government Responsibility*, 24 W. POL. Q. 789, 795–801 (1971); Pargendler, *supra* note 1, at 2925–32; Verret, *Treasury Inc., supra* note 6, at 289.

[32] *Lebron*, 513 U.S. at 386 (citing Act of Feb. 25, 1791, ch. 10, 1 Stat. 191, 196).

[33] *See id.* at 386–87.

[34] *See id.* (citing Act of Apr. 10, 1816, 3 Stat. 266 and 269).

[35] Congress chartered the Union Pacific Railroad in 1862 and authorized the President to appoint two of its fifteen directors. *Id.* at 387 (citing Act of July 1, 1862, § 1, 12 Stat. 489, 491).

[36] The Panama Railroad Company was incorporated in 1849 in the State of New York. The U.S. government purchased its stock from the New Panama Canal Company of France in 1902 and became the sole shareholder. The Secretary of War, as the holder of the stock, elected all of its thirteen directors. *Id.*

the United States Grain Corporation, the United States Emergency Fleet Corporation, the United States Spruce Production Corporation, and the War Finance Corporation.[37] Nevertheless, it dissolved most of them after the War ended.[38]

Government corporations subsequently re-emerged during the Great Depression.[39] To stabilize the economy and make distress loans to farms, homeowners, banks, and other enterprises, the U.S. government again employed government corporations.[40] The major instance was the Reconstruction Finance Corporation (RFC); Congress chartered it to make loans to banks, insurance companies, railroads, land banks, and agricultural credit organizations[41] and empowered it to incorporate corporations.[42] Other instances included the Federal Deposit Insurance Corporation (FDIC), the Tennessee Valley Authority (TVA), the Defense Homes Corporation, and the Tennessee Valley Associated Cooperatives, Incorporated.[43] At the end of World War II, there were in total fifty-eight government corporations.[44]

After World War II, government corporations gradually lost their popularity.[45] Skeptics were increasingly concerned that the U.S. government might circumvent its accountability through incorporating government corporations.[46] These concerns ultimately led to the abrogation of this practice.[47] Many government corporations were dissolved.[48] Although thereafter Congress still created

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[37] *Id.* at 388.

[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] The RFC, in turn, incorporated, among others, the Defense Plant Corporation, the Defense Supplies Corporation, the Metals Reserve Company, the Petroleum Reserves Corporation, the Rubber Development Corporation, and the War Damage Corporation. *Id.* at 389.

[43] *Id.* at 388–89.

[44] *Id.* at 389.

[45] *Id.*

[46] *Id.*

[47] *Id.* at 389–90. Congress passed the Government Corporation Control Act (GCCA) in 1945, ordering the dissolution or liquidation of all government corporations except for those Congress should act to reincorporate and prohibiting the creation of new government corporations without specific congressional authorization. *Id.*

[48] *Id.* at 389.

government corporations, their charters usually made it clear that they were agencies of the U.S. government.[49]

Only a few ambiguities have occurred since the 1960s. One was the Communications Satellite Corporation (Comsat).[50] It was a publicly traded corporation chartered by the Communications Satellite Act of 1962.[51] Though private shareholders own all the shares of Comsat, the Comsat 1962 federal charter allowed the U.S. President to appoint three "public interest" directors out of its fifteen board members.[52] This governance structure was designed to ensure governmental influence and supervision without implicating the government's financial interest in Comsat.[53] It also permitted a private company to raise private capital while enjoying preferential treatment from the government.[54] The U.S. government subsequently followed this "Comsat model" and created several "private" corporations.[55]

Two well-known government corporations that suffered severe criticism during the Financial Crisis are the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac).[56] Congress chartered these two government-sponsored enterprises ("GSEs") to establish secondary market facilities for residential mortgages.[57] Before the Financial Crisis, the government held no equity interest in these two publicly traded companies, but, according to their charters, the President

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[49] For instance, the Foreign Assistance Act of 1969 created the Overseas Private Investment Corporation while making it clear that it is "an agency of the United States under the policy guidance of the Secretary of State." Foreign Assistance Act of 1969, Pub. L. No. 91-175, § 105, 83 Stat. 809 (1969) (codified as amended 22 U.S.C. § 2191 (1969)).

[50] *Lebron*, 513 U.S. at 390.

[51] *Id.* at 390, 397.

[52] *Id.* at 390–91.

[53] Pargendler, *supra* note 1, at 2927.

[54] *Lebron*, 513 U.S. at 390.

[55] Instances include the Corporation for Public Broadcasting, Legal Services Corporation, and Amtrak. *See id.* at 391.

[56] *Statement of FHFA Director James B. Lockhart at News Conference Announcing Conservatorship of Fannie Mae and Freddie Mac*, FHFA (Sept. 7, 2008), https://www.fhfa.gov/media/publicaffairs/pages/statement-of-fhfa-director-james-b--lockhart-at-news-conference-announcing-conservatorship-of-fannie-mae-and-freddie-mac.aspx [https://perma.cc/S5DT-SRXW] [hereinafter *Lockhart Announcement*].

[57] *Id.*

had the authority to appoint directors to their boards.[58] After the Financial Crisis broke out, the Federal Housing Finance Agency, the competent authority in charge of these two GSEs, decided to place these two companies in its conservatorship in September 2008.[59] The Treasury, through the Making Home Affordable Program, injected $50 billion in Troubled Asset Relief Program (TARP) funding, together with the Federal Reserve's $200 billion, to support these two entities.[60] Eventually, the Treasury held new senior preferred stock and common stock warrants amounting to 79.9 percent of each entity.[61]

Government corporations are incorporated by Congress through special charter laws to pursue certain governmental objectives.[62] While they are in corporate form, and some of them are even publicly traded companies, their operation often implicates other social or policy goals that are beyond commercial purposes; this complicates the corporate governance of government corporations.[63] In this Article, I do not intend to address the corporate governance issues associated with these special corporations. Rather, I will focus on those ordinary private banks of which the government holds ownership.[64]

B. Government Ownership of Private Corporations Before the Financial Crisis

Beyond chartering corporations to achieve governmental objectives, the U.S. government occasionally holds ownership of ordinary private corporations as a consequence of a political or economic crisis.

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[58] Verret, *Treasury Inc.*, *supra* note 6, at 292.

[59] *Lockhart Announcement*, *supra* note 56.

[60] Verret, *Treasury Inc.*, *supra* note 6, at 296.

[61] Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1300, 1309. For further discussion of the details of the Fannie Mae and Freddie Mac bailouts, see Casey & Posner, *supra* note 26, at 507–12.

[62] Richard Scott Carnell, *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565, 570–71 (2005).

[63] Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1318.

[64] For discussions of government corporations, see, e.g., Carnell, *supra* note 62, at 567, 569–72; Jill Spencer et al., *The Cooperative Structure of the Federal Loan Banks: A Model for Government Sponsored Enterprises*, 13 N.C. BANKING INST. 227, 228, 245 (2009).

1. RFC Investments

The first notable instance was the RFC investments.[65] As mentioned above, Congress established the RFC in 1932 as a government corporation to make loans to banks, railroads, and local governments. In March 1933, Congress passed the Emergency Banking Act, authorizing the RFC to purchase preferred stock of banks that ran short of capital.[66] The RFC thus invested around $1.2 billion in U.S. banks from 1933 to 1935.[67] After 1935, banks started to repay the government to purchase back their preferred stock; when the RFC was abolished in 1957, less than $5 million in two banks was unpaid.[68]

The RFC's approach for managing the banks is arguable.[69] The preferred stock that the RFC held carried voting rights.[70] Based on these voting rights, the RFC often appointed new executive officers and directors after making an investment.[71] In exchange for the RFC's assistance, senior executives of the receiving banks even had to reduce their salaries.[72] That said, the RFC Chairman repeatedly emphasized that the RFC did not intend to dictate management or coerce bank policies or bank investment.[73]

2. APC Companies

Another notable instance of government ownership of private corporations was the Alien Property Custodian companies

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[65] For a brief account of the RFC investments and comparison of the RFC to the TARP, see Lissa L. Broome, *Government Investment in Banks: Creeping Nationalization or Prudent, Temporary Aid?*, 4 FLA. INT'L U. L. REV. 409, 422–24, 426–28 (2009); *see also* Walker F. Todd, *History of and Rationales for the Reconstruction Finance Corporation*, 28 FED. RES. BANK CLEVELAND, ECON. REV. 22, 22–23, 27, 32 (1992).

[66] Emergency Banking Act, Pub. L. No. 73-1, § 304, 48 Stat. 1, 6 (1933).

[67] Broome, *supra* note 65, at 423.

[68] *Id.* at 423–24.

[69] According to one commentator, the RFC's experience "might provide some comfort that government voting rights did not unnecessarily complicate the management of the banks in which the government invested." *Id.* at 428. According to another commentator, the RFC, over time, became corrupted by politics. Todd, *supra* note 65, at 26–28.

[70] Broome, *supra* note 65, at 422.

[71] *Id.*

[72] Todd, *supra* note 65, at 26.

[73] Broome, *supra* note 65, at 427.

(APC companies).[74] At the time the United States entered into World War II, it seized enemy-owned assets in the United States, including the stakes of German and Japanese corporations in seventeen U.S. companies, some public and some private.[75] The portion of shares held by the government differed, ranging from 35 to 100 percent.[76] The actual holding period also differed, ranging from one to twenty-three years.[77]

In these APC companies, the government's approach was seemingly hands-off. After acquiring blocks of shares, the government largely altered the composition of board members and placed its representatives on the board.[78] After changing board members, however, the government's role became passive. Except for transactions not in the normal course of business, which required the government's specific authorization, the government did not actively direct the operation of these APC companies; rather, it granted general authorizations to the management.[79] In this way, the government essentially played a supervisory role in these companies.

3. Continental Illinois Corporation

Another notable example was Continental Illinois Corporation (CIC) in the 1980s. CIC was a publicly traded holding company of Continental Illinois National Bank in Chicago, then the seventh largest bank in the United States.[80] Due to the bailout of Continental Illinois National Bank in 1984, the government held CIC's ownership.[81] The FDIC purchased a $720 million issue of permanent, non-voting and junior preferred stock and a $280 million issue of permanent, adjustable-rate and cumulative

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[74] For an introduction to the APC companies, see generally Stacey R. Kole & J. Harold Mulherin, *The Government as a Shareholder: A Case from the United States*, 40 J.L. & ECON. 1 (1997).

[75] *Id.* at 1.

[76] *Id.*

[77] *Id.*

[78] *Id.* at 6–8.

[79] *Id.* at 8–9.

[80] Black, *supra* note 12, at 576.

[81] *Id.*

preferred stock of CIC.[82] This effectively gave the FDIC 80 percent ownership of CIC.[83]

In managing CIC, the government again seemed to be rather hands-off. Except that the FDIC, pursuant to the terms of the government assistance, had a veto power over the nomination of any director, and its shares bore no voting rights during the holding period.[84] Additionally, except in limited areas, such as the appointment of board members or proposed mergers, the FDIC did not interfere with CIC's day-to-day operations.[85]

4. Summary

In sum, the U.S. government was not unfamiliar with the practice of government ownership before the Financial Crisis. In addition, in light of the governance practice adopted in the RFC investments, APC companies, and CIC, the U.S. government appeared to have developed a set of guidelines for managing its ownership, which featured a rather hands-off approach.

C. The "Treasury, Inc." and the Resistance to It

1. The "Treasury, Inc." During the Financial Crisis

Aside from the above cases, the U.S. government generally refrained from holding ownership in private firms and private financial institutions.[86] It, however, abandoned such self-constraint during the Financial Crisis.

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[82] *Id.* at 577.

[83] *Id.*

[84] *Id.* at 577–78.

[85] *Id.* at 578. Despite this, both the banking community and Continental Illinois still feared that the public would perceive CIC as a "nationalized" bank, which could incur some competitive disadvantages. *See id.*

[86] A prime exception to government-owned financial institutions is the Bank of North Dakota ("BND"). "The BND is a wholly state owned and operated bank [formed in 1919]—the only one of its kind in the United States currently," and is organized to foster local economic development, small business growth, and localism and relational banking via community banks and credit unions. Marc Schneiberg, *Organizational Diversity and Regulatory Strategy in Financial Markets: Possibilities for Upgrading and Reform*, 18 N.C. BANKING INST. 141, 158 (2013). For a comprehensive introduction to the BND practice, especially how it performs its development mission, see *id.* at 157–65.

The bailout during the Financial Crisis, particularly the TARP, brought about the U.S. government's large-scale ownership of financial institutions. To provide additional liquidity to the credit market and prevent failures of systemically important financial institutions, the U.S. government launched a series of bailout measures during the Financial Crisis.[87] Among them, Congress passed the Emergency Economic Stabilization Act of 2008 (EESA), which established the TARP in October 2008.[88] Within the TARP framework, the Treasury launched several equity injection programs,[89] including, among others, the Capital Purchase Program (CPP).[90] This led to the Treasury's investment of around $205 billion into 707 financial institutions,[91] including BoA, Citigroup, JP Morgan, Wells Fargo, Goldman Sachs, and Morgan Stanley.[92] In addition to the CPP, the AIG Investment Program (previously known as Systemically Significant Failing Institutions Program) provided further investment in AIG,[93] and the Targeted Investment Program (TIP) provided further investment in Citigroup and

[87] For a summary of the U.S. government's bailout measures during the Financial Crisis, see SCOTT & GELPERN, *supra* note 2, at 52–93.

[88] For an introduction to the U.S. government's investment under TARP, see, e.g., SCOTT & GELPERN, *supra* note 2, at 78–82; Black, *supra* note 12, at 561–63.

[89] Kahan & Rock indicated that the TARP originally aimed at stabilizing the financial system by authorizing the Treasury to engage in the purchase of troubled assets from troubled financial institutions, but the Treasury took advantage of the broad definition of "troubled assets" to obtain the entitlement to purchase shares of troubled financial institutions. Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1309–10. Shahabian also reviewed legislative history and suggested that Congress, when passing the TARP, intended equity purchase to be only a secondary tool to toxic assets purchase. Shahabian, *supra* note 11, at 357–58.

[90] Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1309.

[91] *Capital Purchase Program*, U.S. DEP'T OF THE TREASURY, https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/bank-investment-programs/cap/Pages/overview.aspx [https://perma.cc/K9SC-8PSD].

[92] For information related to the Treasury's investment and subsequent disposition under the CPP, see generally U.S. DEP'T OF THE TREASURY, MONTHLY REPORT TO CONGRESS: December 2018 (2018), https://www.treasury.gov/initiatives/financial-stability/reports/Documents/2018.12%20December%20Monthly%20Report%20to%20Congress.pdf.

[93] *Investment in American International Group*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/aig/Pages/default.aspx [https://perma.cc/7LK5-D6X9].

BoA.[94] In addition to bailing out financial institutions, the Treasury later extended its equity investment to automobile industries through the newly created Automotive Industry Financing Program, which invested in General Motors, Inc. (GM), Chrysler Holding LLC (Chrysler), GM's finance subsidiary General Motors Acceptance Corporation (GMAC, now Ally Financial), and Chrysler Financial.[95] Through these equity investments, the Treasury held considerable ownership of financial institutions and automobile firms.[96]

The Treasury, however, identified itself as a "reluctant shareholder."[97] Under the CPP, the Treasury invested in financial institutions mostly in the form of preferred stock with warrants, which did not involve voting power except in certain specified situations.[98] Under other programs, although the Treasury occasionally held voting stock, it declared several principles to guide its actions as a shareholder. For instance, it would not interfere in the day-to-day management decisions and would dispose of its investment as soon as practicable.[99] In addition, it would exercise its voting rights as a common shareholder only in respect of core shareholder matters, such as board membership, amendments to corporate charters or bylaws, mergers, liquidations, substantial asset sales, and significant common stock issuances.[100] In this way,

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[94] *Targeted Investment Program*, U.S. DEP'T OF THE TREASURY, https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/bank-investment-programs/tip/Pages/overview.aspx [https://perma.cc/7NFS-SG92].

[95] *Auto Industry*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/automotive-programs/Pages/default.aspx [https://perma.cc/ZZ2V-ACFP].

[96] For more detailed summaries of these bailout investments, see Davidoff, *supra* note 8, at 1736–56. *See generally* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463 (2009).

[97] U.S. DEP'T OF THE TREASURY, OFFICE OF FINANCIAL STABILITY, AGENCY FINANCIAL REPORT, FISCAL YEAR 2009, at 41 (2009), https://www.treasury.gov/about/organizational-structure/offices/Mgt/Documents/OFS%20AFR%2009_24.pdf [https://perma.cc/UBE8-XLGC].

[98] The Treasury, however, might exercise the voting rights when the amendments to the charter or certain transactions could adversely affect the Treasury's investment. *Id.* at 41.

[99] *Id.* at 42

[100] *Id.* The White House also declared similar sets of principles for the government's management of automobile restructuring initiative. *See Fact Sheet: Obama*

the Treasury again adopted a "shareholder restraint" policy: no interference in daily management decisions, as well as restricted voting rights limited to core shareholder issues.[101] One commentator characterized the governance model adopted by the Treasury during this period as akin to a venture capital model: instead of taking active control of the firm, the Treasury left the management of the rescued banks to continue to run their enterprises.[102]

The specific practice of government ownership during this period contains at least three distinct models, as seen below.

2. AIG: A Majority Shareholder Model

AIG is a special example of government ownership during the Financial Crisis due to the government's majority voting right. The Treasury bailed out AIG before the TARP came into place.[103] It engaged in several rounds of equity investment in AIG from September to November of 2008 and agreed on a restructuring plan with AIG in September of 2010.[104] Initially, the Treasury held only non-voting preferred stock of AIG.[105] Through the subsequent restructuring, however, the Treasury held up to 92 percent of AIG's common stock together with other preferred stock in AIG and its two special purpose vehicles.[106] Moreover, since AIG failed to pay four quarterly dividends on preferred shares, in April 2010, the

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Administration Auto Restructuring Initiative General Motors Restructuring, U.S. DEP'T OF THE TREASURY, https://www.treasury.gov/press-center/press-releases/Pages/tg179.aspx [https://perma.cc/AK7J-BE5N].

[101] Black, *supra* note 12, at 575.

[102] Davidoff & Zaring, *supra* note 96, at 539–40. For a different observation, see Davidoff, *supra* note 8, at 1767–72 (arguing that the government's governance model during the bailouts did not resemble any of the private equity firms, institutional investors, or venture capitalists).

[103] Kimberley Amadeo, *AIG Bailout, Cost, Timeline, Bonuses, Causes, Effects*, BALANCE (Nov. 5, 2018), https://www.thebalance.com/aig-bailout-cost-timeline-bonuses-causes-effects-3305693 [https://perma.cc/X7ZR-UJ2X].

[104] This debt and equity arrangement subsequently triggered the taking lawsuits initiated by AIG's shareholders against the government. For related discussion, see generally Mahoney, *supra* note 10; Morris, *supra* note 10.

[105] *See* Morris, *supra* note 10, at 908.

[106] U.S. DEP'T OF THE TREASURY, OFFICE OF FINANCIAL STABILITY, AGENCY FINANCIAL REPORT, FISCAL YEAR 2011, at 30–31 (2011), http://www.treasury.gov/initiatives/financial-stability/briefing-room/reports/agency_reports/Documents /2011_OFS_AFR_11-11-11.pdf [https://perma.cc/2DDH-YVZN].

Treasury exercised its right to appoint two additional directors to the board of AIG.[107] After a series of restructurings and dispositions, the Treasury finally sold its shares of AIG in December 2012.[108]

To manage the AIG shares it held, the Treasury employed a special trust vehicle. Instead of directly holding them, it established the AIG Credit Facility Trust to hold AIG's shares for the sole benefit of the Federal Reserve Bank of New York ("FRBNY").[109] The purpose of this design was to prevent potential conflicts between the government's role as both a regulator and an investor.[110] According to the trust agreement, the government would not influence the voting rights vested by the stock, and the Trust would leave the day-to-day management of AIG to its management.[111] This was the only bailout case during the Financial Crisis in which the Treasury adopted a trust structure to hold and manage the equities.[112]

3. Citigroup: A Major Shareholder Model

In contrast to AIG, Citigroup was a different case during the Financial Crisis because the Treasury did not hold majority equities.[113] The Treasury, pursuant to the CPP, invested $25 billion in Citigroup in October 2008 in exchange for non-voting perpetual preferred stock.[114] It invested another $20 billion in December 2008 pursuant to the TIP in exchange for preferred stock.[115] In July 2009, in order to strengthen its capital, Citigroup agreed to convert the preferred stock held by the Treasury, under the CPP,

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[107] Press Release, U.S. Dep't of the Treasury, Treasury Names Two Appointees to AIG'S Board of Directors (Apr. 1, 2010), http://www.treasury.gov/press-center/press-releases/Pages/tg623.aspx [https://perma.cc/9N2S-S7W9].

[108] *Investment in AIG: Program Status*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/aig/Pages/status.aspx [https://perma.cc/Y24E-43T6].

[109] *See* Morris, *supra* note 10, at 907–08.

[110] AIG CREDIT FACILITY TRUST AGREEMENT 2 (Jan. 16, 2009), https://www.newyorkfed.org/medialibrary/media/newsevents/AIGCFTAgreement.pdf [https://perma.cc/4TWX-SK9H].

[111] *Id.* at 2. For a further introduction to this Trust Agreement, see Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1351–52.

[112] *See* Black, *supra* note 12, at 579–80.

[113] *See id.* at 573.

[114] *See* U.S. DEP'T OF THE TREASURY, *supra* note 92, at 33.

[115] *See id.* at 56.

into Citigroup's common stock, which allocated 34 percent of Citigroup's outstanding common stock to the Treasury.[116] After this conversion, Citigroup accelerated its repayment to the Treasury; it repaid the Treasury's TIP holding in December 2009.[117] The Treasury also commenced selling its CPP holdings in April 2010, and it completed the disposal of Citigroup's common shares in December 2010.[118]

In the Citigroup bailout, the Treasury, throughout the holding period, held equities in Citigroup directly.[119] To prevent excessive government intervention, the Treasury agreed to limit its exercise of voting power.[120] This included an explicit promise in the exchange agreement to vote in the same proportions as other shareholders, except for major corporate matters (such as director election or removal, charter amendment, and major change to the company).[121]

4. BoA: A Minority Shareholder Model

In contrast to AIG and Citigroup, the case of BoA was different since the Treasury held extremely little and non-voting equities in BoA.[122] The Treasury, pursuant to the CPP, invested $15 billion in BoA's preferred stock with warrants in October 2008, and another $10 billion in January 2009.[123] It further invested another $20 billion in BoA's non-voting preferred stock pursuant to the TIP in January 2009.[124] These equities, however, only represented around 0.04 percent of BoA's total outstanding shares and bore no voting rights.[125] Even if it exercised the warrants,

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[116] Citigroup, Inc., Quarterly Report (Form 10-Q), at 9 (Nov. 6, 2009).

[117] *See* U.S. DEP'T OF THE TREASURY, *supra* note 92, at 56.

[118] *Id.* at 56.

[119] *See* Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1300.

[120] *See id.* at 1310.

[121] *See* Citigroup, Inc., Amendment No. 5 (Form S-4), at 75–76 (July 17, 2009).

[122] *See* William O. Fisher, *When the Government Attempts to Change the Board, Investors Should Know*, 40 PEPP. L. REV. 533, 543–44 (2013).

[123] *See id.* at 544.

[124] *See* U.S. DEP'T OF THE TREASURY, *supra* note 92, at 56.

[125] David M. Barnes, Note, *Shotgun Weddings: Director and Officer Fiduciary Duties in Government-Controlled and Partially-Nationalized Corporations*, 63 VAND. L. REV. 1419, 1439 (2010).

the Treasury would at most own around 5.2 percent of BoA's shares.[126] Therefore, the Treasury's role in BoA was even more hands-off. BoA had repaid all of the Treasury's investments by December 2009.[127]

After the Financial Crisis was under control, the Treasury kept its promise to liquidate its equity holding in banks. As of December 31, 2018, the Treasury had collected $226.8 billion in proceeds as opposed to the $205 billion original investment and retains holdings in only three financial institutions as opposed to the 707 initially funded institutions.[128]

5. Debates over Government Ownership in the United States

The Treasury's ownership of banks during the Financial Crisis received strong criticism in the U.S. industries and academia. The majority of commentators criticized that the Treasury's bailout was unnecessary and urged it to relinquish its equity holdings as soon as possible. They grounded their criticism on three major concerns: the Treasury's ignorance of taxpayers' interests,[129] misappropriation of incumbent shareholders' interests,[130] and inadequate protection of private shareholders' interests in these banks.[131] In this Article, I will focus on the latter concern.[132]

The majority argued, in a nutshell, that when the government employs its ownership to influence corporate policy for its own interest, shareholders risk diminished firm value.[133] This

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[126] *See id.* at 1434–40.

[127] *See* U.S. DEP'T OF THE TREASURY, *supra* note 92, at 56.

[128] *See id.* at 1.

[129] *See generally, e.g.*, Casey & Posner, *supra* note 26; Davidoff, *supra* note 8; Manns, *supra* note 8.

[130] *See generally, e.g.*, Mahoney, *supra* note 10.

[131] *See generally* Mahoney, *supra* note 10; Morris, *supra* note 10.

[132] A separate concern relates to the distortion of competition. For instance, the Treasury's bailout could result in adverse selection, where customers may have more faith and confidence in those bailed-out banks because they have the government's backup. This could give them a competitive advantage over their competitors that were "ironically safer prior to the bailout." Verret, *Treasury Inc.*, *supra* note 6, at 306; *see also* Verret, *The Bailout Through a Public Choice Lens*, *supra* note 7, at 1525.

[133] *See, e.g.*, Shahabian, *supra* note 11, at 352. And such negative effects arise not only when the government holds majority shares (such as 79 percent in AIG case) or substantial shares (such as 34 percent in the Citigroup case). Even

argument tracks the conventional wisdom of the property rights theory.[134] The property rights theorists believe that government-owned firms incur more serious moral hazard problems and agency problems than private firms.[135] In their view, a government is essentially owned by all diffused taxpayers.[136] Since no taxpayer can sell his/her ownership of the government to express his/her dissatisfaction, the government bureaucrats and politicians who exercise the ownership are subject to less supervision.[137] In the context of the banking sector, this concern is greater for the following reasons. First, government bureaucrats and politicians can disguise their political motivation more easily since the banking sector is more complicated and outsiders may thus suffer more serious informational asymmetry to supervise the quality of a specific bank loan.[138] Second, it takes more time to ascertain the costs of any politically motivated loan since loans usually have a longer period of maturity.[139] Third, government bureaucrats and

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when the government holds few shares or even non-voting shares (such as the BoA case), these shareholdings, together with the government's position as a regulator, the statutes and regulations associated with the TARP program, and the terms of bailout contract, etc., are sufficient to make the government a controlling, or at least influential, shareholder. *See* Barnes, *supra* note 125, at 1445–54; Shahabian, *supra* note 11, at 359–60; Verret, *Treasury Inc.*, *supra* note 6, at 299–307.

[134] Related literature often cites Armen Alchian as the leading proponent of the property right theory. *See generally* Armen A. Alchian, *Some Economics of Property Rights*, 30 II POLITICO 816 (1965); Enrico Perotti, *State Ownership: A Residual Role?* (World Bank Pol'y Res., Working Paper No. 3407, 2004).

[135] *See* Alchian, *supra* note 134, at 818–19.

[136] *See id.* at 823.

[137] Douglas W. Caves & Laurits R. Christensen, *The Relative Efficiency of Public and Private Firms in a Competitive Environment: The Case of Canadian Railroad*, 88 J. POL. ECON. 958, 959 (1980); *see also* Alchian, *supra* note 134, at 822; Cotton M. Lindsay, *A Theory of Government Enterprise*, 84 J. POL. ECON. 1061, 1064 (1976) (arguing that, as it is difficult for Congress to define and monitor social outputs, a government-owned enterprise may tend to spend costs on those outputs visible to Congress, which could result in social inefficiency because government-owned enterprises may not necessarily achieve social objectives.); Perotti, *supra* note 134, at 4–5. For a more recent discussion, see, e.g., Eduardo Levy Yeyati et al., *A Reappraisal of State-Owned Banks*, 7 ECONOMIA 209, 209 (2007).

[138] Serdar Dinc, *Politicians and Banks: Political Influences on Government-Owned Banks in Emerging Markets*, 77 J. FIN. ECON. 453, 454 (2005).

[139] *Id.*

politicians can divert funds more easily since the banking sector operates across the whole economy rather than in a defined industry.[140] Finally, government bureaucrats and politicians may possess more control over the banking sector due to the higher entry barriers of this sector.[141]

To be fair, there remain some theories supporting government ownership of banks.[142] For instance, the regulatory theory argues that government ownership of banks can facilitate banking regulation and supervision.[143] In this view, the government may have limited ability to design complete regulations ex ante.[144] If the regulator cannot control misbehaviors of private banks through ex ante regulation, government ownership may vest the regulator with direct control over these banks and thus supplement incomplete regulation.[145] Nevertheless, this regulatory function of government ownership largely depends on a benevolent government; the property rights theory, based on the difficulties of supervising the government, challenges this fundamental assumption.[146]

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[140] *Id.*

[141] *Id.*

[142] For a summary of these theories, see Perotti, *supra* note 134, at 4–5, 8–9; Yeyati et al., *supra* note 137, at 218–21.

[143] Perotti, *supra* note 134, at 5.

[144] *See generally* Oliver Hart et al., *The Proper Scope of Government: Theory and an Application to Prisons*, 112 Q. J. ECON. 1127 (1997); David E.M. Sappington & Joseph E. Stiglitz, *Privatization, Information and Incentives* (Nat'l Bureau Econ. Res., Working Paper No. 2196, 1987).

[145] *See* Perotti, *supra* note 134, at 5. Perotti, however, rebuts that private ownership only reduces the government's discretion rather than deprives the government of discretion. With the power of legislation, the regulator can always change laws to regulate private sectors and manage their misbehavior. *Id.* at 11–12.

[146] Rafael La Porta et al., *Government Ownership of Banks*, 57 J. FIN. 265, 266 (2002); *see also* Andrei Shleifer & Robert W. Vishny, *Politicians and Firms*, 109 Q.J. ECON. 995, 995 (1994); Yeyati et al., *supra* note 137, at 221–23.

Another theory supporting government ownership of banks is the developmental theory. It argues that when a government cannot create a friendly environment for private investment, direct government ownership in production can be a substitute. *See, e.g.*, Andrei Shleifer, *State versus Private Ownership*, 12 J. ECON. PERSP. 133, 147–48 (1998); Joseph E. Stiglitz et al., *The Role of the State in Financial Markets*, WORLD BANK ANN. CONF. ON DEV. ECON. 1992 at 19, 19 (1993), http://documents.worldbank.org/curated/en/239281468741290885/pdf/multi-page.pdf [https://perma.cc/UCP3-GSTE]. In banking sectors, for countries where economic institutions have not sufficiently developed for private banks

According to a majority of opinions in the United States, the U.S. experience during the Financial Crisis supported the property rights theory from at least four interrelated aspects.[147] First, the government does not maximize shareholders' interest due to its different definition of utility with other shareholders.[148] It might use shareholders' investments for social or political purposes rather than for economic gains.[149] Several instances during the Financial Crisis evidenced this concern. For example, it was reported that the President and Congress continually pressed government-owned banks, including Citigroup and BoA, to increase lending to small businesses, restrain actions against struggling homeowners, and maintain specific mortgage loan modification programs.[150] These actions might achieve the social utility pursued by the government, but at the same time they may diminish the value of shareholders' investment.

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to play the crucial role of financial development for economic growth, the government could step in by creating government-owned banks to fill this gap and improve the general welfare. After the Financial Crisis, some commentators further highlighted the countercyclical role of government-owned banks. *See also* Alejandro Micco & Ugo Panizza, *Bank Ownership and Lending Behavior*, 93 ECON. LETTER 220, 220–21 (2006); Yeyati et al., *supra* note 137, at 224, 231–32. *See generally* Ata Can Bertay et al., *Bank Ownership and Credit over the Business Cycle: Is Lending by State Banks Less Procyclical?* (World Bank Pol'y Res., Working Paper No. WPS 6110, 2012); Martin Cihak & Asli Demirguc-Kunt, *Rethinking the State's Role in Finance* 13–15 (World Bank Pol'y Res., Working Paper No. WPS 6400, 2013); Eva Gutierrez et al., *Development Banks: Role and Mechanisms to Increase their Efficiency* 8–9 (World Bank Pol'y Res., Working Paper No. WPS 5729, 2011). This development view, however, might sound too aggressive in the United States considering that the United States has a relatively developed financial sector. For the studies of this development view in the U.S. context, see generally Schneiberg, *supra* note 86.

[147] *See* Templin, *supra* note 12, at 1198.

[148] *See* Verret, *Treasury Inc.*, *supra* note 6, at 316.

[149] *See* Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1306, 1318–19; Shahabian, *supra* note 11, at 360–63.

[150] *See* Barnes, *supra* note 125, at 1451; Kahan & Rock, *Implications for Delaware*, *supra* note 12, at 410; Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1302–04; Shahabian, *supra* note 11, at 362. In the bailout of GM and Chrysler, it was reported as well that Congress pressed these two firms to prevent the closure of GM and Chrysler dealers. Kahan & Rock, *Implications for Delaware*, *supra* note 12, at 410; Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1304–05; Shahabian, *supra* note 11, at 362–63.

Second, the government is susceptible to political interference from different interest groups. Government ownership thus invites political intervention into the corporate decisions of government-owned firms. An example was the government's exercise of influence to alter the board or management of TARP-supported financial institutions. For instance, it was reported that the Treasury, through its majority voting power derived from its bailout, influenced the restructuring of AIG's board.[151] This action might meet the expectation of the public and restore the public's confidence in the government, but it does not necessarily serve the best interests of the rescued banks and their shareholders.

Third, the government is inefficient in managing banks. Government bureaucrats might not possess the requisite market expertise to manage private banks efficiently. In particular, for countries like the United States where the government has long refused to involve itself in firms' operation, government bureaucrats can hardly have adequate experience to handle corporate affairs. This could lead to waste and inefficiency. For instance, the Congressional Oversight Panel studied the Treasury's investment during the Financial Crisis and found that the Treasury generally overpaid for all of the assets in the study.[152] This evidences the Treasury's inefficiency in the business world.

Fourth, the government has conflicting interests. In government-owned firms, the government has a dual role as both the regulator and an investor. To the extent that the government's investment interest in the firms affects its exercise of governmental authority, the conflict of interest arises.[153] For instance, in the bailout of Fannie Mae, it was reported that the Treasury blocked Fannie Mae's contemplated sale of $3 billion in tax credits to Goldman Sachs and Berkshire Hathaway because it feared that it would lose tax revenues should the buyers use the credits to offset their taxes.[154] Such conflicting interests can also conversely benefit the government-owned banks in the sacrifice of the quality of regulations. For instance, during the bailout, the Treasury

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[151] Fisher, *supra* note 122, at 536–43.

[152] *See* CONG. OVERSIGHT PANEL, *supra* note 9.

[153] *See* Pargendler, *supra* note 1, at 2919.

[154] *See* Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1305–06.

issued a series of notices granting AIG a "special tax break," which acknowledged AIG's continued use of its net operating losses in the future.[155] These notices arguably distorted section 382 of the Tax Code.[156] Regardless in which direction, the regulator fails to perform effective supervision due to its conflicts of interest.[157]

To be fair, not all the voices in the United States oppose government ownership of banks. Benjamin Templin, for instance, applies the stakeholder theory to justify the "policy-driven management" of the government.[158] He noted that even in ordinary firms, as reflected in the stakeholder theory, not all shareholders are interested in maximizing the value of firms.[159] To mitigate potential negative effects associated with the stakeholder theory, he proposed some sets of institutional norms to permit the use of government ownership while preserving free market principles.[160] Barbara Black proposed a more aggressive model of government

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[155] Kevin Roose, *Bailout Watchdogs Criticize A.I.G. Tax Breaks*, N.Y. TIMES: DEALBOOK (Mar. 12, 2012, 12:15 PM), https://dealbook.nytimes.com/2012/03/12/bailout-watchdogs-criticize-a-i-g-tax-breaks/ [https://perma.cc/FW86-RHS5].

[156] For related criticism, see generally J. Mark Ramseyer & Eric B. Rasmusen, *Can the Treasury Exempt its Own Companies from Tax?: The $45 Billion GM NOL Carryforward*, 1 CATO PAPERS ON PUB. POL'Y 1 (2011) (arguing that Section 382 of the Tax Code prevents an acquirer from using the target's net operating losses). If the Treasury sold the stock it holds in bailout firms, such as AIG or GM, it should trigger this section. Nevertheless, the Treasury issued a series of notices interpreting that section 382 would not apply in its cases and AIG and GM would be entitled to use its net operating losses after the Treasury sold its stock.

[157] Moreover, some commentators also cautioned that because government ownership to a certain extent implies some form of government guarantee, the private sector will have no incentive to monitor these government-owned firms as well. In the end, none of the private and public sectors provide effective supervision. Gerard Caprio, Jr. & Ross Levine, *Corporate Governance in Finance: Concepts and International Observations*, *in* FINANCIAL SECTOR GOVERNANCE: THE ROLES OF THE PUBLIC AND PRIVATE 17, 39–41 (Robert E. Litan et al. eds., 2002).

[158] *See generally* Templin, *supra* note 12, at 1185.

[159] *Id.*

[160] Templin raised three core principles for government ownership. First, there must be political insulation of the investment decision and management of assets by creating an independent investment authority. Second, there must be ethical walls between the investment authority and the regulatory agencies overseeing private enterprise. Third, the investment authority must act as a prudent investor with the goal of maximizing the return on investment. *Id.* at 1131, 1203–14.

ownership.[161] She opposed the Treasury's "hands-off" practice during the Financial Crisis[162] and suggested that the government should be actively involved in corporate governance affairs when it is a substantial shareholder.[163] She expected that, unlike ordinary business directors, government directors could present the government's perspectives and concerns to management and other members of the board.[164] Emma C. Jordan followed this line of reasoning and suggested that the government should appoint government directors with a history of public service to the recipients' boards on a proportional level to the amount of invested funds.[165] These arguments for government ownership of banks, however, are not the mainstream opinion.

D. Summary

To summarize, the majority opinion in the United States opposes government ownership of banks. Templin offered a political economy viewpoint for explaining why government ownership is not well-accepted in the United States.[166] This viewpoint observed that the U.S. economy is a typical liberal market economy, which is more associated with neoliberalism and a free market approach.[167] In his view, it would be adverse to this traditional path if the U.S. government re-establishes some form of ownership of banks, an interventionist approach that is less compatible with the free market approach.[168]

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[161] Black, *supra* note 12, at 569.

[162] *Id.*

[163] *Id.* at 565. Specifically, she proposes that the government should: first, use its power to nominate and run its own nominees for the board of directors, who would serve on the board as representatives of the government in order to represent the interests of the U.S. taxpayer; second, select at least some high-level Treasury officials to serve as directors when it has the power to elect or appoint; and third, regularly provide the general public with clear, specific statements about the government's acts and their effect on the corporation.

[164] *Id.* at 594.

[165] Emma Coleman Jordan, *A Fair Deal for Taxpayer Investments: Public Directors are Necessary to Restore Trust and Accountability at Companies Rescued by the U.S. Government*, CTR. FOR AM. PROGRESS (Sept. 16, 2009), https://www.americanprogress.org/issues/regulation/report/2009/09/16/6608/a-fair-deal-for-taxpayer-investments [https://perma.cc/Z3KB-JJZ4].

[166] Templin, *supra* note 12, at 1135–37.

[167] *Id.*

[168] *Id.* at 1132–52.

Nevertheless, I wish to revisit government ownership of banks in the U.S. context through a more balanced lens. Admittedly, government ownership introduces enhanced government intervention. The government, however, is not doomed to exercise such intervention in a negative way as feared by the property rights theorists. After all, the banking sector is a regulated industry, which implies that this sector needs some level of government intervention. With proper institutional designs, the perceived downsides of government ownership might be controllable, and the government can thus exercise its ownership in a positive way that supplements its regulation and supervision of banks. I will examine them more closely in the following two Parts.

II. The Myth of Government Ownership in the U.S. Context

The majority opinion opposes government ownership of banks mainly because it distrusts the government.[169] A government, however, is not always untrustworthy. In theory, a government can be either a "helping hand" or a "grabbing hand." In the real world, whether the U.S. government is a helping or grabbing hand is not a problem of black or white, but a problem of degree. A government could be a helping hand on some occasions and a grabbing hand on other occasions. Specifically, government bureaucrats and politicians acting on behalf of the government could pursue their own political agendas in some cases while serving the public good to society in other cases. Consequently, the bright sides and dark sides of government ownership could coexist and interplay with each other.[170] What we need to ascertain is, after accounting for all these positive and negative effects, whether government ownership, in the end, brings premiums or discounts to the bank as well as society. This is essentially an empirical question.

To ascertain this question in the U.S. context, I will reference available empirical findings that analyze the effects of government ownership of banks and apply these observations to the United States. I will demonstrate that the United States, unlike other jurisdictions in the world, has antidotal institutions to control the negative effects of government ownership. In other words, the majority view could be exaggerating these negative effects.

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[169] Black, *supra* note 12, at 593–94.
[170] Yeyati et al., *supra* note 137, at 246.

A. Empirical Evidence of Government Ownership of Banks: Developed Countries Exception?

Methodologically, since the U.S. banking sector is the subject of this Article, I should inquire into those U.S.-specific studies that observe the effect of government ownership of U.S. banks. Such studies, however, hardly exist due to the rare precedent and short implementation of this practice in the United States. Consequently, I instead adopt a comparative approach that turns to cross-countries evidence for shedding some light here.

Empirical studies in the early 2000s almost all consistently found that government ownership of banks correlated with enhanced financial risks and lower financial and economic development. For instance, Gerard Caprio and Maria Soledad Martinez Peria, based on data of banks in 64 countries over the period of 1980–1997, found that government ownership of banks posed danger to financial stability and thus significantly increased the likelihood and fiscal costs of a banking crisis.[171] Rafael La Porta et al. found, based on data of government-owned banks from 92 countries around the world, that government ownership of banks in 1970 was associated with slower subsequent financial development and lower subsequent growth in per capita income.[172] James R. Barth et al., based on data of bank regulation and supervision in 107 countries, also found that government ownership of banks was positively associated with the level of nonperforming loans in an economy.[173] According to these studies, government ownership of banks is negative.[174]

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[171] Gerard Caprio & Maria Soledad Martinez Peria, *Avoiding Disasters: Policies to Reduce the Risk of Banking Crises* 8–15 (World Bank mimeo & Egyptian Ctr. for Econ. Stud., Working Paper No. 47, 2000).

[172] La Porta et al., *supra* note 146, at 265.

[173] James R. Barth et al., *Bank Regulation and Supervision: What Works Best?*, 13 J. FIN. INTERMEDIATION 205, 240, 245 (2004). That said, they did not find evidence suggesting that government ownership of banks was positively associated with bank development, efficiency, or stability.

[174] *See also* Dinc, *supra* note 138, at 475–76; Giuliano Iannotta et al., *The Impact of Government Ownership on Bank Risk*, 22 J. FIN. INTERMEDIATION 152, 154, 169, 175 (2013); Alejandro Micco et al., *Bank Ownership and Performance: Does Politics Matter?*, 31 J. BANKING & FIN. 219, 227–28 (2007); Paola Sapienza, *The Effects of Government Ownership on Bank Lending,* 72 J. FIN. ECON. 357, 359–60 (2004); James R. Barth et al., *Banking Systems around the Globe: Do*

A closer examination of empirical evidence, however, challenges the above general finding. The negative effects of government-owned banks mostly appeared in developing countries while disappearing in developed countries. For instance, Rafael La Porta et al. found that the negative effects associated with government ownership of banks were more serious in relatively poor countries, relatively financially underdeveloped countries, and countries with poor protection of property rights.[175] Dinc, based on data of banks in 36 countries (19 emerging countries and 17 developed countries), found that government-owned banks significantly increased their lending in election years, which suggested that political motivations influenced their actions; however, in developed countries, he failed to detect such election-year increase.[176] Alejandro Micco et al., based on financial information from 179 countries, also found that government-owned banks in developing countries were associated with lower profitability and higher costs than their private counterparts, and such performance differences increased during election years; but again, they failed to find any strong correlation in industrial countries.[177] In a country-specific study, Yener Altunbas et al., based on data of German banks, failed to find strong evidence showing that private banks outperformed government-owned banks.[178] These empirical findings suggest that the negative effects of government ownership of banks are associated with the development status of individual countries.[179]

These findings lead us to question whether there are some country-specific institutional factors that may mitigate the negative effects of government ownership of banks. La Porta et al. suggested that this difference might result from the better access

Regulation and Ownership Affect Performance and Stability? 27 (The World Bank Dev. Res. Group, Pol'y Res., Working Paper No. 2325, 2000); Alejandro Rainer Haselmann et al., *Real Effects of Bank Governance: Bank Ownership and Corporate Innovation* (CEPR, Discussion Paper No. DP7488, 2009).

[175] La Porta et al., *supra* note 146, at 290.

[176] Dinc, *supra* note 138, at 475–76.

[177] Micco et al., *supra* note 174, at 227–32.

[178] *See* Yener Altunbas et al., *Bank Ownership and Efficiency*, 33 J. MONEY, CREDIT & BANKING 926, 936, 938, 944 (2001).

[179] In fact, recent empirical evidence also presents some results favorable to government ownership of banks. *See, e.g.*, Chung-Hua Shen et al., *The Government's Role in Government-owned Banks*, 45 J. FIN. SERV. RES. 307, 319–27, 338–39 (2013); Yeyati et al., *supra* note 137, at 237–44.

to foreign capital in richer countries.[180] Micco et al. instead offered two possible explanations. First, high-income countries might be better equipped to deal with distortions arising from government ownership of banks; therefore, governance issues are less serious in industrial countries.[181] Second, in industrial countries, government-owned banks have ceased to play a developmental role; therefore, their actions mimic the behavior of private banks.[182] Dinc, in contrast, considered that his findings did not result from better legal and political institutions in developed countries, but simply from some methodological problems.[183] Nevertheless, none of them provided further studies to support their explanations.

The above empirical findings suggest that the hypothesis held by the mainstream opinion is flawed. Government ownership of banks is not doomed to produce negative results in the United States. In the following parts, I will demonstrate that the United States may possess some antidotal institutions to mitigate these perceived negative effects.

B. Government Ownership of Banks in the U.S. Context

1. The Potential Exaggeration of the Perceived Negative Effects

As mentioned above, opponents of government ownership of banks in the United States draw on the property rights theory to justify their position.[184] According to them, the government is unable to maximize shareholders' interests, falls prey to political influence, behaves inefficiently, and involves conflicts of interest.[185] Its decisions in government-owned firms may be politically determined and susceptible to capture.[186]

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[180] La Porta et al., *supra* note 146, at 290.

[181] Micco et al., *supra* note 174, at 227.

[182] *Id.*

[183] Dinc, *supra* note 138, at 476 (arguing that the lack of an election-year effect in developed countries could be because government-owned banks are owned by regional or local governments in these countries. Therefore, his survey, which focuses on central elections instead of local elections, could not detect any election-year effect).

[184] *See supra* notes 134–37 and accompanying text.

[185] *See supra* notes 147–52 and accompanying text.

[186] Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 312 (2011).

These, however, concerns could be exaggerated. As Mariana Pargendler pointed out, although there is a difference between government bureaucrats and private businesspersons in terms of their motives, it is often easy to overstate the *extent* of such difference.[187] The opportunism of government-owned firms may well mirror that of private controlling shareholders,[188] which may, in turn, mirror that of managers.[189] In other words, failure to maximize firm profits is not unique to the government owner.[190] "[T]oo much emphasis on the differences between private and public control of enterprise has largely obscured their similarities."[191]

Moreover, mainstream opinion might also overlook the interplay between government supervision vis-à-vis government ownership and thus exaggerate the negative effect of the latter. Notably, the banking sector, the subject of this Article, is a highly regulated sector that is subject to heavy governmental regulation and supervision.[192] Moreover, the banking regulator often has considerable discretion to promulgate new banking regulations and supervise banks as it deems proper.[193] Accordingly, with or without ownership, the government, as the regulator, already possesses considerable authority to intervene in banks' corporate decisions. For this reason, the perceived negative effects associated with government ownership, if any, could be marginal.

The controversial merger between BoA and Merrill Lynch during the Financial Crisis can illustrate this point.[194] When BoA's

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[187] Pargendler, *supra* note 1, at 2923.

[188] *Id.* at 2923–24.

[189] *Id.* at 2923.

[190] *Id.*

[191] *Id.*

[192] *See, e.g.*, Janet E. Kerr, *The Financial Meltdown of 2008 and the Government's Intervention: Much Needed Relief or Major Erosion of American Corporate Law? The Continuing Story of Bank of America, Citigroup, and General Motors*, 85 ST. JOHN'S L. REV. 49, 50, 53–55, 98 n.280 (2011).

[193] *See generally id.*

[194] As a brief background note, the Treasury held a very small amount of BoA stock during the Financial Crisis. In September 2008, Merrill Lynch faced serious liquidity problems and was at the edge of collapse. The Fed successfully facilitated a $50 billion merger between BoA and Merrill Lynch to solve this problem on September 15, 2008, pending the shareholder vote. In the following three months, however, the value of Merrill Lynch's assets depreciated significantly, and this fourth-quarter loss, which occurred after the conclusion of the merger agreement, caused BoA to consider invoking the material adverse change

management considered terminating the deal, the Federal Reserve threatened to use its authority as a banking regulator to remove BoA's senior management and board members.[195] Some commentators took this case as an example illustrating how government ownership of a firm, despite how limited such ownership is, could intervene in the corporate decisions of that firm.[196] However, the Federal Reserve's threat was real not because of its ownership of BoA; as a matter of fact, at that time, the Federal Reserve had no voting power in BoA to vote out the management and board members.[197] Rather, what scared BoA's board was the Federal Reserve's supervisory power to remove the management of banks.[198] With or without government ownership, the political interference that concerned the property rights theorists had been in place.[199] In this sense, the magnitude of additional negative effects that government ownership per se could add is doubtful.

Some empirical studies on the efficiency of government-owned firms can further support the above observation. In general, most empirical studies report that government-owned firms are less efficient than their private counterparts.[200] Nevertheless, the empirical evidence on the performance of government-owned firms

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clause in the merger agreement to terminate the deal. For an introduction of this deal, see Barnes, *supra* note 125, at 1422–31; *see also* Kerr, *supra* note 192, at 49.

[195] Federal banking agencies are entitled to remove any institutional affiliated party from office or prohibit any further participation by such party, in any manner, in the conduct of the affairs of any insured depository institution. The Federal Reserve falls within the definition of "federal banking agency," and any director, officer, and employee falls within the definition of "institutional affiliated party" here. 12 U.S.C. §§ 1813(u), (z) (2012); § 1818(e)(1).

[196] *See generally* Barnes, *supra* note 125; Robert J. Rhee, *Fiduciary Exemption for Public Necessity: Shareholder Profit, Public Good, and the Hobson's Choice during a National Crisis*, 17 GEO. MASON L. REV. 661 (2010).

[197] Fisher, *supra* note 122, at 558.

[198] *See, e.g.*, Federal Deposit Insurance Act § 38(f)(2)(F) (codified at 12 U.S.C. § 1831o(f)(2)(F) (2012)).

[199] For similar observations, see Fisher, *supra* note 122, at 543–52.

[200] Pargendler, *supra* note 1, at 2958; *see also* Anthony E. Boardman & Aidan R. Vining, *Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed, and State-Owned Enterprises*, 32 J.L. & ECON. 1, 17 (1989); Anthony Boardman et al., *The Price of Government Ownership: A Study of the Domtar Takeover*, 31 J. PUB. ECON. 269, 270 (1986); William L. Megginson & Jeffry M. Netter, *From State to Market: A Survey of Empirical Studies on Privatization*, 39 J. ECON. LIT. 321, 380 (2001); Mary M. Shirley & Patrick Walsh, *Public v. Private Ownership: The Current State of the Debate* (World Bank Policy Res., Working Paper No. 2420, 2001).

in a regulated environment is surprisingly different. For instance, Scott E. Atkinson and Robert Halvorsen analyzed the data of U.S. electric utilities and found that government-owned and private firms were equally cost-inefficient.[201] Catherine C. Eckel and Theo Vermaelen analyzed data of governmental purchase of stock in private Canadian firms and found that private shareholders suffered losses from government's purchase of shares only in unregulated industries.[202] Eckel and Vermaelen offered two explanations of their findings. One is that a government's regulation through internal direct ownership is less costly than external regulation.[203] The other is that government ownership might not increase agency costs in regulated firms because existing regulations have already incorporated these costs.[204] These inferences support my above arguments.

To be sure, government ownership still differs from government regulation and supervision. The extent, however, might be limited. The mainstream opinion could exaggerate the negative effects associated with government ownership.

C. Antidotal Institutions in the United States

Even if some negative effects associated with government ownership of banks remain, they are likely to be minimal or controllable in the United States. At least three major U.S. institutions can mitigate the negative effects of government ownership: the competitive financial market, developed financial system, and advanced political institutions.

1. The United States Has a Competitive Financial Market

To begin, the United States possesses a competitive financial market. Market competition is always a crucial corporate governance institution.[205] In a competitive financial market, investors

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[201] Scott E. Atkinson & Robert Halvorsen, *The Relative Efficiency of Public and Private Firms in a Regulated Environment: The Case of U.S. Electric Utilities*, 29 J. PUB. ECON. 281, 285 (1986).

[202] Eckel & Vermaelen, *supra* note 1, at 399–400.

[203] *Id.*

[204] *Id.*

[205] *See* Mark J. Roe, *The Institutions of Corporate Governance, in* HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 371, 377–79 (Claude Menard & Mary M. Shirley eds., 2005).

and outsiders can easily measure the economic performance of government-owned banks. If government bureaucrats in charge of government-owned banks are inefficient, the threat of competition by private counterparts will reveal such inefficiency and force them to improve their efficiency. Competition can also constrain the politicians and government bureaucrats who operate government-owned banks from pursuing their own political agendas or personal interest.

The above inference finds a comparative piece of empirical support. Marcia Million Cornett et al. studied the data of East Asian banks during and after the East Asian financial crisis and found that government-owned banks performed more poorly than private banks in 1997 to 2000, but such difference disappeared in 2001–2004.[206] They interpreted this change as consistent with a life-cycle model, under which the increasing globalization of financial services brought about competition and thus pressured government-owned banks to improve their banking policy, which, in turn, enhanced the performance of government-owned banks.[207] This empirical finding suggests that market competition may control government inefficiency.

2. The United States Has a Highly Developed Financial System

The United States also possesses a highly developed financial system.[208] A highly developed financial system contains more readily available financial techniques, experienced talents,

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[206] *See generally* Marcia Million Cornett et al., *The Impact of State Ownership on Performance Differences in Privately-Owned versus State-Owned Banks: An International Comparison*, 19 J. FIN. INTERMEDIATION 74 (2010).

[207] *Id.* As a general matter, Douglas W. Caves and Laurits R. Christensen, who compared the performance of government-owned Canadian railroads and private railroads in a competitive environment, found that both perform equally well. They explain this finding by stating that market competition may overcome inefficiency resulting from government ownership. Caves & Christensen, *supra* note 137, at 958. Other literature also found that government-owned firms may be as efficient as private firms in competitive environments, provided that there is sufficient competition between these firms and that the government does not provide discriminatory regulations and subsidies in favor of government-owned firms. Boardman & Vining, *supra* note 200, at 7.

[208] *See generally* Herbert L. Baer & Larry R. Mote, *The United States Financial System*, *in* BANKING STRUCTURES IN MAJOR COUNTRIES 469 (George G. Kaufman ed., 1992).

and market rules, which can field the inexperienced government bureaucrats necessary to exercise government ownership. It would also be easier for government bureaucrats to mimic their private counterparts, which reduces the difference in expertise between private and government-owned banks.

This inference also finds a comparative piece of empirical support. As mentioned above, La Porta et al. found that government ownership of banks caused more adverse effects on economic growth in financially underdeveloped countries than in financially developed countries.[209] Tobias Korner and Isabel Schnabel further elaborated this point. Their studies, based on a sample of eighty-two countries, showed that the impact of government ownership of banks on economic growth depended strongly on a country's degree of financial development.[210] In highly developed financial systems, as measured by a country's private credits (i.e., the value of credits of financial intermediaries to private sectors divided by GDP), they did not find any significant effect of government ownership on growth.[211] At even higher levels of financial development, the marginal effect of government ownership even became positive and large.[212] According to Korner and Schnabel, a well-developed financial system possesses existing high financial standards, such as ready-made new techniques, well-trained job-market candidates, experienced employees, good regulation, prudential supervision, and adequate competition.[213] These standards can mitigate the principal-agent problem within government-owned banks and thus benefit these banks.[214]

3. The United States Has More Advanced Political Institutions

Finally, the United States possesses more advanced political institutions. One major concern regarding government ownership relates to the distrust of government bureaucrats and politicians.[215]

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[209] La Porta et al., *supra* note 146, at 290.

[210] *See* Tobias Korner & Isabel Schnabel, *Public Ownership of Banks and Economic Growth: The Impact of Country Heterogeneity*, 19 ECON. OF TRANSITION 407, 434–35 (2011).

[211] *See generally id.* at 420–22.

[212] *Id.* at 420–21.

[213] *Id.* at 435.

[214] *Id.*

[215] *Id.* at 409–12.

Such concerns can be largely mitigated if a country possesses relatively advanced and transparent legal and political institutions that may supervise government bureaucrats and politicians.[216] Even though U.S. society distrusts its politicians,[217] this country has far more advanced political institutions that are relatively transparent and institutionalized, which results in relatively less corruption than many other countries.[218] With these advanced political institutions to hold politicians and bureaucrats accountable, the U.S. banking sector should be subject to a less negative effect associated with government ownership of banks.

This inference again finds a comparative piece of empirical support. Korner and Schnabel also found that the impact of government ownership on economic growth depended on the quality of a country's political institutions and governance structures.[219] In countries with high-quality political institutions, as measured by democracy indices, assessments of political rights, governance indicators, and corruption indices, government ownership of banks does not influence economic growth at all.[220] Their explanation of this finding is that good political institutions may mitigate the agency problem between taxpayers and politicians, which controls the abuse of government-owned banks by politicians.[221]

To summarize the above, as a well-developed country with adequate antidotal institutions, the United States, in fact, possesses some born advantages to adopt government ownership of banks. Indeed, government ownership of banks may incur some negative effects. Nevertheless, many institutions as suggested above may alleviate these concerns. Unlike many other developing countries, the United States possesses all the necessary mitigation institutions: a competitive financial market, a developed financial system,

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[216] *Id.*

[217] *See*, *e.g.*, Uri Friedman, *Trust is Collapsing in America*, ATLANTIC (Jan. 21, 2018), https://www.theatlantic.com/international/archive/2018/01/trust-trump-america-world/550964/ [https://perma.cc/VML9-7CV8].

[218] *See Corruption Perceptions Index 2016*, TRANSPARENCY INT'L (Jan. 25, 2017), https://www.transparency.org/news/feature/corruption_perceptions_index_2016 [https://perma.cc/T46J-4UGX] (finding that the United States ranked eighteenth out of 176 countries in terms of corruption).

[219] Korner & Schnabel, *supra* note 210, at 435, 439.

[220] *Id.* at 422–25.

[221] *Id.* at 435.

and advanced legal and political institutions. As a developed country with these institutions, government ownership of banks per se may be less detrimental in the United States. The experience of RFC investments and the CIC case, under which the government generally refrained from intervening in the firms' daily operational decisions, may also provide some comfort to U.S. society.[222]

The above inferences can also find support from a U.S.-specific empirical study. Stacey R. Kole and J. Harold Mulherin conducted an empirical study of APC companies which were government-owned during the post–World War II period.[223] They found that the performance of APC companies was not significantly different from that of their private counterparts.[224] This finding, which is precious considering the rare government ownership practice in the United States, shows that government ownership in the United States does not necessarily bear the negative effects normally attributed to government ownership.

III. Government Ownership and Bank Governance in the Post–Financial Crisis Era

On the other hand, government ownership may have particular merits in the banking sector considering that it can promote sound corporate governance of banks, especially in improving poor risk management practices.[225]

Corporate governance of banks has a different face from that of general firms.[226] In the post–Financial Crisis era, bank governance increasingly emphasizes a robust risk management system to protect creditors' interests as well as the stability of individual

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[222] Broome, *supra* note 65, at 433.

[223] *See generally* Kole & Mulherin, *supra* note 74.

[224] *Id.*

[225] *Id.* at 1, 16.

[226] Considering that different industries have their own characteristics that call for different sets of governance codes, a sector-specific study of corporate governance is warranted. Klaus J. Hopt, *Corporate Governance of Banks after the Financial Crisis, in Financial Regulation and Supervision: A Post-crisis Analysis* 338, 344 (European Corp. Governance Inst. Law, Working Paper No. 181/2011, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1918851 (emphasizing that there is a "clear trend toward sector-specific corporate governance and governance codes").

banks and the whole financial system. In this Part, I will demonstrate how government ownership of banks, coupled with the use of government directors, can help to build robust risk management in banks.

A. Banks Are Special

Banks are special for at least five major reasons.[227] First, banks serve the function of liquidity production by engaging in maturity mismatch activities, i.e., borrowing short and lending long; this causes their assets to be largely comprised of liabilities as opposed to equities.[228] Accordingly, unlike general firms where shareholders are the ones having the largest interest in the firm, in banks, creditors also have considerable stakes, and their interests must be duly taken into account.[229] The problem of bank runs, which erode the liquidity of banks and accelerate their collapse, further underscores the importance of maintaining the trust and confidence of public creditors in banks.[230]

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[227] Plenty of literature has documented many features of banks which justify a different regulatory regime. *See, e.g.*, Caprio & Levine, *supra* note 157, at 27–39; Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks,* 9 ECON. POL'Y REV. 91, 97–99 (2003) (summarizing four characteristics of banks, including the liquidity production role of banks, the deposit insurance fund, the conflict between fixed claimants and shareholders, and asset structure and loyalty problems); Ross Levine, *The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence* 7–11 (World Bank Policy Res., Working Paper No. 3404, 2004) (summarizing three characteristics of banks, including that banks are opaque and heavily regulated and widely involve government ownership); Peter O. Mulbert, *Corporate Governance of Banks after the Financial Crisis—Theory, Evidence, Reforms* 10–14 (European Corp. Governance Inst. Law, Working Paper No. 151/2010, 2010) (summarizing seven special attributes of banks, including (1) banks serve a liquidity producing function; (2) banks are highly leveraged; (3) banks are notoriously opaque; (4) banks largely engage in business with each other; (5) banks holding a substantial portfolio of derivatives and securities with embedded options subject themselves to sharp changes in their risk profiles; (6) banks are subject to the creditor runs problem; and (7) banks are heavily regulated and supervised).

[228] Macey & O'Hara, *supra* note 227, at 97; Mulbert, *supra* note 227, at 10.

[229] Mulbert, *supra* note 227, at 15–16.

[230] To elaborate, the liabilities of banks are mostly short-term, either on demand (e.g., deposits) or in an extremely short term (e.g., repo). When there is panic which causes creditors to lose confidence in a specific bank, their rational choice will be to withdraw the lending as soon as possible. This is a prisoner's dilemma problem which results in runs problems and serves no one's best interest. For an introduction of the runs problem, see RICHARD S. CARNELL ET AL., THE LAW

Second, banks are subject to several types of systemic risks. Banks engage in similar activities, which expose them to the risk of correlation, that is, the failure of any of those activities could simultaneously harm all entities in the financial system.[231] In addition, banks largely engage in business with each other, which exposes all of them to the risk of connectedness, meaning the failure of one bank could harm all its counterparties and thus spread the negative effects of one single failure to the whole financial system.[232] The risk of connectedness may further evolve into the risk of contagion, that is, one single failure may send a strong negative signal to market participants and cause them to panic.[233] They may thus withdraw their lending all of a sudden, which results in the bank runs problem.[234] In sum, any one single failure case can shake the stability of the whole financial system. This systemic risk concern further leads to the notorious too-big-to-fail problem.

Third, banks are closely connected with the economic development of a society. They play the intermediary role by receiving the household savings in forms of deposits, mutual funds, etc., accumulating them into investment funds and investing them in forms of loans or equity. This series of activities ultimately transforms household savings into investment in businesses, which creates the flow of money and thus promotes economic development.[235] Through this process, banks also serve the money creation function. They create extra money in addition to that actually issued by the government, which again promotes economic development.[236] The collapse of one bank will naturally cause negative effects on the flow of money, and the function of money creation, and thus harm the economy of a country.[237] Accordingly, banks not only create profits for their investors but also play a public role.[238]

OF FINANCIAL INSTITUTIONS 49–51 (5th ed., 2013); Macey & O'Hara, *supra* note 227, at 97; Mulbert, *supra* note 227, at 12–13.

[231] Hal S. Scott, *How to Improve Five Important Areas of Financial Regulation*, *in* RULES FOR GROWTH: PROMOTING INNOVATION AND GROWTH THROUGH LEGAL REFORM 114, 118–19 (Robert E. Litan ed., 2011).

[232] *Id.* at 114–16.

[233] *Id.* at 116–18.

[234] *Id.*

[235] *See* CARNELL ET AL., *supra* note 230, at 39–40.

[236] *See id.* at 51–54.

[237] Scott, *supra* note 231, at 116–18.

[238] Macey & O'Hara, *supra* note 227, at 102.

Fourth, banks are notoriously opaque in terms of their balance sheets, quality of loans, etc. This opaqueness can be attributed to several factors. For instance, the activities of banks, such as loans, derivatives, securitizations, etc., are relatively too complicated for outsiders to assess the quality of these activities.[239] The multilayer organizational structure within a banking conglomerate, especially a multinational one, also makes it more challenging for the central decision body to integrate necessary information to make a comprehensive judgment.[240] The opaqueness of banks makes it difficult for bank insiders to understand the real status of that bank, as well as for outside investors, stakeholders, and regulators to monitor that bank.[241]

Finally, banks are heavily regulated, which creates unique governance issues. For instance, the deposit insurance mechanism creates the well-known moral hazard problem, under which depositors have little incentive to monitor banks.[242] Capital adequacy requirements also provide incentives for shareholders to undertake excessive risks because higher capital requirements cause shareholders to ask for higher investment premiums.[243] This induces management to take a riskier business strategy to satisfy the needs of shareholders.[244] In sum, while banking regulations and supervisions address some problems unique to banks, they also create new challenges to the corporate governance of banks.

B. Pictures of Bank Governance

The special characteristics of banks mentioned above imply that their corporate governance should differ from that of general firms.[245] One major difference is that bank governance should

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[239] Mulbert, *supra* note 227, at 11.

[240] Hopt, *supra* note 226, at 347.

[241] *See* Caprio & Levine, *supra* note 157, at 29–35; Hopt, *supra* note 226, at 347; Levine, *supra* note 227, at 7–9.

[242] Hopt, *supra* note 226, at 352; Macey & O'Hara, *supra* note 227, at 97; Levine, *supra* note 227, at 10–11.

[243] Levine, *supra* note 227, at 10–11.

[244] Luc Laeven & Ross Levine, *Bank Governance, Regulation and Risk Taking,* 93 J. FIN. ECON. 259, 206 (2009); Mulbert, *supra* note 227, at 16–19.

[245] *See, e.g.*, Caprio & Levine, *supra* note 157, at 27–39; Hopt, *supra* note 226, at 352–53; Macey & O'Hara, *supra* note 227, at 99–102; Levine, *supra* note 227, at 7–11; Mulbert, *supra* note 227, at 14–21. *Cf.* ORGANISATION FOR ECONOMIC

place greater emphasis on the creditors' interests; creditors are a crucial group of stakeholders due to the high leverage of banks.[246] The agency conflict between creditors and shareholders is especially severe.[247] Nevertheless, the vehicles available for addressing creditors' interests are limited.

Shareholders will hardly consider interests other than their own; protected by limited liability, they pursue more risks than creditors.[248] Therefore, entrusting the supervision of banks to shareholders cannot adequately incentivize management to consider the risk control of banks. Quite the opposite, it may induce the management to pursue a profit-seeking and risk-pursuing direction.[249] Without adequate risk-control incentive, empowering shareholders could ultimately endanger the survival of individual banks as well as the whole financial system and economy.[250]

Creditors, who have substantial stakes in banks, can hardly monitor as well. For one thing, most creditors of banks are the diffused public, which has neither the ability nor the incentive to monitor banks.[251] Deposit insurance further introduces the moral hazard problem to creditors and thus weakens their incentive to

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CO-OPERATION AND DEVELOPMENT ("OECD"), OECD PRINCIPLES OF CORPORATE GOVERNANCE 11 (2004) (considering itself containing principles applicable to firms "both financial and non-financial"). Nevertheless, OECD also acknowledges that bank governance may be different in the more important role of stakeholders (i.e., depositors), implicit or explicit government guarantees with respect to classes of liabilities, and serious externality problems, which justify more intensive government involvement. OECD, CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS: KEY FINDINGS AND MAIN MESSAGES 12–13 (2009) [hereinafter 2009 OECD KEY FINDINGS].

[246] Macey & O'Hara, *supra* note 227, at 99.

[247] Hopt, *supra* note 226, at 352–53; *see also* Dirk Heremans & Katrien Bosquet, *The Future of Law and Finance after the Financial Crisis: New Perspectives on Regulation and Corporate Governance for Banks*, 2011 U. ILL. L. REV. 1551, 1565–73 (2011); Monika Marcinkowska, *Corporate Governance in Banks: Problems and Remedies*, 2 FIN. ASSETS & INVESTING 47, 56–58 (2017); Martin Cihak & Asli Demirguc-Kunt, *Rethinking the State's Role in Finance* 3–4 (World Bank Policy Res., Working Paper No. WPS 6400, 2013).

[248] Hopt, *supra* note 226, at 349–50.

[249] *Id.*

[250] *See id.*; William W. Bratton & Michael L. Watcher, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 722–23 (2010); Mulbert, *supra* note 227, at 16–17.

[251] Hopt, *supra* note 226, at 350.

monitor the management of banks.[252] The ceiling amount of insurance under deposit insurance further poses obstacles to introducing large-sum concentrated creditors in banks.[253] These all weaken the creditor governance of banks, which, in turn, encourages managements to increase risk-taking in banks to honor shareholders' interests.

Given the inherent defects of shareholders and creditors, the best practice of bank governance entrusts the mission to the board of directors. The Basel Committee issued eight principles for bank governance in 1999 and updated them in 2006.[254] These principles highlighted the role of the board of directors in bank governance.[255] Such emphases also obtained some recognition in the United States. Jonathan R. Macey and Maureen O'Hara, for instance, suggested that bank directors should "take solvency risk explicitly and systematically into account when making decisions."[256] They further argued that the bank directors should owe duties and obligations to creditors as well, instead of exclusively to shareholders.[257] These all highlight the central role of the board of directors in bank governance.

C. Dilemma of Bank Governance After the Financial Crisis

The Financial Crisis ruthlessly exposed the deficiency of the current practices of bank governance as well as many other problems of banking regulation and supervision.[258] While some

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[252] Macey & O'Hara, *supra* note 227, at 98; Mulbert, *supra* note 227, at 18.

[253] Mulbert, *supra* note 227, at 18.

[254] BASEL COMMITTEE ON BANKING SUPERVISION, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANISATIONS 6–18 (2006) [hereinafter ENHANCING CORPORATE GOVERNANCE]. This was the first institution to codify corporate governance principles on minimum requirements for bank governance before the Crisis. *See also* Hopt, *supra* note 226, at 356.

[255] ENHANCING CORPORATE GOVERNANCE, *supra* note 254, at 6–18.

[256] Macey & O'Hara, *supra* note 227, at 92.

[257] *Id.*

[258] Mulbert, *supra* note 227, at 7–8 (enumerating the discussions that deal with the causes of the financial crisis, such as the United States President's Working Group on Financial Markets, the Financial Stability Board, the IMF, the Institute of International Finance, the G-20 Study Group, the Declaration of the Washington Summit of the G-20 proposing the "Action Plan to Implement

commentators argued that failures of bank governance had little or even no relevance to the outbreak of the Financial Crisis,[259] the majority opinion, both on international levels (such as in the OECD[260] and the Basel Committee[261]), and on regional levels (such as in the United States,[262] European Union[263] and the United Kingdom[264]), maintained that failures of bank governance accelerated and aggravated the Financial Crisis.[265]

Principles for Reform," etc.). *See generally* THE FINANCIAL CRISIS INQUIRY COMMISSION, FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011) [hereinafter 2011 REPORT ON THE FINANCIAL CRISIS IN THE U.S.].

[259] *See* Renee Adams, *Governance and the Financial Crisis*, 12 INT'L REV. FIN. 7, 34 (2012); Peter J. Wallison & Arthur F. Burns, *Financial Crisis Inquiry Commission: Dissenting Statement*, *in* 2011 REPORT ON THE FINANCIAL CRISIS IN THE U.S., *supra* note 258.

[260] *See* 2009 OECD KEY FINDINGS, *supra* note 245, at 12; OECD, CORPORATE GOVERNANCE AND FINANCIAL CRISIS: CONCLUSIONS AND EMERGING GOOD PRACTICES TO ENHANCE IMPLEMENTATION OF THE PRINCIPLES 13 (Feb. 24, 2010) [hereinafter 2010 OECD CONCLUSIONS].

[261] The Basel Committee proposed its new reports in 2010 and 2015 to expand principles for bank governance. *See generally* BASEL COMMITTEE ON BANKING SUPERVISION, PRINCIPLES FOR ENHANCING CORPORATE GOVERNANCE (2010) [hereinafter BASEL 2010 PRINCIPLES]; BASEL COMMITTEE ON BANKING SUPERVISION, CORPORATE GOVERNANCE PRINCIPLES FOR BANKS (2015) [hereinafter BASEL 2015 PRINCIPLES].

[262] 2011 REPORT ON THE FINANCIAL CRISIS IN THE U.S., *supra* note 258, at xviii–xix.

[263] The European Commission in 2010 put forward the Green Paper on numerous issues of financial institution governance. *See generally* European Commission, *Green Paper: Corporate Governance in Financial Institutions and Remuneration Policies*, COM (2010) 284 final (Feb. 6, 2010), accompanied by European Commission, *Corporate Governance in Financial Institutions: Lessons to be Drawn from the Current Financial Crisis, Best practices*, SEC (2010) 669 (Feb. 6, 2010).

[264] The Walker Review in 2009 went through the bank governance issues in the United Kingdom. *See generally* DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES—FINAL RECOMMENDATIONS (Nov. 26, 2009).

[265] OECD, for instance, identified four areas of corporate governance failures, i.e., (1) remuneration, (2) risk management, (3) board practices, and (4) exercise of shareholder rights. *See* 2009 OECD KEY FINDINGS, *supra* note 245, at 7–11; Mulbert, *supra* note 227, at 19, 28–30. *See generally* Hopt, *supra* note 226; Grant

1. Risk Management and Control

The failure of banks to manage their risks is a major problem revealed by the Financial Crisis.[266] A number of banks either failed to identify the risks or sought to explain them away to justify the risks.[267] Due to their multilevel organizational structures, many banks even failed to pass their risks to the ultimate decision level for consideration.[268] A notorious example is that many banks engaged in the subprime mortgage market and derivatives such as collateralized debt obligations ("CDOs") without fully comprehending the incurred risks and how these risks would influence their own financial status.[269] This is a major reason why the Financial Crisis expanded in such a fast and broad manner.

The counter-argument claims that the above observations are simply hindsight narratives. It argues that virtually all participants in the financial system failed to foresee the crisis; therefore, we should not blame banks for their failure to manage these unexpected risks.[270] Nevertheless, the spirit of risk management lies not only in foreseeing the unexpected risks, but also in being well-prepared to reduce losses to the minimum once any unexpected risks occur. Before the Financial Crisis, most banks apparently ignored the importance of equipping themselves to sustain unexpected risks. As the Financial Crisis Inquiry Commission specified, before the Financial Crisis, the five major investment banks—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating with extraordinarily thin capital, which was less than 2.5 percent of the leverage ratio.[271] This means that a 2.5 percent drop in asset value could make them

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Kirkpatrick, *Corporate Governance Lessons from the Financial Crisis*, 2009 FIN. MKT. TRENDS 1 (2009).

[266] 2009 OECD KEY FINDINGS, *supra* note 245, at 31; 2010 OECD CONCLUSIONS, *supra* note 260, at 13; 2011 REPORT ON THE FINANCIAL CRISIS IN THE U.S., *supra* note 258, at xviii–xix; Mulbert, *supra* note 227, at 28.

[267] 2009 OECD KEY FINDINGS, *supra* note 245, at 31; 2011 REPORT ON THE FINANCIAL CRISIS IN THE U.S., *supra* note 258, at xviii–xix; Kirkpatrick, *supra* note 265, at 66.

[268] 2009 OECD KEY FINDINGS, *supra* note 245, at 31.

[269] Kirkpatrick, *supra* note 265, at 65; Mulbert, *supra* note 227, at 28.

[270] Wallison & Burns, *supra* note 259, at 446.

[271] 2011 REPORT ON THE FINANCIAL CRISIS IN THE U.S., *supra* note 258, at xix–xx.

insolvent.[272] The Commission also pointed out that they relied too much on "short-term [borrowing] in the overnight market."[273] This shows that they were just too ignorant of the importance of risk management.

2. Board Capacity and Practices

Following the lack of adequate risk management, another problem relates to the capacity of banks' decision-makers to act as gatekeepers. Preventing banks from taking excessive risks requires not only a *system* of risk management but also having the *right persons* there. Good bank governance shall emphasize "expertise" more than "independence," or at least place them on an equal footing.[274] Many directors and senior managers of banks, however, did not possess sufficient expertise, experience, and knowledge to conduct proper risk management.[275] Another key lesson from the Financial Crisis is that, in practice, bank directors tend to take false comfort from their regulatory capital ratios—they failed to inquire further into the risk profile of the banks once they found compliance with regulatory requirements.[276]

3. Compensation Regime

Compensation regimes are another aspect of corporate governance that attracted focus during the Financial Crisis. Many commentators believed that equity-based pay caused directors and

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[272] *Id.* at xix.

[273] *Id.*

[274] 2009 OECD KEY FINDINGS, *supra* note 245, at 44–46; 2010 OECD CONCLUSIONS, *supra* note 260, at 19–21; Hopt, *supra* note 226, at 362; Kirkpatrick, *supra* note 265, at 81–82; Mulbert, *supra* note 227, at 29–30. Some commentators even point the fingers at the widespread imposition of independent director requirements in financial sectors, which caused directors on the boards of financial institutions to have limited professions and experience. *See* Adams, *supra* note 259, at 34; Renee B. Adams & Hamid Mehran, *Bank Board Structure and Performance: Evidence for Large Bank Holding Companies*, 21 J. FIN. INTERMEDIATION 243, 249 (2012); Kirkpatrick, *supra* note 265, at 81–82.

[275] Kirkpatrick, *supra* note 265, at 62.

[276] 2009 OECD KEY FINDINGS, *supra* note 245, at 31; Brian R. Cheffins, *The Corporate Governance Movement, Banks and the Financial Crisis*, 16 THEORETICAL INQ. L. 1, 40 (2015); Mulbert, *supra* note 227, at 37.

managers to place greater emphasis on shareholders' interests, resulting in greater risk-taking by banks and leading to the Financial Crisis.[277] Specifically, the compensation design before the Financial Crisis aligned the interests of directors and management of banks too much with the firms' short-term stock performance. This created incentives for directors and management to undertake myopic and risky activities to boost short-term stock performance at the risk of the stability and survival of banks.[278] Without reshaping such compensation regimes, banks can hardly have people on the board with the right incentive to conduct proper risk management even though they are capable of doing so.[279]

4. Reform and Dilemma: How to Create a Robust Board of Directors?

a. Better Regulation Is Needed, but Not Enough

After the Financial Crisis, reformers proposed a number of ways to enhance the risk control of banks. One straightforward way is to promulgate a complete set of banking regulations to impose stricter requirements on banks. For instance, the Basel Committee adopted the Basel III standards in 2010, which significantly raised the capital requirement, added the leverage ratio requirement, and adopted measures of liquidity risks.[280]

While enhanced banking regulation and supervision is definitely needed and helpful for preventing another crisis, they are not capable of resolving all the associated concerns. This is because they merely set a minimum requirement for banks to observe but satisfying these requirements does not guarantee that banks will be free from any risks.

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[277] *See, e.g.*, 2009 OECD KEY FINDINGS, *supra* note 245, at 14–30, 40; 2011 REPORT ON THE FINANCIAL CRISIS IN THE U.S., *supra* note 258, at xix; Bruner, *supra* note 186, at 316–17; Hopt, *supra* note 226, at 367; Kirkpatrick, *supra* note 265, at 72–73.

[278] 2011 REPORT ON THE FINANCIAL CRISIS IN THE U.S., *supra* note 258, at xix.

[279] For related proposals to reform bankers' pay, see, e.g., Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 249 (2010).

[280] *See generally* BASEL COMMITTEE ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS (2010) [hereinafter BASEL III]. For a summary of key changes under Basel III, see SCOTT & GELPERN, *supra* note 2, at 607–31.

For one thing, banking regulations are doomed to be incomplete. The financial world is so complicated and ever-changing, and the innovation of financial products and financial techniques are so rapid. Banking regulations can hardly catch up with them immediately. Even though the regulator can amend banking regulations from time to time after it finds the deficiency of the current laws, the amendment itself needs time, which inevitably leaves a significant window period. The evolution of Basel capital requirements provides a vivid example. Before the Financial Crisis, Basel II had largely revised Basel I, introducing a far more detailed set of capital requirements to address credit risks of banks.[281] Nevertheless, the Financial Crisis made us realize that Basel II was just not enough. Basel II simply ignored the liquidity risk, which was a major cause of the Financial Crisis.[282] Therefore, Basel III adopted the liquidity coverage requirements and net stable funding ratios to resolve this deficiency.[283] This experience taught us a lesson: we can hardly be sure that the current banking regulations and standards have exhausted all possible categories of risks.

Moreover, it is nearly impossible to come up with one-size-fits-all banking regulations. Each bank has its own risk profile. For instance, the regulator can certainly promulgate a rule prohibiting any banks from extending loans to a single borrower above a specified numerical limit. Nevertheless, it does not guarantee that banks would not suffer serious harms as long as it observes this limit. Banks still need to consider, in each specific case, the identity, financial conditions, and credit record of this borrower, the quality of its collateral, the bank's own financial conditions, and loans profile, and so on. There are too many factors to consider on a case-by-case basis. No benevolent regulator can possibly enact regulations to prescribe for all these details. Even if it is possible, the regulatory cost would be unimaginably enormous, which makes it impracticable.

To be sure, I do not intend to argue that improving banking regulation and supervision is futile. They are always the

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[281] BASEL II COMMITTEE ON BANK SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK COMPREHENSIVE VERSION i–ii, ¶ 11 (2004) [hereinafter BASEL II].

[282] BASEL III, *supra* note 280, ¶¶ 34–36.

[283] *Id.* ¶¶ 40–42.

main tool to control misbehaviors and associated risks of banks. The point is that banking regulations and supervisions have their own limits. As mentioned above, one key lesson from the Financial Crisis was that bank directors took too much comfort from their compliance with regulatory requirements without inquiring further into the risk profile of the banks.[284] In light of that, improving bank governance is still warranted. In a sense, bank governance and banking regulation are complementary with each other in functional terms.[285]

b. Better Governance Is Needed but How Can It Be Achieved?

Reforms resulting from the failure of bank governance during the Financial Crisis stress the importance of a robust risk management system.[286] Nevertheless, a well-functioning bank governance system depends on the quality of *people*.[287] Rules and principles of best practices are all in the book, but it is the people who give them life. The problem thus rests not only on *how* to conduct risk management but also on *whom* to entrust to conduct it.

Related reforms again stress the important role of the board of directors.[288] OECD made it clear that "*oversight of risk*

[284] 2009 OECD KEY FINDINGS, *supra* note 245, at 31; Mulbert, *supra* note 227, at 37.

[285] Mulbert, *supra* note 227, at 25–26; *see also* Renee Adams & Hamid Mehran, *Is Corporate Governance Different for Bank Holding Companies*, 9 ECON. POL'Y REV. 123, 123 (2003); Cheffins, *supra* note 276, at 2, 11, 37; Heremans & Bosquet, *supra* note 247, at 1568; Dirk Heremans, *Corporate Governance Issues for Banks: A Financial Stability Perspective* 8–9 (Center for Econ. Stud., Discussion Paper Series No. 07.07, Feb. 2007).

[286] 2009 OECD KEY FINDINGS, *supra* note 245, at 31.

[287] Hopt, *supra* note 226, at 368.

[288] As a side note, the reform of general corporate governance, as opposed to bank governance, appears to focus on enhancing shareholder empowerment. For instance, the Dodd-Frank Act passed several legal designs to enhance the shareholders' say on corporate decisions, such as non-binding shareholder vote to approve executive compensation ("say on pay"), enhanced disclosure regarding the executive compensation and financial performance of the issuer, three-year clawback of incentive-based pay following accounting restatements, the SEC's authority to expand proxy access, etc. Bruner, *supra* note 186, at 320. While shareholder empowerment undeniably has some merits in better preventing managers from failing to pursue shareholders' interests, it can hardly resolve the

management is a clear duty of the board" and "it is considered good practice that the Board is responsible for both establishing and overseeing the company's enterprise-wide, risk management system and ensuring that it is compatible with its strategy and risk appetite."[289] "*Particularly in financial institutions*, a separate channel of risk reporting to the board such as via a chief risk officer is warranted in the same way as internal audit reports separately to the audit committee and not just to the CEO."[290] In its revised principles for corporate governance of banks, the Basel Committee also reiterated that "*the board has overall responsibility for the bank*, including approving and overseeing the implementation of the bank's strategic objectives, *risk strategy*, corporate governance and corporate values."[291] Grant Kirkpatrick made it clear that *"qualified board oversight and robust risk management is important."*[292] Klaus J. Hopt also held a similar position, stating that "the problem is rather enforcement" and stressed the importance of strengthening supervisory requirements such as establishing a separate risk committee and independent Chief Risk Officer ("CRO") as well as having qualified and experienced board members; "*[i]n the end, everything depends on the people*."[293]

The board of directors ought to be the central focus, but its poor performance during the Financial Crisis, as mentioned above, exposed its inherent deficiency.[294] As revealed in the Financial

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real problem, i.e., the protection of creditors' interests as well as other public interests. According to Bruner, the reason for such movement could be because "our corporate governance system largely revolves around two powerful constituencies, the board and the shareholders. Thus, to the degree the crisis was caused by board oversight failures, the answer must be more shareholder[s'] monitoring of boards themselves." *Id.* at 321. This simple dichotomy, however, does not really scratch where it itches. *See id.*

[289] 2010 OECD CONCLUSIONS, *supra* note 260, at 14–15 (emphasis added).

[290] 2009 OECD KEY FINDINGS, *supra* note 245, at 40 (emphasis added). OECD also made it clear that "[t]he board bears primary responsibility for strategy and for associated risk management." *Id.* "Boards must therefore monitor the structure of the company and its culture and also ensure a reliable and relevant flow of information (the assurance perspective) to the board about the implementation of its strategy and the associated risks." *Id.*

[291] BASEL 2010 PRINCIPLES, *supra* note 261, at 7 (emphasis added); BASEL 2015 PRINCIPLES, *supra* note 261, at 8 (emphasis added).

[292] Kirkpatrick*, supra* note 265, at 62 (emphasis added).

[293] Hopt, *supra* note 226, at 367–68 (emphasis added).

[294] *Id.* at 349.

Crisis, business directors may lack adequate expertise and experience to comprehend the risk profile of the bank and conduct meaningful risk management accordingly.[295] Even if they have the knowledge and capacity, they may have insufficient incentive to pay attention to such risks.[296] This is because their profit-seeking mindset, together with the profit-based compensation scheme, may induce them to undertake and justify risks rather than control risks.[297] In the end, banks' boards of directors might lack necessary capacity and incentive to duly conduct risk management.[298]

The board of directors remains the key to robust bank governance and risk management in a post–Financial Crisis era. The central problem now is how to find the right people with the right incentive, expertise, and experience to sit on the board.

D. Can Government Directors Supplement Business Directors?

To have the right people sit on the board, the core question is: which entity is best suited to select the right people? I propose that, when the private ordering fails, the government may well be

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[295] *Id.* at 362–63.

[296] *Id.* at 349.

[297] *Id.*

[298] One intuitive proposal to address this dilemma is to strengthen board independence, such as increasing the portion of independent directors on the board of banks. This might not scratch where it itches. The independence requirement, since its adoption, has been subject to long-time criticism. On the one hand, systemic evidence demonstrating that independent directors will enhance firm performance in the United States appears absent. On the other hand, it could restrict the room for banks to retain experienced talent as board directors because in banking sectors these suitable persons would be mostly affiliated ones. Besides, independence of the board merely ensures that board members may be less captured by management, but independence itself has nothing to do with enhanced capacity and incentive of board members to perform risk management for banks. Therefore, simply following the old path to ask for more independence of the board does not appear to be a convincing solution. *See* SCOTT & GELPERN, *supra* note 2, at 178–83; Kirkpatrick, *supra* note 265, at 81–82; Hopt, *supra* note 226, at 362. For studies finding no positive correlation between board independence and firm performance, see, e.g., Sanjai Bhagat & Bernard Black, *The Non-correlation between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233–34 (2001); Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Operating Performance*, 32 REV. QUANTITATIVE FIN. & ACCT. 129, 130–31 (2009).

that entity.[299] Government ownership of banks facilitates the government's appointment of government directors to banks' boards and thus the government's new role.[300]

1. Better Protection of Creditors

To begin with, government owners and their appointed government directors may better represent creditors' interests on the boards of banks than shareholder-elected directors. As mentioned above, corporate creditors are as crucial as shareholders in capitalizing banks.[301] Government directors can better represent creditors' interests on the board because the regulator's interests are closely aligned with those of creditors.[302] They both prefer a less risky bank: creditors prefer their debts repaid and the regulators prefer a stable financial system.[303] Deposit insurance also renders the regulator the ultimate creditor of insured banks and further aligns the government's interest with creditors.[304] Accordingly, the government is better motivated to implement risk management systems within banks and thus protect creditors' interest. This common objective of creditors and the regulator is exactly what is missing in the current board practice. Government directors can supplement this missing piece by bringing more robust risk management and balancing banks' profits against risk control. As a consequence of enhanced creditor protection, government directors also stabilize individual banks, as well as the entire financial system.[305]

To be sure, I do not intend to assert that shareholders' interests should be subordinated to creditors' interests. The primary objective of banks remains to maximize firms' value. The role of government directors on the board is simply to ensure that banks do not pursue profits at the expense of creditors.

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[299] For the literature favoring this idea, see Black, *supra* note 12, at 594–95; Mulbert, *supra* note 227, at 20. For the literature disfavoring this idea, see Hopt, *supra* note 226, at 353–54.

[300] Black, *supra* note 12, at 594–95.

[301] Mulbert, *supra* note 227, at 10.

[302] *Id.* at 25–26.

[303] Bruner, *supra* note 186, at 312.

[304] *Id.*

[305] *Id.* at 317.

2. Supplement Incomplete Banking Regulation and Supervision

In addition, government directors can be a useful tool for the banking regulator to implement regulatory policies within banks. Banking regulations are inevitably incomplete due to the complexity and ever-changing nature of the financial world. While amending or supplementing problematic banking regulations is feasible, in reality, it is always one pace behind the pace of rapid financial innovation.[306] In addition, each bank has its own risk profile, and banking regulations can only impose minimal requirements, not optimal requirements. Therefore, simply vesting the regulators with rulemaking and supervision authority might not be able to address all problems in advance and in time. Banking regulation and supervision just have their limits.

To address such limits, the regulator can perhaps promulgate a general rule in advance with abstract standards while authorizing the regulator to implement it through its discretion on a case-by-case basis. Basel II partly adopted this approach: its internal-ratings-based approach applicable to sophisticated banks does not stipulate specific numerical capital requirements.[307] Instead, it merely specifies several factors for each bank's consideration.[308] Banks may conduct their own internal estimates of risk components to determine their own capital requirements.[309] To prevent sophisticated banks from abusing their discretion, this approach also vests the banking regulator with wide supervisory power, which largely relies on the regulator to supervise the reasonableness and appropriateness of each bank's own model.[310] In this way, it is the banking regulator's ex post supervision of each individual bank that guards the safety and soundness of banks, rather than the ex ante banking regulation.[311] Undeniably, this ex post regulatory approach may be more feasible than promulgating complete banking regulations. Nevertheless, this approach

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306 *See* BASEL II, *supra* note 281, ¶ 15.
307 *Id.* ¶ 211.
308 *Id.* ¶ 219.
309 *Id.* ¶ 211. For an example of the internal-ratings-based approach under Basel II, see SCOTT & GELPERN, *supra* note 2, at 599–601.
310 BASEL II, *supra* note 281, ¶ 216.
311 *Id.*

involves intensive governmental supervision and inevitably contains considerable regulatory costs.[312]

In contrast to regulators, government directors can be more efficient. Government directors can monitor and reflect the regulator's concerns on a case-by-case basis, which may supplement the banking regulation and supervision. Specifically, government directors could implement regulatory policies based on the risk profile of each bank without promulgating a complete set of banking regulations to address all the details. This saves the regulatory cost. Another benefit is that government directors do not need to be restricted to government officials. The regulator may retain other private professionals in law, accounting, or finance, such as professors, lawyers, accountants, bankers, or retired managers, to serve as government directors. This reduces the staffing problem. Moreover, as these representatives are directors of banks, their fees would be paid by banks instead of the government budget, which saves the government budget as well. In this sense, government directors may be another option that supplements the incomplete banking regulation and supervision.

3. The Regulator's Better Access to Information

An additional benefit of employing government directors is that they can facilitate the regulator's information gathering. The opaqueness of banks creates informational asymmetries that plague the regulator's regulation and supervision.[313] By having government directors on the board, the regulator can obtain more internal information not easily accessible to outside regulators. This facilitates banking regulation and supervision in several ways. First, government directors may serve as an early warning system, allowing the regulator to receive information about the status of specific banks more immediately and accurately. Second,

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[312] For instance, to gather adequate information to monitor banks and to timely address different individual cases, the regulator needs to send a large number of government officials to station at each bank. A large number of government employees would be needed to supervise all the internal-ratings-based approaches of the national banks, especially to supervise each bank's many transactions, such as lending decisions, equity issuance, derivatives, or investment in securitization, etc.

[313] *See* Jonathan R. Macey, *The Regulator Effect in Financial Regulation*, 98 CORNELL L. REV. 591, 599 (2013).

government directors may also reduce the information cost between the regulator and the regulated firms; the regulator can thus obtain more knowledge and know-how in banking industries for designing banking regulations that are more suitable to sectoral needs. Finally, these government directors can accumulate considerable knowledge, experience, and expertise related to banking sectors, and may become more reliable talents for the regulator in the future. Some directors may even become candidates for the chief of regulatory agencies.

To be sure, the regulator can also obtain access to internal information of banks by requiring them to provide information periodically to the regulator. In fact, the U.S. regulator already has such power.[314] The regulator can even promulgate a rule which requires all banks to provide all board meeting materials to the regulator so that the regulator can obtain information equally with a board member of banks without sitting on the board. Nevertheless, there remain some differences between this regulatory approach vis-à-vis a directorship approach. For one thing, government directors cannot only access the information but also influence banks' decisions. Accordingly, the regulator's authority to request information from banks cannot fully replace government directorship of banks. Moreover, as a regulator, the government seeks information for the regulatory purpose. Therefore, the government's request of information needs a regulatory justification. Outside this scope, the government, as a regulator, is less justified to ask for information. In contrast, as a board member, the government may have more justified access to corporate information, which extends to all business-related information, because a director does not need to restrict his/her concern to regulatory matters. Therefore, government directors can request more information for consideration. This is of merit particularly when the banking regulation is incomplete so that the regulator has less legal ground to ask for information.[315]

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[314] BASEL II, *supra* note 281, ¶ 536.

[315] For instance, when the amount of a financial institution's loan to a single entity does not exceed the statutorily prohibited amount, the government, as a regulator, should have little grounds to make further inquiries. The government, as a board member, however, will undoubtedly be justified in inquiring further into the details in order to conduct risk assessment and risk management for precautionary purposes.

E. Summary

To conclude, I argue that government ownership of banks, accompanied with the use of government directors, can facilitate a robust bank governance system. A major concern against this argument could be that government directors may implicate dramatic political influences and shift the government's focus from regulatory concern to political self-interest.[316] In most jurisdictions, this concern could be true. Nevertheless, as illustrated in Part III of this Article, comparatively speaking, the United States can be optimistic thanks to its more competitive financial market, more advanced financial system, and more well-developed political and legal institutions.

My argument finds support from the study of Svetlana Andrianova et al.[317] Based on similar samples as those employed by La Porta et al., they found that, after controlling two additional institutional factors, i.e., index measuring bureaucratic quality and its insulation from political intervention and index of property rights, government ownership of banks was in fact positively associated with long-run economic growth.[318] Their explanation of this result is that government ownership of banks may alleviate the "extreme, yet real, threat to the growth promoting role of banks" posed by the extreme yet unchecked moral hazard behavior of opportunistic bank insiders.[319] Based on these findings, Andrianova et al. believe that "even in the 21st century, government owned banks can continue to play a 'developmental' role, not only in developing but also in industrialized countries by constraining extreme moral hazard behaviors that have a capacity to undermine long term economic growth."[320] This finding supports my argument that government ownership and directorship of banks could enhance bank governance and risk management.

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[316] Hopt, *supra* note 226, at 354.

[317] *See generally* Svetlana Andrianova et al., *Is Government Ownership of Banks Really Harmful to Growth?* 1 (Brunel Univ. Econ. & Fin. Dep't, Working Paper No. 09-20, 2009).

[318] *Id.* at 1.

[319] *Id.* at 10.

[320] *Id.*

IV. A Practical Framework for Government Ownership of Banks in the United States

A. The United States Should Be More Positive

To be sure, I do not propose a general application of government ownership or directorship to all banks. It could be too costly for the U.S. government to purchase shares of all banks. Besides, even though it is technically feasible to promulgate statutes or regulations authorizing the regulator to appoint government directors on the board of all banks, this approach would prove impossible for political reasons. Furthermore, the regulator would find it difficult to recruit an adequate number of government directors for all banks. Therefore, a general application of this reform to all banks is not a feasible option.

I do, however, believe that the U.S. banking sector should hold a more positive view toward government ownership of banks. As I argued, the United States has the position to be more optimistic of government ownership than other countries. This positive attitude may allow the U.S. government to be less hesitant when it needs to hold ownership of banks for policy reasons, such as bailouts.

A step further, government ownership and directorship should at least remain an option for complementing banking regulation and supervision. The U.S. banking regulator could consider a regime, under which it appoints a small number of government directors to sit on the board of a specific bank when that bank fails to perform its risk management appropriately. For instance, where a bank significantly or repetitively fails the stress test, falls below a specific capital requirement threshold, fails the liquidity requirement, encounters serious internal control deficiencies, breaches laws, etc., these instances could be understood as signals demonstrating the unqualified corporate governance and risk management of that bank. In these cases, the government may not want to hesitate to step in anymore; otherwise, risks could be further exposed and expanded. Specifically, when a bank goes insolvent and requires the equity bailout from the government, it suggests the risk management failure of this bank, which should justify the government's ownership and directorship of that bank.[321]

This alternative approach harmonizes with the prevalent resistance to government ownership and directorship. It leaves the task of corporate governance and risk management to the private sector in the first place. As long as the private sector can perform well on its own initiative, the regulator need not insist on intervening. If, however, there is a sign that business directors are unable to prevent excessive risk-taking, they may have less legitimate excuses to refuse the government's intervention. In such cases, government ownership and directorship may find more justification and thus absorb more resistance. Besides, such government ownership and directorship of banks need not be on a permanent basis. The regulator can set a specific period for the mandatory government representation and, on expiration, reassess whether it is necessary to extend this period.[322]

B. *Some Practical Considerations*

Plenty of literature has discussed how to design a regulatory structure for future bailouts, in particular in respect of how to institutionalize government bailouts[323] and how to address the potential conflict of interest.[324] In addition to these proposals, I

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[321] *See* Simone M. Sepe, *Regulating Risk and Governance in Banks: A Contractarian Perspective*, 62 EMORY L.J. 327, 329 (2012).

[322] It also harmonizes with the arguments that government ownership, if needed, should be at most temporary. Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1362–63; Hopt, *supra* note 226, at 354 (arguing that permanent representation would allow too much political interference into the decision-making of banks).

[323] For instance, Manns proposed an insightful set of bailout rules which centers on the incorporation of a "Federal Government Investment Corporation" to handle future bailouts based on a long-term investment approach. *See generally* Manns, *supra* note 8. His proposal, however, tends to focus on the protection of taxpayers and prevention of moral hazard, which is different from the focus of this Article on risk management of banks. To some extent, the issues addressed below complement Manns' proposals. *See* Verret, *The Bailout Through a Public Choice Lens*, *supra* note 7, at 1566–78 (advocating the use of a trust structure resembling that in the AIG case for unavoidable bailouts).

[324] *See, e.g.*, Kathleen Clark, *Fiduciary-Based Standards for Bailout Contractors: What the Treasury Got Right and Wrong in TARP*, 95 MINN. L. REV. 1614, 1623 (2011); Richard W. Painter, *Bailouts: An Essay on Conflicts of Interest*

add some more practical considerations in case the U.S. government needs to hold ownership or directorship of banks in the future.

1. Source of Talents

The first question relates to "whom" the government should appoint to the board of banks. Black and Jordan, representing the minority opinion supporting government ownership, proposed that the government should appoint its public officials to serve as government directors.[325] A concern related to this proposal is a problem of quality. The U.S. government officials may lack sufficient experience in business sectors due to the government's long self-constraint from involving itself in corporate operations.[326] They may not have adequate capacity to make sound business decisions for banks.[327]

A more desirable approach is to reach out to professionals outside the governmental system. The government could establish a database of "professional directors,"[328] including, in addition to governmental officials, professionals in law, finance, or accounting, such as professors, researchers, lawyers, accountants, investment bankers, former bank officers, and so on. The idea is to retain the "professionals" with either the street smarts or school smarts, who comprehend the necessary expertise or possess experience in the banking sector and can appreciate the importance of risk management in banks.

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and Ethics when Government Pays the Tab, 41 MCGEORGE L. REV. 131, 155–59 (2009).

[325] Black, *supra* note 12, at 594; Jordan, *supra* note 165, at 17–18.

[326] *See* Jon D. Michaels, Book Review, *Running Government Like a Business ... Then and Now*, 128 HARV. L. REV. 1152, 1164 (2015).

[327] *Id.*

[328] The idea of "professional directors" was firstly proposed by Ronald J. Gilson and Reinier Kraakman, but they introduce this concept in a different context. What they contemplate is having institutional investors establish an organized clearinghouse, or other intermediaries, which set up a database of professionals to be nominated to the boards of companies. *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 881 (1991). In contrast, what I propose here is that the government would be the "intermediary" that establishes such a database and appoints proper talents to be board members of banks.

After the appointment, the regulator and these representatives should regularly communicate with each other on regulatory policy concerns and exchange necessary information. The stationed bank should pay these government directors from its own pocket in accordance with its compensation standard. There might be a concern that the stationed bank would thus capture these government directors. With the government's supervision, particularly its appointment and dismissal power, however, such capture should be less of a problem.

2. Minority Ownership and Directorship Structure

To reduce the negative effects of government ownership of banks, the government should take as minority of a position on the board of banks as possible (except in extreme cases, e.g., where there is a strong need to inject large capital into a specific financial institution, such as that in the AIG case).[329] This minority model aims to build in a mechanism which represents creditors' interests and risk management so as to facilitate the board to make a safer and sounder judgment. Since the government does not take majority control of the board, it cannot unilaterally dominate management appointment or corporate decisions. Rather, its role is to echo the risk concern and supervise the majority members in order to pull back business directors from over-pursuing short-term profits without regard to the risks undertaken by banks. The final word is still subject to the collective decision of the board, not dominated by government minority directors. By acting as a supervisor rather than a controller, this model can subtly mitigate the negative concerns associated with government ownership and directorship.

Undeniably, the fact that the regulator backs these directors may trigger some regulatory and political implications. This inevitably makes their "minority" voice louder in the boardroom. Therefore, laws should restrict actions of government directors

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[329] Manns also holds a similar position by proposing that government investments should be limited to 50 percent of the equity value of any recipient in order to avoid excessive entanglement of the government in the private sector. Manns, *supra* note 8, at 1386–87. *Cf.* Verret, *The Bailout Through a Public Choice Lens*, *supra* note 7, at 1566–78 (proposing to use the trust structure to prevent political intervention).

to those related to risk management of banks. I will discuss this in the following Section.

3. Role and Duty of Government Directors

In terms of the role of government directors, I propose that they should be actively involved in the risk management of banks. The goal of government directors is to improve risk management to protect creditors' interests, the stability of the individual bank, and the whole financial system. Accordingly, unlike the APC practices, where the government adopted a hands-off approach and took intervention only in transactions not in the normal course of business,[330] government directors here should be more active in the corporate affairs bearing on risk management of banks.[331]

The fiduciary duty of these government directors should be generally similar to ordinary business directors. Even though government directors would focus more on the stability and survival of banks and less on shareholders, this is not inconsistent with the prevalent shareholder primacy view—that shareholders' interest should be the primary concern of directors.[332] Shareholders remain the residual claimants of banks; thus, when government directors pursue the stability and survival of banks without diverting firm value for other purposes, they also benefit shareholders. Undeniably, sometimes shareholders favor short-term interests at the cost of stability and survival of banks, such as some excessively risky investments.[333] In such cases, however,

[330] Kole & Mulherin, *supra* note 74, at 9.

[331] Manns further proposed that the government should make corporate governance and systemic risk reform a condition of bailouts up front. Manns, *supra* note 8, at 1391–92.

[332] For the content and rationale of shareholder primacy, see, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 35–39 (1992); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 576–79 (2014); American Bar Association Committee on Corporate Laws, *Other Constituency Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2268–70 (1990); John Armour et al., *What is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 1, 28 (Reinier Kraakman et al. eds., 3d ed., 2017); Ryan J. York, *Visages of Janus: The Heavy Burden of Other Constituency Anti-takeover Statutes on Shareholders and the Efficient Market for Corporate Control*, 38 WILLAMETTE L. REV. 187, 197–98 (2002).

[333] York, *supra* note 332, at 203.

several Delaware court decisions have suggested that directors may take into account the interest of the corporation itself to the extent that the corporation's interest differs from that of shareholders'.[334] Accordingly, as long as government directors pursue the stability and survival of banks, even though their risk-adverse attitude could reduce shareholders' immediate profit (such as the risk premium associated with such risk-taking behaviors), the business judgment rule protects their decision.[335]

On the other hand, what government directors should *not* pursue are those social objectives unrelated to the stability of banks and the financial system. The mission of government directors should be as simple as possible. Involving other social objectives could incur too much complexity and therefore leave leeway for politicians to exercise their political influence.[336] Vivid examples having bearing here are the government corporations of Fannie Mae and Freddie Mac as mentioned above. The government exercised its leverage in these GSEs to pursue its housing policy, which was arguably a socially beneficial policy yet unrelated to

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[334] *See* Eric J. Gouvin, *Resolving the Subsidiary Director's Dilemma*, 47 HASTINGS L.J. 287, 297 (1996) (arguing that *Unocal Corp. v. Mesa Petroleum Co.* and *Paramount Communications Inc. v. Time Inc.* "support the discretion of directors under the business judgment rule to make the best decision for the corporation, even if the shareholders would have preferred other action"); Robert A. McCormick, *Union Representatives as Corporate Directors: The Challenge to the Adversarial Model of Labor Relations*, 15 U. MICH. J.L. REFORM 219, 247 n.132 (1982) (arguing that "a majority of courts will not void a board decision that is fair and reasonable to the corporation, merely because a director with an outside interest participated in making the decision" and citing Pepper v. Litton, 308 U.S. 295, 306 (1939), Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66 (Cal. App. 1952), and Fill Bldgs. Inc. v. Alexander Hamilton Life Ins. Co., 241 N.W.2d 466 (Mich. 1976), as examples.); E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761, 765 (2008).

[335] McCormick, *supra* note 334, at 247.

[336] Nicholas O. Kennedy, for instance, advocated an expansive view of corporate purpose, which makes fiduciary duties imposed on the government controlling shareholder unnecessary. *See* Nicholas O. Kennedy, *Citizens or Shareholders?: Analyzing the Federal Government's Fiduciary Duties as a Controlling Shareholder in Corporations Receiving Funds from the Troubled Asset Relief Program*, 12 J. BUS. & SEC. L. 21, 56 (2011). Under this view, however, there is a real concern that the United States would lose an important tool for controlling government shareholder's and directors' behaviors.

their financial stability.[337] It turned out that the whole financial system paid for the government's intervention for such unrelated purposes.[338] Accordingly, the mission of government directors should be simply balancing creditors' interests and the stability and survival of their stationed banks with shareholders' interests, without regard to other social objectives.[339]

4. Access to Fiduciary Claims Against Government Directors

Aside from the substance of the fiduciary duty of government directors as discussed above, there could be a procedural concern about whether government directors bear fiduciary duties. This issue arises from the sovereign immunity doctrine.[340]

The sovereign immunity doctrine provides that the sovereign (i.e., the federal government) cannot be sued unless it allows itself to be.[341] Under this doctrine, procedurally, plaintiffs can bring a claim against the federal government only in federal court.[342] Substantively, they cannot bring such claims unless the claims fall within the waivers of sovereign immunity, i.e., the Federal Tort Claims Act, the Tucker Act, or the Administrative Procedure Act.[343] Where an officer's or agent's conduct incurs personal liability, relief against that person would normally be considered as relief

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337 Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1305–06.

338 *Id.*

339 On the other hand, I do not suggest that all banks cannot voluntarily engage in activities of social welfare. My proposal simply wishes to set a limit to government directors' actions in order to mitigate the concerns of political influence. It is another story if it is the business directors, rather than the government directors, who initiate such social activities. Plenty of literature has argued that with or without regard to the interest of a corporation, a corporation is entitled to engage in public welfare activities. *See, e.g.*, Einer Elhauge, *Sacrificing Corporate Profit in the Public Interest*, 80 N.Y.U. L. REV. 733, 763 (2005); Rhee, *supra* note 196, at 662.

340 For a discussion of the fiduciary duty of government directors, other directors as well as the government controlling shareholders, see generally Barnes, *supra* note 125, at 1445–66; Kahan & Rock, *Implications for Delaware*, *supra* note 12, at 418–26; Verret, *Treasury Inc.*, *supra* note 6, at 333–40.

341 United States v. Mitchell, 463 U.S. 206, 212 (1982).

342 *Id.*

343 *See* Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1325–46; Verret, *Treasury Inc.*, *supra* note 6, at 307–13.

against the sovereign if the decree would "operate against the [sovereign]."[344] This, in turn, forbids a court from taking jurisdiction in a suit against him or her.[345] Although related court rulings did not consistently reconcile with each other,[346] in practice, if a judgment would expend itself on the public treasury or domain, interfere with the public administration, or if the effect of the judgment would restrain the government from acting or compel it to act, it could be considered as a judgment against the sovereign.[347]

Applying these sets of rules to a fiduciary claim against government directors, who could be considered the government's agents, it is possible that courts would treat these claims as against the government. After all, such a claim has the potential to interfere with the public administration or restrain the government's action. In that case, it is arguable as to whether any waivers under the Federal Tort Claims Act, the Tucker Act, or the Administrative Procedure Act can apply to the fiduciary claims here.[348] Even though state courts find such claims are not precluded by the sovereign immunity doctrine, they, particularly Delaware courts, would tend to refrain from judging on this issue in order to prevent a confrontation with the federal government so as to preserve the state right to regulate corporate matters.[349] According to Marcel

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[344] Verret, *Treasury Inc.*, *supra* note 6, at 314 (quoting Pennhurst State Sch. & Hosp. v. Halderman, 465 U.S. 89 (1984)).

[345] *Id.*; Pennhurst State Sch. & Hosp. v. Halderman, 465 U.S. 89, 101 (1984).

[346] Larson v. Domestic & Foreign Commerce Corp., 337 U.S. 682, 698 (1949).

[347] Dugan v. Rank, 372 U.S. 609, 620 (1963).

[348] In respect of the Federal Tort Claims Act, it is arguable as to whether a breach of fiduciary duty is a tort. In respect of the Administrative Procedure Act, it is also arguable as to whether the actions of government shareholders or directors are an exercise of agency authority. The Tucker Act could be a possible chance for fiduciary claimants. However, since court precedent suggests a precondition to the Tucker Act that the government has established comprehensive federal control over those banks and thus taken on the fiduciary duties, it is arguable as well, though no case law has opined on this issue. *See* Kahan & Rock, *When the Government Is the Controlling Shareholder*, *supra* note 12, at 1326–45.

[349] Kahan & Rock, *Implications for Delaware*, *supra* note 12, at 426–30. They reference the Delaware court's stay of *In re Bear Stearns Cos. Shareholder Litigation* case in favor of the New York court's decision during the Financial Crisis, and infer that Delaware courts will tend to duck when the case implicates a confrontation with the federal government. For their detailed reasons, see also Kahan & Rock, *When the Government Is the Controlling Shareholder*,

Kahan and Edward Rock, a potential vehicle for the Delaware courts to achieve this purpose may be Delaware Court of Chancery Rule 19, which provides substantial flexibility for the court to dismiss the case on grounds that a necessary joinder for trying the fiduciary claim against government directors, i.e., the government, is absent.[350] In that case, government-owned banks can never claim the accountability of government directors.

To ensure the accountability of government directors, Congress needs to explicitly clarify the access to fiduciary claims against government directors. Government directors need to be accountable and undertake their fiduciary duties. To the extent that such liability could be precluded, I propose that Congress should consider clarifying it explicitly in the statutes by creating an enabling legislation to waive the government's sovereign immunity with regard to its involvement in corporate affairs of banks. This proposal is not unprecedented: Congress created such enabling legislation when establishing the Resolution Trust Corporation (RTC) to bail out the savings and loan industry.[351] Enhancing the accountability of government directors can also effectively mitigate political influence because government directors, fearing personal liabilities, would have less incentive to succumb to politicians' requests. Reducing these political risks may further assist banks to raise private capital and increase the value of firms' stock.[352]

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supra note 12, at 1324–25; Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity*, 58 EMORY L.J. 713, 713–17 (2009).

[350] *See* Kahan & Rock, *Implications for Delaware*, *supra* note 12, at 431–35.

[351] When establishing the Resolution Trust Corporation (RTC) to bail out the savings and loan industry, Congress created such enabling legislation, which provided that the RTC may "sue and be sued in its corporate capacity in any court of competent jurisdiction." 12 U.S.C. § 1441a(b)(9)(E) (2006). A similar precedent also exists for the RFC during the Great Depression, where Congress passed similar statutes to waive the sovereign immunity of the RFC. Reconstruction Finance Corporation Act § 4; Reconstruction Fin. Corp. v. J.G. Mehinan Corp., 312 U.S. 81, 84–86 (1941). *See* Verret, *Treasury Inc.*, *supra* note 6, at 346–47.

[352] Verret, *Treasury Inc.*, *supra* note 6, at 316. On the other hand, some commentators also proposed some administrative review of an agency decision under the Administrative Procedure Act. *See* Shahabian, *supra* note 11, at 379–83.

5. Disclosure

Finally, the government should disclose all actions and opinions of government directors on any corporate affairs of banks to the public. The purpose of such disclosure is twofold. On the one hand, it ensures exposure of the political influence from politicians on these government directors to the sunshine. On the other hand, it also ensures that government directors are faithfully implementing the government's regulatory purpose and policy and communicates such purpose and policy to the public.

In addition, when majority board members do not adopt the opinion of government directors, the bank should disclose it to the public. In such cases, disclosure can serve as an alarming signal for public investors and creditors. They can accordingly assess whether the decision of the business directors is excessively risky, or whether it is simply that the opinion of the government directors is less persuasive.[353]

CONCLUSION

This is a post–Financial Crisis era, where people still have fresh memories regarding the fragility of financial systems as well as the practice of government ownership. While the mainstream opinion in the United States disfavored government ownership of banks during the Financial Crisis, I provide some balanced analysis to make the case for it to prevent bias against this practice from evolving into blind antagonism. I believe that the U.S. banking sector should take a more positive view of government ownership of banks. The downsides should not be exaggerated, considering that the United States has antidotal institutions to handle them. The benefits should neither be obscured because of widespread antagonism against this practice. With complementary institutions and proper legal design, government ownership and directorship can be another useful tool for the regulator to improve risk management of banks and preserve their stability. While government ownership of banks may not function well in other jurisdictions, there should be a U.S. exception, under which the United States can make government ownership of banks a blessing instead of a curse!

[353] From a different perspective, Fisher proposed to improve the disclosure rules in respect of the government's exercise of influence in changing the board members. *See* Fisher, *supra* note 122, at 585–98.