ARTICLES

A FRAMEWORK FOR BAILOUT REGULATION

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During the height of the financial crisis in 2008 and 2009, the government bailed out numerous corporations, including banks, investment banks, and automobile manufacturers. While the bailouts helped end the financial crisis, they were intensely controversial at the time, and were marred by the ad hoc, politicized quality of the government intervention. We examine the bailouts from the financial crisis as well as earlier bailouts to determine what policy considerations best justify them, and how they are best designed. The major considerations in bailing out and structuring the bailout of a firm are the macroeconomic impact of failure; the moral hazard effect of the bailout; the discriminatory effect of the bailout; and procedural fairness. Future bailouts should be guided by principles that ensure that the decisionmaker properly takes into account these factors.

Introduction

Since the financial crisis of 2008, the word "bailout" has become a term of abuse in our political lexicon. The bailouts of numerous financial institutions and two automobile manufacturers were extremely controversial.[1] Congress sought in the Dodd-Frank Act to ensure that bailouts would never take place again, going so far as to write into the preamble that one purpose of

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1 Sheryl Gay Stolberg, *Constituents Make Their Bailout Views Known*, N.Y. Times (Sept. 24, 2008), http://www.nytimes.com/2008/09/25/business/25voices.html?_r=0 ("Senator Barbara Boxer, Democrat of California, has received nearly 17,000 e-mail messages, nearly all opposed to the bailout, her office said.").

the Act was "to protect the American taxpayer by ending bailouts."[2] President Barack Obama agreed that "because of this law, the American people will never again be asked to foot the bill for Wall Street's mistakes."[3] But after his former Treasury Secretary admitted that Dodd-Frank would not end bailouts, Republicans in the House of Representatives issued a scathing report entitled *Failing to End "Too Big to Fail": An Assessment of the Dodd-Frank Act Four Years Later*.[4] The political unpopularity of bailouts is matched in the academic literature, where the traditional view is that bailouts are almost always unwise, and usually result from political failure.[5]

But the word "bailout" is used in different ways, and it is sometimes hard to understand what people are complaining about. A bailout is, essentially, a transfer of money or other resources from the government to a private agent (or sometimes to another government). Such transfers occur every day and hardly ever cause anyone to lift an eyebrow. The government transfers money or other valuable consideration to solar panel manufacturers, dairy farmers, poor people, and research universities. While many people disagree about the wisdom of these transfers, they do not regard them as illegitimate in the same way that they often regard bailouts.

We can make some progress by observing that in common parlance the word bailout refers to a subset of transfers where the transfer is intended to rescue an agent who cannot meet its financial obligations. Even here, however, the source of complaint is obscure. If the government is willing to subsidize a manufacturer of solar power panels by giving it money, making loans to it, or guaranteeing its debt (as it often is), then what's wrong with a policy of paying off an unpaid debt if otherwise it would default? The effect of all these policies is the same: to lower the cost of capital for the beneficiary. The policy justification is also the same: to encourage people to invest in solar power.

Indeed, the government routinely helps agents who are about to default on debts. The Federal Deposit Insurance Corporation (FDIC), for example, insures people against loss of their deposits up to $250,000.[6] If a bank fails, the FDIC transfers money to depositors, in this way paying the bank's debts (or some of them) for it. Similarly, if a natural disaster strikes, the government frequently assists victims by supplying them with loan guarantees and

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2 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in 12 U.S.C. §§ 5301–5641).

3 Remarks on Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act, 2 PUB. PAPERS 1087, 1089 (July 21, 2010), http://www.gpo.gov/fdsys/pkg/PPP-2010-book2/pdf/PPP-2010-book2.pdf.

4 REPUBLICAN STAFF OF H.R. COMM. ON FINANCIAL SERVS., FAILING TO END "TOO BIG TO FAIL": AN ASSESSMENT OF THE DODD-FRANK ACT FOUR YEARS LATER (2014), http://financialservices.house.gov/uploadedfiles/071814_tbtf_report_final.pdf.

5 *See infra* Part I.

6 12 U.S.C. § 1821(a)(1)(E) (2012).

other benefits that make it easier for them to pay off their debts while they are rebuilding their lives.[7]

FDIC payments are not called "bailouts"; why not? One reason is that the payouts are part of a regulatory program that puts burdens on banks and depositors. Banks must pay for FDIC insurance, and they must submit to regulations that are designed to prevent them from taking excessive risks. These costs are passed on to depositors in the form of interest rates on checking accounts that are lower than they would otherwise be. Thus, the FDIC payouts seem no more objectionable than payouts made by a private insurance company. In both cases, the insured party pays for the insurance, so when insurance payouts are made, they do not seem undeserved.

Similarly, banks often receive cheap loans from the Federal Reserve System that help them through spells of illiquidity. These discount window loans, as they are called, do not offend public values because the banks can receive them only if they are members of the Federal Reserve System, which requires them to purchase capital in Federal Reserve banks and submit to regulations. Banks must also pay for the loans in the form of interest.

Any reasonable definition of bailouts will need to encompass "good" (or at least uncontroversial) bailouts as well as "bad" bailouts. We are comfortable with the following definition. A bailout occurs when the government makes payments (including loans, loan guarantees, cash, and other types of consideration) to a liquidity-constrained private agent in order to enable that agent to pay its creditors and counterparties, when the agent is not entitled to those payments under a statutory scheme. As we will see, this definition of bailout admits for some fuzzy cases, but it will serve.

The key feature of the bailout—and the feature that makes people so uncomfortable—is that it is ex post. People who operate in the private market are expected to be responsible for their debts when they have not paid for guarantees or insurance. Everyone expects them to take precautions to ensure that they can pay their debt, or not to take on the debt in the first place.

It is for this reason that many people believe that bailouts violate the rule of law or offend other norms of our constitutional system.[8] Bailout recipi-

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7 *See, e.g.*, 15 U.S.C. § 636(b) (2012) (authorizing the Small Business Administration to offer loans and other financial assistance to businesses and private citizens after a disaster). There are many such programs. *See generally* CONG. RESEARCH SERV., 94-195 ENR, A DESCRIPTIVE ANALYSIS OF FEDERAL RELIEF, INSURANCE, AND LOSS REDUCTION PROGRAMS FOR NATURAL HAZARDS (1992); Barry J. Barnett, *US Government Natural Disaster Assistance: Historical Analysis and a Proposal for the Future*, 23 DISASTERS 139 (1999).

8 *See, e.g.*, Timothy A. Canova, *Financial Market Failure as a Crisis in the Rule of Law: From Market Fundamentalism to a New Keynesian Regulatory Model*, 3 HARV. L. & POL'Y REV. 369, 392 (2009) (describing the Federal Reserve's actions during the crisis as extreme violations of the rule of law and "flagrant" constitutional violations); Gary Lawson, *Burying the Constitution Under a TARP*, 33 HARV. J.L. & PUB. POL'Y 55, 58 (2010) (describing TARP as "a constitutional monstrosity"); John B. Taylor, *The Role of Policy in the Great Recession and the Weak Recovery*, 104 AM. ECON. REV. 61, 62–63 (2014) (noting that "ad hoc bailout policy" trampled existing law); Lawrence H. White, *The Rule of Law or the Rule of Central Bankers?*,

ents have no entitlement to a bailout yet they receive one anyway. Moreover, the prospect of a bailout may encourage firms to engage in risky behavior. Often bailouts occur during emergencies, and it is thought that the beneficiary takes advantage of the press of time to push through the bailout plan. That is why Congress sought to end bailouts once and for all in Dodd-Frank.

Yet, as we will argue, governments should not try to legislate away bailouts. Bailouts are socially desirable because Congress cannot anticipate the contingencies that would make possible an ex ante insurance system that regulates behavior and charges firms in advance for liquidity support or other transfers. The question then arises whether bailouts can nonetheless be regulated in advance so that the worst types of bailouts are avoided and only good bailouts are implemented. In short, can we develop some rules or principles that govern how the government uses bailouts when, by hypothesis, we cannot legislate the specific conditions under which they must or must not be used?

The answer is—yes. Congress frequently regulates the way that the government (including itself, but mainly the President and regulatory agencies) addresses some problem while nonetheless allowing it the discretion to determine whether to address the problem in the first place. A humdrum example comes from law enforcement. Law enforcement officials enjoy enormous discretion whether to respond to a call for help, investigate a crime, file charges, and prosecute. But they face numerous constraints on how they pursue actions once they decide to take them. A police officer can refrain from helping someone pursue a bike thief, but if the officer chooses to help, he cannot make searches without a warrant. A prosecutor can decline to prosecute, but if she prosecutes, she cannot do so in a way that violates the code of ethics.

Moreover, the law already provides a basis for challenging bailouts, albeit a weak and confusing one. Bailouts are "givings" rather than "takings," and thus not directly addressed by the Takings Clause of the Constitution.[9] There is no law that permits people to compel the government to bail them out. Yet both statutory and constitutional law provide some constraints on bailouts. The Fed—the major bailout agency—is governed by a statute that limits who it can bail out, and the terms of bailouts. The Bankruptcy Code puts constraints on bailouts when they take place in bankruptcy. And both the Takings Clause and the unconstitutional conditions doctrine may come

30 CATO J. 451, 451 (2010) (arguing that government officials in the crisis "consider[ed] every possible remedy but applying the rule of law"); Todd J. Zywicki, Commentary, *Chrysler and the Rule of Law*, WALL ST. J. (May 13, 2009), http://online.wsj.com/articles/SB124217356836613091 (arguing that the 2009 Chrysler bailout violates the rule of law principle).

9 *Cf.* Abraham Bell & Gideon Parchomovsky, *Givings*, 111 YALE L.J. 547 (2001) (observing that givings pose the same constitutional problems that takings do).

into play if the government conditions a bailout on waiver of constitutional rights.[10]

These bodies of law have played a role in significant litigation that has emerged from the financial crisis. In 2013, shareholders of Fannie Mae and Freddie Mac sued the government on the ground that the federal rescue expropriated their property by eliminating their right to the firms' profits. In 2011, automobile dealers brought a lawsuit against the government that argued that during the bailout the government compelled the automakers to terminate contracts with them. Also in 2011, shareholders of the vast insurance company AIG sued the government for diluting their equity when it made emergency loans to AIG. All of the lawsuits argued that the government violated the Takings Clause, and in each case a court was willing to entertain the argument if the plaintiffs could prove the factual predicates of their claims.[11]

Thus, one cannot avoid thinking about the optimal regulation of bailouts—if only to understand and criticize existing law. At the same time, the regulation of bailouts poses some special problems. The source of a bailout is often Congress itself, and so Congress may choose to disregard earlier legislation that seeks to constrain it. Even when a bailout comes from the Fed or another agency, Congress might be reluctant to impose constraints on it just because bailouts are by definition pursued in extraordinary, hard-to-anticipate situations, unlike regular law enforcement. For this reason, we will propose bailout "principles" without taking a position on whether they can be embodied in a statute. Perhaps they can; but if they can't, we will argue that stated principles, even if not legally enforceable, may be a useful way to structure the political response to bailouts.

In Part I, we provide a brief review of the legal literature on bailouts. In Part II, we discuss the idea of a bailout, and explain why it is useful to identify it as a residual category of transfers that the government makes when existing law "runs out." In Part III, we draw some lessons from notable bailouts—from the financial crisis, and before. Criticism of them can be divided into four categories: they were not socially desirable from an ex post perspective; they were unfair (they treated like people or firms unalike); they produced moral hazard and other bad incentives for people who expect more bailouts in the future; and they did not obey principles of procedural due process. These lessons motivate our proposed Bailout Principles, which we discuss in Part IV. The Bailout Principles describe rules that maximize the likelihood that bailouts will serve the public interest.

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10 The question whether the government exceeded these constraints during the financial crisis bailouts is the subject of various ongoing lawsuits. *See* David Zaring, *Litigating the Financial Crisis*, 100 VA. L. REV. 1405 (2014).

11 *See* discussion *infra* Section III.E.

I. Background

Before the financial crisis, the legal literature on bailouts was sparse. A single article, written by Professor Cheryl Block, offered a framework for thinking about certain bailouts.[12] Block points out that bailouts are ex post government interventions that may produce perverse incentives, but she defines bailouts more broadly than we do to encompass insurance payouts made pursuant to ex ante insurance schemes.[13] So while Block ends up discussing how such insurance schemes should be designed,[14] we focus on payouts that are made in the absence of such schemes.

The post-financial crisis literature on bailouts is vast. Most of the scholarship describes and evaluates specific bailouts,[15] and does not attempt to provide principles of bailout regulation, as we do. Many scholars have also written about the implications of the financial crisis for financial regulation, bankruptcy law, and other insolvency regimes.[16]

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12 Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L.J. 951, 956–58 (1992).

13 *Id.* at 972–76 (discussing "prospective bailout" regimes).

14 *Id.* at 1033–34.

15 *See, e.g.*, Adam B. Badawi & Anthony J. Casey, *The Fannie and Freddie Bailouts Through the Corporate Lens*, 10 N.Y.U. J.L. & BUS. 443 (2014); Steven Davidoff Solomon & David Zaring, *After the Deal: Fannie, Freddie, and the Financial Crisis Aftermath*, 95 B.U. L. REV. 371 (2015); Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727 (2010); *see also* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463 (2009) (providing a descriptive examination of some of the government reactions to the financial crisis).

16 *See, e.g.*, Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469 (2010); Anna Gelpern, *Financial Crisis Containment*, 41 CONN. L. REV. 1051 (2009); Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?*, 82 TEMP. L. REV. 449 (2009); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008); *see also* Richard W. Painter, *Bailouts: An Essay on Conflicts of Interest and Ethics When Government Pays the Tab*, 41 MCGEORGE L. REV. 131 (2009) (discussing the implication of the crisis and bailouts on theories of political corruption). An enormous amount has been written on the regulation and resolution of financial institutions specifically. Much of this literature is focused more on assessing the Dodd-Frank Act and ex ante regulations to prevent the systemic spread of the failure of financial institutions. It is difficult, however, to separate this literature from bailout literature more broadly as the two issues are so deeply intertwined after the financial crisis. *See, e.g.*, John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35 (2014); Robert P. Bartlett, III, *Making Banks Transparent*, 65 VAND. L. REV. 293 (2012); Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151 (2011); Thomas H. Jackson & David A. Skeel, Jr., *Dynamic Resolution of Large Financial Institutions*, 2 HARV. BUS. L. REV. 435 (2012); Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951 (2011); Jeffrey N. Gordon & Christopher Muller, *Avoiding Eight-Alarm Fires in the Political Economy of Systemic Risk Management* (Columbia Law and Econ., Research Paper No. 369, 2010), http://ssrn.com/abstract=1553880.

A few scholars have begun exploring how bailouts should be regulated.[17] Professor Adam Levitin argues that a bailout system should have "political accountability as the paramount institutional design goal"—by which he means that a bailout should please the median voter—and offers some design principles for ensuring that bailouts will be politically legitimate.[18] By contrast, we argue that bailouts should serve public policy (should be "efficient," in a broad sense); we assume that they will be politically legitimate if they are consistent with principles that tend to ensure efficiency or good public policy. Indeed, when the government enacts bad policy in response to short-term public demand, its legitimacy can be hurt in the long run. This is especially true where, as in the case of bailouts, popular preferences tend to exhibit significant temporal inconsistency.[19]

Professor Jeffrey Manns proposes to subject bailouts to a set of limitations.[20] He identifies three principles behind these limitations: (1) deterring moral hazard; (2) recouping the government's investment; and (3) linking bailouts to governance reform.[21] These principles lead him to propose an investment fund—the Federal Government Investment Corporation (FGIC)—with the limited power to make bailout funds available under certain conditions.[22] The FGIC would have authority to invest in systemically significant firms where it could certify that default raises systemic risk.[23] Even with those thresholds met, the FGIC would be limited in implementing the bailout. The fund would be permitted to invest no more than 50% of the equity value of any bailout recipient for a limited period of time.[24] Creditors would be required to take a haircut, and the bailout recipient would be required to undergo corporate governance reforms.[25]

But the second and third principles are not proper goals of a bailout system.[26] While the performance of a government investment is one relevant

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17 *See, e.g.*, Iman Anabtawi & Steven L. Schwarcz, *Regulating* Ex Post*: How Law Can Address the Inevitability of Financial Failure*, 92 TEX. L. REV. 75 (2013); Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435 (2011); Jeffrey Manns, *Building Better Bailouts: The Case for a Long-Term Investment Approach*, 63 FLA. L. REV. 1349 (2011); *see also generally* Peter Conti-Brown, *Elective Shareholder Liability*, 64 STAN. L. REV. 409 (2012) (proposing an elective shareholder liability mechanism to reduce moral hazard and windfall problems inherent in the operation bailouts of financial institutions).

18 Levitin, *supra* note 17, at 506.

19 *See infra* subsection III.F.4.

20 Manns, *supra* note 17, at 1383–84.

21 *Id.* at 1388.

22 *Id.* at 1383–84.

23 *Id.* at 1396.

24 Under this rule, the government has to take a share of convertible equity in the firm that is proportional to the amount it invests. And that share is limited to 50% of the firm's equity value. *Id.* at 1386–87.

25 *Id.* at 1388–89, 1391–92.

26 Manns's first principle—deterring moral hazard—is one on which we agree. But Manns overweighs this principle's importance. He identifies moral hazard concerns as the "key" to designing bailouts. *Id.* at 1388. We suggest below that moral hazard can be a concern in some but not all cases. A narrow focus on moral hazard can obscure the other

measure of ex post efficiency, it is not an end in itself. A bailout that prevents social losses of $100 billion at a cost of $5 billion for the government is a socially beneficial bailout. And while corporate governance reform is a valid goal, a bailout is not a good time to implement it. The government's role as a bailout monopolist gives it leverage over recipients, which lends itself to abuse. Moreover, because bailout decisions must typically be made with great rapidity, officials do not have the time to evaluate a firm's governance structure and propose reforms.

Professors Iman Anabtawi and Steven Schwarcz argue that bailouts are part of a necessary ex post system of financial regulation.[27] In an analysis of the broader question of financial regulation, they suggest that financial risk must be regulated both through ex ante and ex post measures.[28] Among the necessary ex post measures, they include bailouts or "safety nets."[29] They suggest that the power to provide safety nets should be institutionalized in a standing government agency with the power to invest in firms that are too big to fail.[30] They identify some costs inherent in these safety nets—namely moral hazard and false positives. Beyond noting some of the ways that moral hazard can be reduced,[31] however, they do not provide guidelines for the exercise of the bailout power.[32]

There is also a large economic literature on bailouts of financial firms during liquidity crises.[33] Most economists believe that the central bank should make secured loans to illiquid but solvent financial institutions during a liquidity crisis.[34] When a bailout produces positive externalities (typically

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principles of fairness, efficiency, and process that we identify. Similarly we agree with Manns that there are risks to ex post discretion, *see id.* at 1404–05, but his attempts to prevent this through strict ex ante formulas for investment remove the value of bailouts and relegates government power to those cases where bailouts are by definition unnecessary.

27 Anabtawi & Schwarcz, *supra* note 17, at 102–12.

28 *Id.* at 131.

29 *Id.* at 77.

30 *Id.* at 106. They argue that an existing authority, rather than an ad hoc response to crisis, will "permit [safety net] design to be developed with the benefit of careful analysis" and "provide a source of preexisting authority, as well as political legitimacy, to market liquidity providers." *Id.* at 112.

31 They identify haircuts and "a credible policy of constructive ambiguity" as measures to reduce moral hazard. *Id.* at 124.

32 Their primary focus is on showing the tradeoff between ex ante and ex post regulation rather than providing a prescriptive guide for implementing the various forms of ex post regulation. *Id.* at 128–31.

33 *See, e.g.*, FINANCIAL CRISES, CONTAGION, AND THE LENDER OF LAST RESORT (Charles Goodhart & Gerhard Illing eds., 2002); INT'L MONETARY FUND, FINANCIAL CRISES: CAUSES, CONSEQUENCES, AND POLICY RESPONSES (Stijn Claessens et al. eds., 2014); THE LENDER OF LAST RESORT (Forrest H. Capie & Geoffrey E. Wood eds., 2007); Stanley Fischer, *On the Need for an International Lender of Last Resort*, 13 J. ECON. PERSP. 85 (1999).

34 *See* J. Bradford DeLong, *This Time, It is Not Different: The Persistent Concerns of Financial Macroeconomics* 13 (Apr. 2012) (unpublished manuscript) (on file with the *Notre Dame Law Review*), http://delong.typepad.com/20120411-russell-sage-delong-paper.pdf.

in the form of restoring liquidity to the market) that exceed moral hazard costs, it is socially beneficial.[35] Many economists and central bankers believe that relatively clear rules are needed to govern bailouts in order to constrain central banks and ensure that they maintain legitimacy in a democratic system.[36]

Our article builds on this literature, but we try to derive a more detailed set of principles for regulating bailouts, based on our interpretation of the successes and problems with numerous bailouts that have taken place since 1970. We draw on some of the insights in the economic literature, but our approach is both more general—we look at all bailouts, not just financial bailouts—and more specific—we propose rules for governing bailouts that are attentive to legal norms and institutional structure.

II. What Is a Bailout?

A. *Definition*

We define a "bailout" as an ex post government transfer (a loan, cash, or other consideration) to an agent or group of agents to provide capital that is otherwise unavailable because of liquidity constraints. In most cases, this will take the form of a transfer to prevent the agent from defaulting on debt, but that is not a technical necessity.

1. Liquidity Constraints

We stipulate that the bailout recipient faces liquidity problems in order to distinguish a bailout from a regular transfer. Consider a firm that makes widgets and finances its operations with debt. A cyclical downturn has imposed a cash-flow shock on the firm. Although the firm remains economically viable, it cannot pay its debts. In a perfectly functioning capital market, the firm would refinance its debts and continue operation without a bailout.[37] Any government transfer under these conditions would be a subsidy.

Now assume that there is a simultaneous liquidity shock to the financial markets that makes it impossible for the firm to raise the funds necessary to continue. This is the most straightforward case for a bailout. The government provides the liquidity to prevent an economically viable firm from collapsing.

Still, a firm may in some cases be unable to raise capital even without defaulting on prior debt. Our widget company may have had an all-equity

35 *See* Antonio E. Bernardo et al., A Model of Optimal Government Bailouts (May 3, 2011) (unpublished manuscript) (on file with the *Notre Dame Law Review*), https://escholarship.org/uc/item/8wv4p90c.

36 *See* Paul Tucker, Independent Agencies in Democracies: Legitimacy and Boundaries for the New Central Banks (2014) (unpublished manuscript).

37 To the extent there is a debt overhang problem, bankruptcy without a government bailout could still facilitate the refinancing. *See* David A. Skeel Jr., *States of Bankruptcy*, 79 U. Chi. L. Rev. 677, 687 (2012).

capital structure. That does not change the fact that when the cyclical downturn hits, it needs to raise funds for future operations. Again, where capital is unavailable, the government's role as liquidity provider is implicated and a transfer made in that role would be a bailout.

In contrast, a firm may be failing economically regardless of capital markets. People may simply not want to buy widgets anymore at a price that makes production worthwhile. Any government transfer to the firm in that situation is a mere subsidy.[38]

Complications pile up when we consider the possibility of indirect bailouts. A financially troubled widget firm may have numerous stakeholders—employees, creditors, and others—who will be badly hurt if the firm collapses. The failure of the firm may cause a financial shock to the employees or counterparties. Again, the problem exists only where an imperfection in capital markets prevents counterparties from obtaining credit. A laid-off employee may not be able to finance her retraining; a counterparty on a major contract or a creditor may not be able to raise enough capital to survive the cash-flow shock from the widget firm's failure. In these cases, the government may want to bail out the employees or counterparties but it may determine that the most cost-effective way to do this is to inject capital into the widget firm. This is (or could be, depending on how the bailout is structured) a wealth transfer or subsidy to the widget firm, but it is also an indirect bailout to the employees or counterparties.[39]

This final example reveals two important points. First, all bailouts are ultimately about liquidity. The government either bails out economically viable liquidity-constrained firms or it indirectly bails out the liquidity-constrained stakeholders in a firm (when the firm may be insolvent). Second, distinguishing indirect bailouts from mere subsidies (especially for nonfinancial firms) can be difficult as the distinction turns on whether the purpose of the transfer is to prevent a liquidity crisis for the firm's stakeholders. And the likelihood that such a liquidity crisis would result from the firm's collapse is difficult to measure. Thus, the assertion that the government is making the transfer for that purpose can rarely be proven or refuted with any certainty.

2. Ex Post

The second feature of the definition just laid out is that the bailout must come ex post—as a transfer that was not paid for in advance, as in the case of

38 We will see below that critics of the auto bailout claimed that they were, in fact, subsidies of this kind. The government took the contrary position. Our view is that intent matters. A transfer to a firm everyone knows is economically failed is not a bailout. A bailout to a firm that is thought by the government to be viable but turns out to be failed is a misguided or bad bailout. As the auto bailouts highlight, actual intent can be difficult to discover. This argues in favor of some of the guiding principles to minimize abuse of discretion that we advocate below.

39 One could also have an indirect bailout of the counterparties of the counterparties (and so on).

insurance.[40] Ex ante safety nets are insurance rather than bailouts. To be clear about this point, imagine a timeline in which an agent makes an investment at time one, and the investment is realized as a success or failure at time two. If the government believes that the investment should be subsidized, it may offer a tax break, loan guarantee, or other subsidy to the agent before time one. Such a subsidy is not a bailout. By contrast, if the investment fails at time two, and then the government makes a transfer to the agent to prevent it from defaulting on its obligations, a bailout has occurred.

The clearest example of government insurance is the FDIC program.[41] Banks pay premiums for this insurance, and in return depositors are entitled to compensation from the FDIC of up to $250,000 if the bank is unable to pay them. FDIC insurance, in principle, is not a subsidy because banks must pay premiums; thus, the payment to the depositors is not a bailout. Moreover, even if FDIC insurance is underpriced, as is sometimes argued,[42] the payouts are not bailouts because depositors have a legal right to the payouts. The underpricing of FDIC insurance is just a typical ex ante subsidy.

By contrast, the Fed's power under section 13(3) of the Federal Reserve Act does give the Fed the power to make bailouts.[43] Under section 13(3), the Fed can make below-market loans to illiquid non-bank institutions.[44] These institutions do not make ex ante payments to the Fed, and have no legal entitlement to the loans, so section 13(3) cannot be classified as an insurance program. The purpose of a section 13(3) loan is to enable the borrower to pay its debts; hence, a section 13(3) loan is a bailout.[45]

An interesting middle case is the Fed's power to make discount-window loans to banks under section 10(b).[46] The banks that receive these loans make mandatory capital contributions to a Federal Reserve Bank, but these contributions are not priced to reflect future need for loans. On the other hand, banks do pay interest on the loans ex post, and must submit ex ante to regulation. Legally, the loans are discretionary rather than as of right; yet banks expect them and the Fed has a legal obligation to use the discount window to end banking panics. For this reason, section 10(b) loans fall somewhere between a pure bailout and an insurance payout.

This two-part definition can be applied to distinguish close cases. Under our definition, government loans to victims of natural disasters should be classified as bailouts to the extent that those loans are designed to enable

40 On the difference between ex post and ex ante legal norms, see Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 571–77 (1992).

41 *Who is the FDIC?*, FDIC (Oct. 30. 2014), https://www.fdic.gov/about/learn/symbol/.

42 George G. Pennacchi, *A Reexamination of the Over- (or Under-) Pricing of Deposit Insurance*, 19 J. MONEY, CREDIT & BANKING 340 (1987).

43 Federal Reserve Act, § 13(3) (codified at 12 U.S.C. § 343 (2012)).

44 *Id.*

45 Not everyone agrees that an emergency loan of this type should be called a "bailout." For example, the former central banker Paul Tucker uses "bailout" to refer only to loans to insolvent firms. *See* Tucker, *supra* note 36, at 40. We use the term more broadly than he does, following popular usage.

46 Federal Reserve Act, § 10(b) (codified at 12 U.S.C. § 347).

victims to avoid defaulting on debts. People do not pay ex ante for the legal right to these payments, so disaster programs are not insurance. At the same time, transfers to victims of natural disasters are not always designed to address the financial shock created by the disaster or enable the people to pay off their debts. Their general purpose is often humanitarian compensation rather than macroeconomic intervention. So natural disaster relief lies close to the borderline of our definition.[47]

3. Targeted

In practice, people refer to bailouts as transfers that are made to specific firms or an industry. This feature of our definition is not essential to it; in principle, the government could bail out the entire economy. When the Fed reduces interest rates, it provides just such a bailout—an ex post transfer in the form of liquidity, which benefits banks and ideally encourages them to lend to businesses and consumers.[48]

Some economists support such open-market operations while opposing bailouts.[49] They are bothered not so much by ex post government intervention but by targeted intervention that may be influenced by political considerations.

Bailouts can take other forms as well. In 2008, the Fed purchased commercial paper from eligible firms.[50] In doing so, it provided low-cost liquidity to a class of firms. The Fed's actions kept them alive but did not fully bail them out. We refer to this type of support as a "partial bailout."

B. Disguised Bailouts

The definition can be difficult to apply where the transfer itself is disguised or hidden. We call these transfers "disguised bailouts." They take place without an explicit transfer of consideration to a firm. In the Savings & Loan (S&L) crisis, regulators initially tried to rescue insolvent firms by encouraging solvent firms to buy them. Since the insolvent firms had nega-

47 Many of the questions that arise in the bailout context—such as moral hazard, discretion, and political favoritism—are similar to those that arise in the context of disaster relief. *See, e.g.*, Howard Kunreuther & Mark Pauly, *Rules Rather than Discretion: Lessons from Hurricane Katrina*, 33 J. RISK & UNCERTAINTY 101 (2006). There are, therefore, many parallels between the analysis we present and the literature on disaster relief. *See, e.g.*, Janet Cooper Alexander, *Procedural Design and Terror Victim Compensation*, 53 DEPAUL L. REV. 627 (2003) (identifying important principles for designing terror-victim relief programs). But there are important differences between disaster relief and bailouts. Chief among them is the fact that bailouts, properly understood, are designed exclusively to contain macroeconomic risk, while disaster relief may be defended on humanitarian or distributive grounds even where it does not reduce externalities or prevent further economic loss.

48 A similar response would be to relax regulations during periods of high unemployment. *See* Jonathan S. Masur & Eric A. Posner, *Regulation, Unemployment, and Cost-Benefit Analysis*, 98 VA. L. REV. 579 (2012).

49 Fischer, *supra* note 33, at 91.

50 *See infra* subsection III.E.2.

tive value, the regulators "paid" the solvent firms in the form of regulatory forbearance—promising not to enforce certain regulations against them. Since those regulations imposed costs on the firms in question, regulatory forbearance amounted to a transfer of value. As another example, the government in 1998 bailed out the creditors of the hedge fund Long-Term Capital Management by persuading all of them to agree to haircuts. The government did not pay money to anyone, but it did manage to force firms to act against their inclination. How it did so is not clear. The government has enormous regulatory power over banks—it can, for example, block mergers and extensions of certain lines of business. The government might have implicitly bribed banks by promising to approve future mergers that it would not otherwise have approved; or it might have implicitly threatened not to approve future mergers that it would otherwise have approved. In either case, the government effected a bailout.

Or, consider, as a final example, the argument that the government bailed out the steel industry in 2002 by imposing trade barriers on foreign imports.[51] The trade barriers artificially raised the price of steel in the United States, which resulted in greater revenues for the steel industry. This is economically not much different from taxing consumers and using the proceeds to bail out the industry. While we focus in this Article on explicit bailouts, it is important to see that if bailouts are understood in a functional way, they may well be ubiquitous rather than rare.

C. Direct and Indirect Beneficiaries of Bailouts

As noted above, the beneficiaries of the bailout are not always the direct recipients of the transfer. Imagine two Banks, X and Y. Bank X owns $100 in illiquid assets, and owes $90 in the form of a demand deposit to Bank Y. Bank Y has a single asset, the demand deposit with X worth $90, and owes $80 to its own depositors. Both banks have equity of $10. During a liquidity crisis, Bank Y might attempt to withdraw its $90 from Bank X, which would drive X into bankruptcy if it cannot sell its assets for that much, as is likely. If Bank X collapses and can only raise, say, $50, to give to Bank Y, then Bank Y will also collapse—because it cannot afford to pay its depositors.

Suppose the government bails out Bank X by lending it $90. Bank X can repay Y, and thus stay in business long enough to sell its illiquid assets or obtain new creditors. Thus, it is easy to see that the government saves Bank X. But the government also saves Bank Y. By enabling Bank X to pay back Bank Y in full, the government also enables Bank Y to pay its depositors. The bailout of X is direct; the bailout of Y is indirect, but no less real.

The government could also save X by bailing out Y. If the government lends $80 to Y so that Y can pay back its depositors, then Y may feel no need

51 *See* Raymond Hernandez, *Santorum, Defender of Free Market, Pushed in Congress to Protect Big Steel*, N.Y. TIMES (Mar. 1, 2012), http://www.nytimes.com/2012/03/02/us/politics/santorum-free-market-defender-used-to-aid-steel-industry.html.

to withdraw its $90 from X. In this case the government bails out Y directly, and X indirectly.

This distinction is important because even though the actions are functionally identical, often the public identifies only the direct recipient as the beneficiary of the bailout, and may put pressure on the government to punish direct recipients but not to punish indirect recipients. In the first case, for example, the government might respond to public pressure by demanding that X pay a high interest rate to the government, or give it equity. X is penalized, and Y is not, but Y is just as much a beneficiary of government action as X is.

Insiders and sophisticated commentators, by contrast, are well aware of this phenomenon. When the U.S. government participated in the bailout of Mexico in 1994, experts understood that major beneficiaries were U.S. banks, including Citigroup, whose loans to Mexico were at stake.[52] Indeed, stock prices of U.S. banks with exposure to the crisis responded to announcements of progress and setbacks in the U.S. bailout talks.[53]

Similarly, when the government bailed out AIG, it wiped out most of AIG's equity, which was politically popular. But the indirect beneficiaries of the bailout—AIG's creditors and counterparties—did not suffer any loss in equity. Critics of the AIG bailout accused the government of engaging in a "backdoor bailout" of AIG's counterparties.[54] Similarly, the indirect beneficiaries of the GM and Chrysler bailouts of 2009 were employee-creditors, while shareholders—the nominal direct beneficiaries—were wiped out.[55]

D. The Structure of a Bailout

The government has many degrees of freedom when designing a bailout, and can use this freedom to favor or discriminate against various stakeholders. Imagine a firm like GM on the brink of default. The govern-

52 *See* NOMI PRINS, ALL THE PRESIDENTS' BANKERS 374 (2014) ("Heavy hitters like BankAmerica, Chase Manhattan, Chemical Banking, Citicorp, Goldman Sachs, and J. P. Morgan . . . accounted for nearly 74 percent of Latin American exposure, or $40.4 billion. The bailout saved them, and later enabled them to buy Mexican banks that were weakened as a result. A decade later, foreign banks, led by Citigroup in the United States, owned 74 percent of Mexican financial assets . . . ." (footnote omitted)). Rubin's public position was that the bailout was a regrettable necessity: "Alan, Larry, and I all opposed making the holders of [Mexican short-term obligations] whole. But we concluded—I think rightly—that Mexico couldn't be rescued without the side effect of helping some investors." ROBERT E. RUBIN & JACOB WEISBERG, IN AN UNCERTAIN WORLD: TOUGH CHOICES FROM WALL STREET TO WASHINGTON 11–12 (2004). Not everyone was convinced. *See, e.g.*, ANDREW ROSS SORKIN, TOO BIG TO FAIL 51 (2010) (referring to "accusations at the time that Rubin had actually organized the international bailout in an effort to save Goldman Sachs").

53 *See* Osman Kilic et al., *An Empirical Investigation of U.S. Bank Risk and the Mexican Peso Crisis*, 22 J. ECON. & FIN. 139, 144–45 (1998) (finding that stocks of U.S. banks with exposure to Mexican loans experienced abnormal positive and negative returns in responses to announcements of progress and setbacks, respectively, in U.S. bailout talks).

54 *See infra* subsection III.F.2.

55 *See infra* subsection III.E.3.

ment could lend GM enough money to pay off its creditors. This loan benefits those creditors, who otherwise would be partially repaid from GM's assets; and shareholders, who retain the value of their equity. The bailout benefits all creditors.

However, the government could also offer a loan that provides more limited benefits. For example, it could demand that all creditors receive haircuts, and that shareholder equity be diluted or even wiped out. It can also discriminate within groups. In the GM loan, for example, the government ensured that employees as pension creditors received higher payoffs as a fraction of their claims than other creditors. Dealers brought a lawsuit claiming that the government discriminated against them by requiring GM to terminate its contractual relationships with them. The government also wiped out the shareholders.

The government treated financial institutions with a great deal of variation as well. Many banks received emergency loans from the Fed that fully preserved shareholder value. Banks that received Troubled Asset Relief Program (TARP) money had to submit to various dilutions of shareholder equity. Bear Stearns and AIG shareholders also were subject to bespoke dilutions. One important issue concerned whether the government should obtain equity in a firm that it bails out. Before the Emergency Economic Stabilization Act (EESA), the government took equity only from AIG; after EESA, using the authorizations in that statute, the government received equity from financial institutions into which it pumped TARP money.[56]

While the question whether the government should take equity or not is outside the scope of this Article, we should note some of the relevant considerations. The justification for taking equity is that it gives the government, and hence the taxpayer, the upside if the target firm recovers; this compensates the government for the risk that it takes. Moreover, equity may give the government control over the firm, which allows it to influence the firm's operations and hence maximize the probability of repayment. And by reducing payoffs to shareholders, equity transfers may counter moral hazard. But there are also fears that the government will abuse control of corporations for political purposes. Since World War II, in the United States (unlike many other countries) the government has avoided taking a controlling share of equity in corporations because of political opposition toward government meddling in industry.[57] The government can protect itself from default with

56 *See, e.g.*, Deborah Solomon et al., *U.S. to Buy Stakes in Nation's Largest Banks*, WALL ST. J. (Oct. 14, 2008), http://www.wsj.com/articles/SB122390023840728367; Ryan Tracy et al., *Hedge Funds, Private Equity Win Big at TARP Auctions*, WALL ST. J. (Jan. 28, 2015), http://www.wsj.com/articles/hedge-funds-private-equity-win-big-at-tarp-auctions-1422421201.

57 *See* Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 388–90 (1995) (recounting the rise of government corporations during the world wars and Great Depression, and the subsequent actions to reverse that trend). The current prohibition on government-controlled corporations is embodied in the Government Corporation Control Act, 31 U.S.C. §§ 1105, 9101–9110 (2012), which prohibits agencies from establishing or acquiring corporations without congressional consent.

devices that are less subject to abuse, like loan covenants. One might also worry that the government could use emergency conditions to take an excessively large equity interest because firms that would otherwise go bankrupt lack the bargaining power that would be necessary to ensure that terms are fair.

E. Who Makes the Bailout?

Because of their ex post nature, one might think that Congress must make bailouts by appropriating funds and distributing them to beneficiaries. In fact, Congress has in a number of statutes delegated the power to make bailouts to other entities—above all, the Fed.[58] Section 10(b) of the Federal Reserve Act gives the Fed the power to quasi–bail out banks, and section 13(3) gives the Fed the power to bail out non-bank financial institutions.[59] The Fed has this power in part as a result of its unique ability to fund itself from its operations. The FDIC also has a traditional power to make bailouts by rescuing banks that pose a systemic threat; in these cases, the FDIC may pay all of the bank's creditors to the full extent of their claims, not just depositors who are covered by insurance.[60] The FDIC has a fund, paid for through its regular assessments on banks that it can draw on to make such payments. Dodd-Frank authorizes the FDIC to borrow from Treasury in order to make bailouts if the fund is depleted.[61]

The difference between a congressional bailout and an agency bailout is important because Congress can regulate agency bailouts by putting appropriate conditions in the statute. Dodd-Frank does just that—by requiring that consulting and approval take place in the executive branch, and limiting the power of the Fed to bail out individual firms (as opposed to classes of firms).[62] By contrast, any effort by Congress to regulate itself by issuing restrictions on its own bailouts in advance runs into time-inconsistency problems. If Congress enacts a statute restricting or regulating bailouts at time one, and then enacts another statute at time two that authorizes a bailout, it can explicitly or implicitly repeal the time one statute in the process. Nonetheless, a general bailout statute at time one may not be easy to overturn. An explicit overturning of the statute may be politically embarrassing, and courts may not recognize an implicit overturning, reasoning instead

58 *See* 12 U.S.C. § 347b (2012).

59 *See id.* § 343.

60 *See id.* § 1823(c)(4)(G). For a description of how the systemic risk exception has been used, see generally U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-100, FEDERAL DEPOSIT INSURANCE ACT: REGULATORS' USE OF SYSTEMIC RISK EXCEPTION RAISES MORAL HAZARD CONCERNS AND OPPORTUNITIES EXIST TO CLARIFY THE PROVISION (2010), http://www.gao.gov/new.items/d10100.pdf.

61 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, § 210, 12 U.S.C. § 5390(n)(1).

62 *See id.* §§ 5383, 5343.

that the first statute is meant to structure the second statute.[63] There are many analogies to this style of reasoning; for example, the Supreme Court's refusal to hold that the 2001 Authorization for Use of Military Force (AUMF) against Al Qaeda implicitly overturned statutes that regulate surveillance and other matters.[64]

F. Some Recent Bailouts

Bailouts might seem extraordinarily rare, but they are not. In the table below, we list ten bailouts from the last forty years—one every four years. The table does not include the bailout of New York City in 1975, or the various bailouts of sovereigns—like Mexico in 1995—that benefited American holders of foreign debt. Arguably, when the Fed lowers interest rates in order to head off a financial crisis—as it did starting in 2007—it is engaging in a kind of bailout of all firms that, as a consequence, can borrow money more cheaply than otherwise. However, in popular usage, bailouts are targeted to individual firms or classes of firms, and we will stick to that usage.

The bailouts differ in many ways. In some cases, the government bailed out multiple firms in whole industries—the S&L bailout and the bailouts of 2008–2009. In other cases, it bailed out single firms. Bailouts took different forms—as cash transfers, loans, and loan guarantees. Bailouts can also be disguised, which is why we include the bailout of Long-Term Capital Management in 1998 when the government did not spend any money but may have used an implicit promise of regulatory forbearance in order to persuade creditors to agree to haircuts.[65] The government bailed out financial firms for the most part, but also bailed out manufacturing firms and transport firms.

TABLE 1: SOME RECENT BAILOUTS[66]

YEAR	BENEFICIARY	AMOUNT SPENT OR LOANED BY GOVERNMENT	OUTCOME
1970	Penn Central Railroad	$557 Million	Reorganized
1971	Lockheed	$245 Million	Recovered
1974	Franklin Bank	$1.75 Billion	Liquidated
1980	Chrysler	$1.2 Billion	Recovered
1984	Continental Bank	$4.5 Billion	Liquidated
1989	Savings & Loan Industry	$132 Billion	Liquidated
1998	Long-Term Capital Management	$0	Liquidated
2001	Airline Industry	$6.56 Billion	Industry recovered
2008–2009	Financial Sector and Homeowners	$534 Billion	Industry recovered
2008	Chrysler & GM	$80 Billion	Reorganized

63 *See* William N. Eskridge, Jr. & John Ferejohn, *Super-Statutes*, 50 DUKE L.J. 1215, 1235 (2001).

64 *See* Hamdan v. Rumsfeld, 548 U.S. 557, 593–94 (2006).

65 *See supra* Section II.B.

66 The information in the table is compiled from the following sources. Air

The table provides a very rough description of the outcome in each case. We will provide details of several bailouts in Part III, but it is worth pointing out here that most of the bailouts were at least superficially successful. In most cases, the government broke even or made substantial profits on loans and other investments; and the bailed-out firm or industry recovered. But all the bailouts were intensely controversial. Why they were is the topic of the next Part.

III. Case Studies

We discuss below a number of the bailouts in Table 1. As we will see, criticisms of most of these bailouts fall into four categories. First, critics frequently argue that a proposed bailout is what we will call "ex post inefficient"—a pure transfer to a lucky group of stakeholders that does not produce a net social good and wastes the taxpayers' dollars. Second, bailouts often appear unfair or discriminatory because they help one group of people while the government does not help similarly situated people—stakeholders in other firms that do not receive a bailout. Third, bailouts might generate moral hazard by creating the expectation that in the future other firms will receive bailouts, an expectation that may distort the incentives of market agents. Fourth, critics sometimes argue that the government has issued a

Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, § 101(a)(2), 115 Stat. 230, 230 (2001) (codified as amended at 49 U.S.C. § 40101 (2012)); Bill Canis & Baird Webel, Cong. Research Serv., R41978, The Role of TARP Assistance in the Restructuring of General Motors 5–6 (2013), https://www.fas.org/sgp/crs/misc/R41978.pdf.; Fin. Crisis Inquiry Comm'n, The Financial Crisis Inquiry Report (2011), http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf; Cong. Oversight Panel, September Oversight Report: The Use of TARP Funds in the Support and Reorganization of the Domestic Automotive Industry (2009); James M. Bickley, Cong. Research Serv., R40005, Chrysler Corporation Loan Guarantee Act of 1979: Background, Provisions, and Cost 4 (2008); U.S. Gov't Accountability Off., GAO-04-836, Commercial Aviation: Legacy Airlines Must Further Reduce Costs to Restore Profitability (2004), http://www.gao.gov/assets/250/243741.pdf; The President's Working Grp. on Fin. Mkts., Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management 13–14 (1999), http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf; U.S. Gen. Accounting Off., GAO/AIMD-96-123, Financial Audit: Resolution Trust Corporation's 1995 and 1994 Financial Statements 13 (1996); U.S. Gen. Accounting Office, PSAD-78-66, Implementation of the Emergency Loan Guarantee Act (1978) [hereinafter Implementation]; U.S. Gen. Accounting Office, CED-76-161, Improved Controls Needed over Federal Financial Assistance to Railroads 5–6, 8, 10, 15 (1976); Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13 FDIC Banking Rev. 26, 31 (2000); Kate McDermott et al., *Continental Illinois National Bank and Trust Company*, *in* Managing the Crisis: The FDIC and RTC Experience 1980–1994, at 560 (1998); Deborah Groban Olson, *Fair Exchange: Providing Citizens with Equity Managed by a Community Trust, in Return for Government Subsidies or Tax Breaks for Businesses*, 15 Cornell J. L. & Pub. Pol'y. 231, 286–88 (2006); Anna J. Schwartz, *The Misuse of the Fed's Discount Window*, 74 Fed. Res. Bank of St. Louis Rev. 58, 64 (1992); Paul Kiel & Dan Nguyen, *Bailout Tracker*, ProPublica (Oct. 2, 2015) http://projects.propublica.org/bailout/.

bailout in a procedurally irregular way—with insufficient transparency and inadequate opportunities for stakeholders and others to make their views known about the wisdom of the bailout or how it should be structured.

A. *The Lockheed Bailout*

In the early 1970s, Lockheed Corporation, an important aerospace manufacturer (one of the companies that later merged to form today's Lockheed Martin), ran into financial difficulties when a major project ran over budget and one of its suppliers filed for bankruptcy. Lockheed argued that if it were forced into bankruptcy, its failure would damage the airline industry and cause massive job losses in California.[67] As the nation's largest defense contractor,[68] Lockheed was also vital to the war effort in Vietnam. Congress responded to Lockheed's pleas by enacting the Emergency Loan Guarantee Act, under which the government provided Lockheed with a $250 million loan guarantee.

Supporters of the bailout emphasized the macroeconomic costs of bankruptcy.[69] President Nixon argued that a Lockheed failure would destroy jobs.[70] The Secretary of the Treasury added that Lockheed's most recent troubles were not its fault but had resulted in part from government cancellations of major projects.[71] Unions and banks also warned of the negative macroeconomic effects of a Lockheed failure.[72]

Critics of a bailout argued that the macroeconomic effects of failure would be small, while the bailout would be costly for the government. A representative of the United Auto Workers union testified that the lost production of Lockheed would be picked up by McDonnell Douglas, which "would be highly advantageous to the American aerospace worker."[73] A report by the majority staff of the House Banking and Currency Committee

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67 *See generally* U.S. GEN. ACCOUNTING OFF., B-169300, IMPLEMENTATION OF EMERGENCY LOAN GUARANTEE ACT (1972), http://gao.gov/assets/210/203532.pdf.

68 *Id.* at 6.

69 Divisions did not follow party lines. Republicans in the Senate voted 27-17 for the bill while Democrats voted 22-31 against and Southern Democrats split 9-8 for in the Senate. The divisions in the House were similar. *Lockheed Loan Guarantee Bill Cleared on Close Votes*, 27 CONG.Q. ALMANAC 1971 (1972), http://library.cqpress.com/cqalmanac/document.php?id=cqal71-1252844.

70 *Id.* ("President Nixon at San Clemente, Calif., May 5 told a news conference the major factor, in his view, was the unemployment that would be caused by a Lockheed bankruptcy and consequent abandonment of the L-1011 program.").

71 *See id.* The chairman of Bank of America, a major lender to Lockheed, also testified to Congress that "[t]o a great extent, the federal government shares responsibility and thus the federal government has an obligation to assist the firm through its present liquidity crisis." *Id.*

72 *Id.*

73 *Id.* (quoting Joel R. Jacobson, Director of Community Relations, Region 9, United Auto Workers).

found a "substantial risk of default and loss to the government in the proposed guarantee."[74]

Critics and defenders also argued about the general propriety of bailouts. The Fed sought permanent authority for the government to issue loan guarantees.[75] On the other side, Senator Proxmire of Wisconsin noted his opposition to "insulating big business from failure."[76] He pointed out that none of the more than 10,000 small businesses that failed in 1970 were being bailed out.[77] Other testimony highlighted the moral hazard problem, noting that the failures at hand raised a presumption of mismanagement.[78]

In the end, the bill passed. Ostensibly, it authorized loan guarantees to all troubled firms whose failure would have systemic effects. The Act created a Loan Guarantee Board and provided that it could guarantee a loan only if—

> (1) the Board finds that (A) the loan is needed to enable the borrower to continue to furnish goods or services and failure to meet this need would adversely and seriously affect the economy of or employment in the Nation or any region thereof, (B) credit is not otherwise available to the borrower under reasonable terms or conditions, and (C) the prospective earning power of the borrower, together with the character and value of the security pledged, furnish reasonable assurance that it will be able to repay the loan within the time fixed, and afford reasonable protection to the United States; and
>
> (2) the lender certifies that it would not make the loan without such guarantee.[79]

But Lockheed was the only firm to apply for or receive assistance under the Act.[80] The amount of guaranteed loans topped out at $245 million in 1974.[81] The loan guarantee was terminated in 1977 as part of a refinancing that replaced the government-supported loans.[82] The government earned $25.5 million in commitment fees.[83]

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74 *Id.*

75 *Id.* ("Developments over the past year or so have underscored the need for standby authority for government guarantees of loans to business firms in emergencies where the alternative could be severe damage to the national economy . . . ." (quoting Arthur F. Burns, Chairman, Board of Governors of Federal Reserve System)).

76 *Id.*

77 *Id.*

78 *Id.* (summarizing the testimony of Senator Cranston of California who had proposed requiring the management to resign as a condition for the bailout).

79 Emergency Loan Guarantee Act, Pub. L. No. 92-70, § 4, 85 Stat. 178, 178 (1971). The Act was originally codified at 15 U.S.C. § 1843(a) until December 31, 1973, when authority of the Board to enter into any guarantee or make any commitments terminated. *Id.* § 13, 85 Stat. at 182.

80 IMPLEMENTATION, *supra* note 66, at 1.

81 *Id.*

82 *Id.*

83 *Id.* at 2. The Board reported receiving $26,503,683 in fees with costs of $983,094. During the course of the program, the Board invested the fees it received in government

The Lockheed controversy set the terms of the debates for future bailouts. First, critics thought that the macroeconomic benefits of a bailout would be slim and the government would lose money. While we do not know whether they were correct on the first point, they were wrong on the second. Second, critics argued that the bailout was unfair because other firms did not receive bailouts, and Lockheed benefited from its political connections. Questions also arose as to whether the bailout could or should be structured to be distributively fair. Third, the question of moral hazard arose as participants debated whether Lockheed or the government was at fault for Lockheed's financial distress, and whether one bailout would give rise to additional bailouts.[84]

B. 1979 Chrysler Bailout

In 1979 Chrysler had lost over a billion dollars. It had "negative working capital" and was unable to borrow on the market.[85] Congress and the White House responded by negotiating a bailout program that would inject $1.5 billion of capital into the firm through a government guarantee. The government agency administering the guarantee estimated that the failure of Chrysler would "lower GNP by $5 billion in 1980 and $6 billion in 1981."[86] Between 700,000 and 800,000 jobs and the solvency of the Pension Benefit Guaranty Corporation were also put at risk.[87] The job-loss estimates were challenged by critics who argued that lost production by Chrysler would be picked up by the other Detroit automakers.[88]

The bailout took the form of a loan guarantee approved by the Chrysler Corporation Loan Guarantee Act.[89] Up to $1.5 billion was made available in

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securities and reported an additional $4.9 million in revenue from interest on those investments. *Id.*

84 While eight years passed between the Lockheed bailout and the Chrysler bailout, critics argued that the first set the stage for the second by rewarding bad management. For example, when the Chicago Tribune ran an editorial criticizing the 1979 Chrysler bailout, it stated, "As we and others warned at the time, the $250 million in federal loan guarantees to Lockheed in 1971 has set a bad precedent. It says in effect that big business needn't worry if it doesn't function efficiently enough to stay competitive. The government will be there to rescue inefficient or uneconomic enterprises." Editorial, *It's Still a Bailout*, CHI. TRIB., Aug. 11, 1979, at 8.

85 *Chrysler Records History-Making Losses*, THE ARGUS-PRESS (Owosso, MI), Feb. 8, 1980, at 4.

86 Paul H. Wilson, Jr. & Peter L. Borowitz, *Working Out with the Government: The Chrysler Loan Guarantee Program*, 4 J.L. & COM. 19, 21 (1984) (quoting CHRYSLER CORP. LOAN GUARANTEE BD., FINDINGS OF THE CHRYSLER CORPORATION LOAN GUARANTEE BOARD 11 (1980), http://catalog.hathitrust.org/Record/002948769).

87 BICKLEY, *supra* note 66, at 2. There were some national security arguments as well because Chrysler manufactured a major battle tank for the military. *Id.*

88 *Id.*

89 Pub. L. No. 96-185, 93 Stat. 1324 (1980). The Act was originally codified at 15 U.S.C. §§ 1861–75, 631 until December 31, 1983, when the authority of the Board to make commitments expired. *Id.* § 16, 93 Stat. at 1335.

guarantees. The Act required that additional funds of at least $1.43 billion be raised from non-federal sources, and that some of those funds would come in the form of haircuts on existing stakeholders.[90] Thus, existing domestic lenders were required to provide $400 million in new loans and $100 million in concessions on existing loans. The remaining funds were to be contributed by foreign lenders ($150 million), state and local governments ($250 million), suppliers and dealers ($180 million), proceeds from asset sales ($300 million), and the issuance of new equity ($50 million).[91] An additional $587.5 million in concessions were required from employees, primarily in reduced compensation for union employees.[92]

Chrysler was the nation's tenth largest company;[93] and its financial problems posed a greater risk to the economy than Lockheed's did. As in Lockheed, the debate about the wisdom of a bailout centered on ex post efficiency, fairness, moral hazard, and the likelihood of failure. Ralph Nader noted,

> Opponents of the Chrysler bill filled their recitals with arguments that it was a bad precedent, that it was unfair to thousands of failing small businesses which are not given federal bail-outs, that the loan guarantee would not be enough to save Chrysler as a full-line auto manufacturer, that Chrysler could reorganize and scale down to a smaller, efficient company, and that the taxpayers shouldn't be required to do what the banks would not do.[94]

However, at least in hindsight, we can say that the bailout was a success: it both saved Chrysler and generated a profit for the government. Chrysler took $1.2 billion in guaranteed loans and redeemed them all by 1982.[95] In exchange for its guarantee, the government took a security interest in Chrysler's assets, and received an annual 1% guarantee fee. The government also took warrants to purchase shares that represented 10% to 15% of Chrysler's common stock. Those warrants were sold after Chrysler recovered and functioned as an additional $311 million fee that the government collected on its guarantee.[96] However, some critics argue that the government made money on the bailout only because it imposed import quotas that artifi-

90 *Id.* §§ 4(a)(4), 4(a)(6), 93 Stat. at 1326 (codified at 15 U.S.C. § 1863 (2012)). *But see* text accompanying note 79.

91 *Id.* § 4(c), 93 Stat. at 1327 (codified at 15 U.S.C. § 1863). *But see* text accompanying note 79.

92 *Id.* § 6(a), 93 Stat. at 1329 (codified at 15 U.S.C. § 1865). *But see* text accompanying note 79.

93 Brian M. Freeman & Allan I. Mendelowitz, *Program in Search of a Policy: The Chrysler Loan Guarantee*, 1 J. POL'Y ANALYSIS & MGMT. 443, 445 (1982).

94 Ralph Nader, *Free Enterprise Undermined in Chrysler Bailout*, THE NADER PAGE (Dec. 30, 1979), https://blog.nader.org/1979/12/30/free-enterprise-undermined-in-chrysler-bailout/.

95 BICKLEY, *supra* note 66, at 4.

96 Wilson & Borowitz, *supra* note 86, at 37–38.

cially inflated Chrysler's sales—in effect, taxing car buyers.[97] If so, the bailout may not have been ex post efficient.

The charge of unfairness cannot be so easily dismissed. Critics saw no sense in imposing haircuts on creditors and employees in order to transfer value to shareholders who would have otherwise been wiped out.[98] The head of GM criticized the bailout as favoring a failed competitor: "If you say, 'O.K., if somebody fails in the competitive race, then we're going to bail them out anyway,' I don't think that's in accordance with what really made this country great."[99] Economist John Kenneth Galbraith lamented the power of corporations to secure favorable treatment: "Even the finest and firmest free enterprise principles, we know, can be bent as needed to pecuniary and corporate need."[100] He also commented that if the bailout was inevitable, the public should at least have received an ownership stake in the firm.

Finally, worries of moral hazard loomed large. Many of those leveling fairness objections tied them to moral hazard. A *Business Week* editorial argued that the bailout "would set the dangerous precedent of relieving the management, the board of directors, and the stockholders of responsibility for the company's good health."[101] Congress sought to address this concern by imposing haircuts on employees and creditors. Perhaps the moral hazard (and unfairness concerns) raised at the time would have been reduced if Congress had imposed a greater cost on shareholders. But once again, the moral hazard claims are at best theoretical possibilities. There is no evidence that the Chrysler bailout caused other firms to engage in mismanagement or risky investments.

C. S&L Bailouts

In the 1980s, a large number of bank-like financial institutions known as Savings & Loans (S&Ls) and Savings Banks collapsed.[102] S&Ls (and Savings Banks, but henceforth we will refer to both types of bank as S&Ls or thrifts) were a type of bank that mainly served consumers by issuing mortgages to homeowners and offering checking accounts. They mostly stayed out of commercial lending and deposit-taking. The thrift industry was a stable and profitable business from the Depression until the 1970s. In the 1970s, inter-

97 *See* Bickley, *supra* note 66, at 1.

98 James K. Hickel, Heritage Found. Backgrounder No. 276, *The Chrysler Bail-out Bust*, at 1, 2 (1983), http://www.heritage.org/research/reports/1983/07/the-chrysler-bail-out-bust (arguing that the only difference between a bailout and a Chapter 11 bankruptcy was the value retained by shareholders that gambled on a bailout and won).

99 Editorial, *Asides: Mr. Murphy Is Right*, Wall St. J., Aug. 6, 1979, at 10.

100 *The Chrysler Loan*, *in* Manuel G. Velasquez, Business Ethics: Concepts and Cases (7th ed. 2012).

101 Editorial, *Chrysler: No Bailout*, Business Week, Aug. 20, 1979, at 132.

102 For accounts, see, for example, Federal Deposit Insurance Corporation, *The Savings and Loan Crisis and Its Relationship to Banking*, *in* History of the Eighties—Lessons for the Future 178–81 (1997), https://www.fdic.gov/bank/historical/history/167_188.pdf.

est rates rose sharply because of budget deficits, the oil shock, and other adverse market conditions. In addition, the government permitted money market mutual funds to offer checking-like services to consumers and to pay them a market interest rate. S&Ls initially lost business to the mutual funds because they were not permitted to charge a high rate of interest. The government responded by allowing S&Ls to charge a market interest rate, but now the problem was that the interest rates demanded by depositors exceeded the very low interest rates on the thirty-year mortgages that the S&Ls had issued when interest rates were very low. As a result of this squeeze, many S&Ls became undercapitalized and possibly insolvent.

Congress, state legislatures (which established rules of state S&Ls, as opposed to nationally chartered S&Ls), and regulators responded in the early 1980s by further deregulating S&Ls.[103] They hoped that by allowing S&Ls to diversify into different markets, such as commercial real estate, and to offer new types of loans, like adjustable-rate mortgages, they would enable S&Ls to return to profitability. Unfortunately, deregulation caused many S&Ls to take on additional risk. Many S&Ls expanded their operations in order to enter the new markets. To do so, they needed additional sources of funds, which they obtained by offering increasingly high interest rates for deposits. Because of deposit insurance, depositors did not pay attention to the credit risk of the S&Ls in which they put their funds. Many S&Ls used this money to make risky loans that went sour, and as a consequence hundreds of S&Ls collapsed.[104]

S&L regulators initially tried to rescue failing S&Ls by persuading healthy S&Ls and banks to buy them.[105] Because no one wants to buy a firm with negative value, the regulators compensated the buyers by offering to excuse them from various regulatory requirements. However, this strategy just weakened the healthy institutions, and Congress put an end to it—in the process making the government liable for breach of contract.[106] Congress finally cleaned up the mess by authorizing regulators to borrow enough funds to pay off depositors and hold the assets of the failed S&Ls until they could be sold off at market prices. By the end of the crisis, hundreds of thrifts had failed. The total cost of the rescue has been estimated at $160 billion.[107]

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103 Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 U.S.C.); Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12 U.S.C.).

104 FEDERAL DEPOSIT INSURANCE CORPORATION, *supra* note 102, at 168–69.

105 United States v. Winstar Corp., 518 U.S. 839, 847–48 (1996) (citing U.S. GEN. ACCOUNTING OFF., GAO/GGD-89-47, SOLUTIONS TO THE THRIFT INDUSTRY PROBLEM 52, http://www.gao.gov/assets/150/147361.pdf; LAWRENCE J. WHITE, THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION 157 (1991)).

106 *Id.* at 843.

107 FEDERAL DEPOSIT INSURANCE CORPORATION, *supra* note 102, at 169.

While the S&L rescue was widely called a "bailout,"[108] it was not a pure case. As the economist Lawrence White has argued, the funds appropriated by Congress were used to pay depositors on the basis of their legal entitlement to government-supplied deposit insurance.[109] What was distinctive about the S&L rescue was that the existing insurance fund was not large enough to satisfy the government's liabilities, and so Congress was required to appropriate additional funds in order to make good on them. With some minor exceptions, depositors received insurance payouts only up to the maximum ($100,000).[110] Shareholders received nothing.[111]

Nonetheless, there was a great deal of public outrage directed at the thrifts and their regulators, which Congress shared.[112] The healthy, well-managed thrifts that did nothing wrong were forced to pay a tax to cover some of the costs of the insurance payouts.[113] The existing regulatory bodies were dissolved and replaced with new ones. The outrage was probably due to some highly publicized cases of criminal activity and political corruption, as well as the expensive bill for the taxpayer that was the result of excessive risk-taking.

The reason that the S&L rescue was called a "bailout" was probably due to the ex post nature of the government intervention. And the term is not as inaccurate as White suggests. From an ex ante perspective, the S&L insurance fund was supposed to be self-sustaining, like any insurance fund. The premiums paid by S&Ls should in aggregate suffice to cover losses. The government did not bail out the S&Ls so much as the insurance fund.

Although the efforts during the 1980s to save the S&L industry without using taxpayer funds was ill-advised and poorly executed, the bailout itself—when it came in 1989[114]—seems to have been properly structured. The government was able to avoid a fire sale of assets by taking control of them and selling them off over a long period of time. As a result, the S&L crisis did not metastasize into a full-blown financial crisis despite the thrift industry's huge share of the mortgage market. Moreover, the bailout was necessary to ensure that people believed the government's deposit guarantee—without which S&Ls, and possibly banks, would be subject to runs and panics. To address moral hazard, Congress passed legislation to strengthen supervision of

108 *E.g.*, Oswald Johnston, *Seidman Puts S&L Bailout at $500 Billion*, L.A. TIMES (July 31, 1990), http://articles.latimes.com/1990-07-31/news/mn-1196_1_l-william-seidman.

109 WHITE, *supra* note 105, at 160–64.

110 *Id.* at 162.

111 *Id.*

112 *Bill to Add Thrift Bailout Funds Dies*, 46 CONG. Q. ALMANAC 179, 180–81 (1991); Vivian Marino, *Public Reaction to S&L Bailout Ranges from Anger to Apathy with AM-S&SL BJT*, ASSOCIATED PRESS (Aug. 10, 1989), http://www.apnewsarchive.com/1989/Public-Reaction-to-S-L-Bailout-Ranges-From-Anger-To-Apathy-With-AM-S-Ls-Bjt/id-884994eee3313a8af8fb7ab82804f1e9.

113 WHITE, *supra* note 105, at 162–63.

114 Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (codified at scattered sections of 12 U.S.C.).

S&Ls.[115] The rescue was fair and nondiscriminatory since it simply ensured that people with legal entitlements to insurance payouts received them. Shareholders and large creditors did not receive payoffs beyond what they were entitled to.

The 1989 bailout can also be contrasted with the implicit (failed) bailout through regulatory forbearance. Because the earlier bailout took the form of secret bargains between regulators, S&Ls, and banks, it was not debated publicly. By contrast, the government used regular and public procedures to liquidate the assets of failed S&Ls after 1989.

The most important lesson of the S&L bailout came from this earlier botched effort by regulators to rescue banks by promising solvent banks and S&Ls that it would allow them to reduce capital below regulatory requirements if they purchased insolvent S&Ls. Congress later reversed this policy, and banks sued, arguing that the government had breached a contract.[116] Arguably, the regulators would not have resorted to such a desperate and ill-considered measure if they had had access to sufficient bailout funds. One benefit of a formal statute or policy that approves of and regulates bailouts is that it may weaken the stigma against bailouts, and in this way permit regulators to bail out firms when appropriate to do so.

Another questionable feature of the (final) bailout was the determination to tax healthy thrifts in order to (partially) fund the losses from the deposit fund.[117] The tax was politically popular because it reduced the cost to taxpayers by throwing part of the burden on shareholders of the healthy thrifts. But the healthy thrifts had done nothing wrong. From an ex ante perspective, the tax informed firms that they will be penalized if they belong to an industry that is bailed out whether or not those specific firms acted prudently or imprudently. The effect is to enhance rather than reduce moral hazard. This is a reminder that temporary political passions—which often take the form of wanting to punish a whole industry rather than specific bad actors—can result in bad policy.

D. 9/11 Airline Bailout

After the terrorist attacks of September 11, 2001, Congress authorized around $15 billion in emergency government funding for the airlines. Under the Air Transportation Safety and System Stabilization Act (ATSSSA), airlines were given $5 billion as a direct payment.[118] This was framed as compensation for the reduction in air travel caused by the grounding of flights after the attacks and the subsequent reduction in air traffic. ATSSSA also

115 *Id.*

116 United States v. Winstar Corp., 518 U.S. 839, 858 (1996).

117 Bert Ely, *Savings and Loan Crisis*, LIBRARY OF ECONOMICS AND LIBERTY, http://www.econlib.org/library/Enc/SavingsandLoanCrisis.html (last visited Oct. 8, 2015) ("[H]ealthy S&Ls as well as commercial banks have been taxed approximately another $30 billion to pay for S&L cleanup costs.").

118 Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, § 101(a)(2), 115 Stat. 230 (2001) (codified at 49 U.S.C. § 40101 (2012)).

authorized the Air Transportation Safety Board (ATSB) to issue up to $10 billion in further loans or loan guarantees to protect failing air carriers.[119] The ATSB used that authority to issue loan guarantees to some—but not all—carriers who applied for them after the attacks.[120] Guarantees were provided to America West, American Trans Air, Aloha Airlines, Evergreen International Airlines, Frontier Airlines, US Airways, and World Airways for a total value of $1.56 billion.[121] Similar to the structure in the Chrysler bailout, in exchange for those loans the ATSB received warrants in the equity stock of those carriers. As a result of those warrants, the loan-guarantee arm of the airline bailout has been profitable for the government.[122]

Congress did not provide a clear explanation for the airline bailouts.[123] One possibility is that the airlines would have collapsed without a short-term liquidity injection from the government because they owed money on their high fixed costs and suddenly were deprived of revenue from ticket sales. However, if this was the case, it seems likely that private creditors would have made loans to the airlines; moreover, the direct transfer part of the bailout would not have been justified. Another possibility is that the bailout was a form of humanitarian relief for airline stakeholders, akin to government support for individuals and businesses struck by a natural disaster like a hurricane. On this view, the bailout was motivated by moral and political, rather than economic, considerations. The government may also have worried that even a temporary disruption in airline operations as a result of bankruptcy might have exacerbated the general economic downturn caused by the shock of the attack.

On the other hand, the moral hazard effects of the bailout were probably minimal because of the unpredictability of the attack. The 9/11 attack was not the sort of disaster that the airlines could have prevented by using ordinary prudence. And while one might argue that it was unfair to single out the airlines for relief, Congress provided other forms of relief for other

119 ATSSSA contained other non-bailout components that served to regulate with regard to future risk. For example, the Act expanded the authority for the government to provide for future insurance on certain routes. *Id.*

120 Margaret Blair chronicles the early loan guarantee decisions in *The Economics of Post-September 11 Financial Aid to Airlines*. Margaret M. Blair, *The Economics of Post-September 11 Financial Aid to Airlines*, 36 IND. L. REV. 367, 367–70 (2003); *see also* Deborah Groban Olson, *Fair Exchange: Providing Citizens with Equity Managed by a Community Trust, in Return for Government Subsidies or Tax Breaks to Businesses*, 15 CORNELL J.L. & PUB. POL'Y 231, 286–89 (2006).

121 Olson, *supra* note 120, at 288–89.

122 *U.S. Sees Profit on Airline Loan Guarantee Program*, USA TODAY (Jan. 30, 2006), http://usatoday30.usatoday.com/travel/news/2006-01-30-loan-profits_x.htm.

123 *See* Jonathan Lewinsohn, Note, *Bailing Out Congress: An Assessment and Defense of the Air Transportation Safety and System Stabilization Act of 2001*, 115 YALE L.J. 438, 457 (2005) (discussing the difficulty in identifying a theory behind the bailouts and concluding, "[t]he ultimate goal of the ATSSSA was to avoid the symbolic cataclysm of multiple carriers declaring bankruptcy a short time after September 11").

direct victims of the 9/11 attack—so charges of political favoritism were muted.

The loan-guarantee component of the bailout raises some additional issues. The government offered these guarantees to struggling airlines that met certain criteria. Firms applying for the guarantee may have failed for reasons unrelated to 9/11. Where a mismanaged firm could not be distinguished from a firm that failed because of 9/11, the loan guarantee would reward mismanagement the same as any other bailout. This is mitigated a bit by the haircuts and oversight that accompanied the loan guarantees.

E. 2008–2009 Financial Crisis Bailouts

The financial crisis of 2008 resulted in a large number of bailouts of institutions. We cannot describe all of them in the space we have, and so will limit ourselves to a few of the most important.

The immediate cause of the financial crisis was the collapse of housing prices, but the severity of the crisis was due to financial innovations that had concentrated risk in major financial institutions.[124] Most financial institutions were exposed in various ways to collateralized debt obligations (CDOs) and related securities whose value was a function of underlying mortgages on houses and other secured loans. Some institutions held these securities on their books; many institutions also used them as collateral for short-term loans in the repo market; still others guaranteed them. Although sophisticated investors understood that housing prices could not rise forever, they did not understand that the models used to predict the value of the CDOs were based on excessively optimistic assumptions about housing prices, with the result that people could not calculate the value of the CDOs when mortgages began to default at a rate that no one anticipated.

Other factors played a role as well. Investors had sought safe, high-yielding investments and CDOs offered higher rates than similarly rated securities. Ratings agencies gave CDOs high ratings because they, too, did not understand the assumptions underlying them. The demand for CDOs drove mortgage originators to lower underwriting standards so that they could sell more mortgages, and mortgage packagers to accept these high-risk mortgages. Meanwhile, investment banks and other financial institutions took on ever more leverage.

The financial crisis was a classic downward spiral. As mortgage defaults increased, and people realized that many CDOs would default, lenders refused to accept them as collateral except at a steep discount. Financial firms that borrowed in the repo market could continue to borrow only by posting higher levels of collateral or finding more liquid collateral like treasuries. The most highly leveraged firms ran out of collateral, and could no longer borrow. This meant that they had to sell their CDOs and related assets in fire sales, which drove down their prices. Indeed, all firms facing

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124 *See generally, e.g.*, THE FIN. CRISIS INQUIRY COMM'N, *supra* note 66; ALAN S. BLINDER, AFTER THE MUSIC STOPPED (2013); RAGHURAM G. RAJAN, FAULT LINES (2010).

liquidity shortages sought to unload their CDOs, but because everyone was acting the same, there were no buyers.

As the most highly leveraged firms collapsed, the panic spread to safer firms. Even banks, which depend mostly on deposits rather than the repo market, began to experience runs. Lenders (including bank lenders) were afraid of lending to a firm exposed to CDOs because they could not determine whether the CDOs would default or not, and thus whether potential borrowers would be able to repay. AIG, an insurance company, faced bankruptcy because it had guaranteed CDOs and had invested in mortgage-related securities. At the height of the crisis, banks refused to lend to each other or anyone else. The crisis ended when the Fed, FDIC, and other government agencies made loans to the market. Some of the toxic assets were taken onto the balance sheets of these agencies, which have been able to hold them to maturity.

During the financial crisis, in the fall of 2008 and winter of 2009, the press reported that the government was engaging in numerous "bailouts." In fact, many of the transactions that were labeled bailouts were not bailouts. Let us distinguish several types of transactions.

1. Fannie/Freddie

The Federal National Mortgage Association (better known as Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are hybrid public-private entities often referred to as Government Sponsored Entities or GSEs.[125]

The two entities, chartered by acts of Congress but privately owned,[126] provide support to the secondary market for mortgages. They purchase mortgages from lenders, put them into pools, and sell securities backed by those pools. The securities entitle the holders to a cash flow based on the principal and interest payments due on the underlying mortgages. Fannie and Freddie then guarantee those cash flows, providing insurance against defaults. In exchange, they charge a guarantee fee. Separately, Fannie and Freddie held large investment portfolios including mortgages and mortgage-based assets. The result of these activities was to provide liquidity to the mortgage market and, thus, at least in theory, fulfill their missions of providing stability and promoting access to mortgage markets.

When the housing market collapsed in 2007 and 2008, Fannie and Freddie began to experience record-setting losses. As mortgage defaults mounted, the entities were hit by escalating obligations on the guarantees.

125 *See, e.g.*, Dwight Jaffee & John M. Quigley, *The Future of the Government Sponsored Enterprises: The Role for Government in the U.S. Mortgage Market* (Nat'l Bureau of Econ. Research, Working Paper No. 17685, 2011), http://www.nber.org/papers/w17685.pdf.

126 Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 82 Stat. 536 (codified at scattered titles of U.S.C.); Financial Institutions Reform, Recovery, and Enforcement Act of 1989 § 731, Pub. L. No. 101-73, 103 Stat. 183, 429 (codified at 12 U.S.C. §§ 1451–56 (2012)).

By the summer of 2008, each entity had lost billions of dollars. Default by Fannie and Freddie became a real possibility.

Such a default was likely to create a feedback loop that accelerated losses. The default of Fannie and Freddie would directly reduce the liquidity in the mortgage market and signal that further liquidity support was unlikely. Banks would then originate fewer mortgages, resulting in fewer home sales and a further decline in housing prices, and further defaults on mortgages guaranteed by Fannie and Freddie.

This had systemic implications. Because Fannie and Freddie had such massive holdings in the secondary mortgage market, many commentators believed that their failure would significantly deepen the housing market collapse. As events would turn out to reveal, creditors and counterparties were massively exposed to mortgage derivatives, and thus, if Fannie and Freddie failed, would suffer enormous losses that would reduce liquidity outside of the mortgage market.[127]

At the same time, there was an open question about whether the government had guaranteed the debt of Fannie and Freddie in the first place. Although no explicit guarantee had been made, market participants generally operated under the assumption that the government would back Fannie and Freddie if they defaulted and the debt traded at a discount that reflected at least some level of guarantee.[128] For our analysis, this fact places the case somewhere between ex ante insurance and a true bailout. On the one hand, an explicit guarantee is no different from ex ante insurance. But this guarantee was uncertain. The legal basis for enforcing it was weak at best.[129] It is probably more accurate to characterize the status quo as an expectation that a bailout would be provided rather than as an actual legal entitlement. And—even if an entitlement to the implicit guarantee existed—its contours and the mechanism for implementing it were unstated and subject to discretion.

Given the implicit promise, many worried that a default by Fannie and Freddie would send a major negative signal about government creditworthiness (or, more specifically, its willingness to selectively default) on its general obligations. This ended up being a major reason given by the government for launching a bailout.[130]

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127 *See Recent Developments in U.S. Financial Markets and Regulatory Responses to Them: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 42 (2008) (written testimony of Secretary of the Treasury Henry M. Paulson) ("[D]ebt and other securities issued by the GSEs are held by financial institutions around the world. Continued confidence in the GSEs is important to maintaining financial system and market stability.").

128 As many analysts have noted, this allowed Fannie and Freddie to raise capital at a much lower rate than other private participants in the market.

129 All relevant legal materials explicitly disclaimed any legal obligation to guarantee the debt.

130 Press Release, Henry M. Paulson, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sep. 9, 2008), http://www.treasury.gov/press-center/press-releases/Pages/

The overall transaction occurred in several steps. The first step was intended to be a preventative move to avoid the need for further bailouts. In June of 2008, Congress passed the Housing and Economic Recovery Act of 2008 (HERA), which gave Treasury the power to make investments to shore up Fannie and Freddie.[131] It also created the Federal Housing Finance Agency (FHFA) and gave it the power to place Fannie and Freddie into conservatorships or receiverships.[132]

Just a few months later, the FHFA—working with Treasury and the Fed—exercised its power to place the entities into conservatorship and Treasury used its new investment power to inject massive capital in the form of preferred equity. The documents governing the bailout evolved through amendment as the crisis unfolded, but ultimately Treasury made a commitment to provide unlimited funds to guarantee liabilities through 2012.[133] The plan also included repayment terms and a requirement to shrink the investment portfolios of the entities. As part of the repayment, Fannie and Freddie had to pay a quarterly dividend at a 10% annual rate on the amount

hp1129.aspx ("These Preferred Stock Purchase Agreements were made necessary by the ambiguities in the GSE Congressional charters, which have been perceived to indicate government support for agency debt and guaranteed MBS. Our nation has tolerated these ambiguities for too long, and as a result GSE debt and MBS are held by central banks and investors throughout the United States and around the world who believe them to be virtually risk-free. Because the U.S. Government created these ambiguities, we have a responsibility to both avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings of GSE debt and MBS."); Press Release, Henry M. Paulson, Remarks by Secretary Henry M. Paulson, Jr. on Financial Rescue Package and Economic Update (Nov. 12, 2008), http://www.treasury.gov/press-center/press-releases/Pages/hp1265.aspx. ("Eight weeks ago, Treasury took responsibility for supporting the agency debt securities and the agency MBS through a preferred stock purchase agreement that guarantees a positive net worth in each enterprise—effectively, a guarantee on GSE debt and agency MBS. We also established a credit facility to provide the GSEs the strongest possible liquidity backstop. As the enterprises go through this difficult housing correction we will, as needed and promised, purchase preferred shares under the terms of that agreement. The U.S. government honors its commitments, and investors can bank on it.").

131 Pub. L. No. 110-289, 122 Stat. 2654 (codified at scattered titles of U.S.C.); *see also* W. Scott Frame, *The 2008 Federal Intervention to Stabilize Fannie Mae and Freddie Mac*, (Fed. Reserve Bank of Atlanta, Working Paper No. 2009-13, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1458662.

132 Before HERA, Fannie and Freddie were regulated by the Office of Federal Housing Enterprise Oversight (OFHEO), which had been created in 1992. The OFHEO had statutory authority to place Fannie and Freddie into conservatorship. But the details of that power were not clear. HERA added the power of receivership and set out the substantive and procedural grounds (including judicial review) for implementing either the conservatorship or the receivership options.

133 Second Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement, U.S. Dep't of Treasury and Fed. Home Loan Mortg. Corp. (Dec. 24, 2009), http://www.sec.gov/Archives/edgar/data/1026214/000095012309073866/f71241exv10w1.htm; Second Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement, U.S. Dep't of Treasury and Fed. Nat'l Mortg. Ass'n (Dec. 24, 2009), http://www.sec.gov/Archives/edgar/data/310522/000095012309074293/w76743exv4w1.htm.

that Treasury had invested. In August of 2012, the terms were amended again to replace the dividend payment with a "net-income sweep." This meant that instead of paying Treasury a 10% dividend on its investment, each firm pays a dividend equal to that firm's positive net worth (defined as total assets less total liabilities).[134] The effect is that all net income gets paid to Treasury every quarter. That essentially wiped out the remaining interest of all equity holders.[135]

The various stages represent some of the different types of bailouts and bailout-like actions that the government can use to address the financial difficulties of systemically important institutions.

The law as it stood before HERA provided vague conservatorship authority that might be viewed as a grant of bailout authority.[136] While the government denied that it would bail out Fannie or Freddie, the market seems to have assumed either that the law provided bailout authority or that Congress would act if necessary.

By contrast, HERA was an ex post bailout statute. Once the crisis was imminent, Congress took ex post actions to limit the impact of the crisis. To be sure, HERA did not implement a bailout; rather it authorized the government to implement a bailout. The statute signaled that the government was standing behind the debt of Fannie and Freddie.[137] In this way, the Congres-

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134 For the first year, the dividend calculation allows the firms to retain a cushion of $3 billion in value. For example, if at the end of a quarter Fannie's net worth (assets minus liabilities) was $10 billion it would pay a dividend of $7 billion. The $3 billion cushion of value is to be reduced by $600 million each year until it reaches zero. Third Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement, U.S. Dep't of Treasury and Fed. Home Loan Mortg. Corp. (Aug. 17, 2012), http://www.sec.gov/Archives/edgar/data/1026214/000119312512359938/d398152dex101.htm; Third Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement, U.S. Dep't of Treasury and Fed. Nat'l Mortg. Ass'n (Aug. 17, 2012), http://www.sec.gov/Archives/edgar/data/310522/000119312512359930/d399489dex41.htm.

135 The amendment also accelerated the reduction in the firms' investment portfolios.

136 The exact contours of that authority are at the heart of the disputed claims in the current litigation. The district court in one of the cases said this much: "Since 1992, when Congress established FHFA's predecessor, the Office of Federal Housing Enterprise Oversight ('OFHEO'), the GSEs have been subject to regulatory oversight, including the specter of conservatorship or receivership under which the regulatory agency succeeds to 'all rights' of the GSEs and shareholders. . . . This enduring regulatory scheme governing the GSEs at the time the class plaintiffs purchased their shares represents the 'background principle' that inheres in the stock certificates." Perry Capital LLC v. Lew, 70 F. Supp. 3d 208, 240–41 (D.D.C. 2014). This will no doubt be litigated further as the cases are appealed.

137 Public statements made by Treasury in association with the passing of HERA suggest that the belief that the mere existence of the power to shore up Fannie and Freddie would be enough to stop the bleeding and that the power would not need to be used. As Paulson characterized the move: "If you have got a bazooka and people know you have got it, you may not have to take it out." *Recent Developments in U.S. Financial Markets and Regulatory Responses to Them: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 110th Cong. 19 (2008) (testimony of Secretary of the Treasury Henry M. Paulson).

sional authorization can be viewed as correcting for Congress's ex ante failure to create sufficient bailout authority.

The crucial aspects of the bailout were the injection of capital through preferred equity that had repayment priority junior to all debt but senior to equity and the imposition of federal control through the FHFA appointed conservator.[138] These were pure ex post bailout measures taken by the executive branch.

The net-income sweep of 2012 can be viewed in several different lights. On one account, it was just one part of a larger orderly resolution plan to wind down the firms.[139] On another, it might be viewed as an ex post measure to impose a haircut so as to minimize moral hazard. Or, in the view of unhappy shareholders, it was a politically motivated transfer of wealth from equity to the government.[140]

With regard to ex post efficiency, Fannie and Freddie have recovered and the government made money on the rescue. The magnitude of the profit for the government is difficult to calculate because of changes in accounting rules and because of the complicated effects of tax credits, which both facilitated repayment of the loan and reduced tax revenues. Profit measures aside, the bailout prevented a more significant collapse of the real estate market and so it is difficult to argue that it was inefficient. That is, of course, not to say that no other better bailout options existed.

The moral hazard complaints are once again salient. By rescuing Freddie and Fannie's creditors, the government confirmed that investors who disbelieved the government's no-bailout vow were correct. Critics feared that the bailout thus set the stage for endless recurrence of the too-big-to-fail phenomenon—that creditors will overinvest in large firms whose collapse would cause a systemic crisis because they expect that those firms will be bailed out.[141] However, it is possible that this message was muted by the specific purposes of housing legislation—to subsidize mortgages—which may not be generalizable to other settings.

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138 N. Eric Weiss, Cong. Research Serv., R42760, Fannie Mae's and Freddie Mac's Financial Status: Frequently Asked Questions 5–6, 10–11 (Aug. 13, 2013), https://www.fas.org/sgp/crs/misc/R42760.pdf.

139 The creditors of Fannie and Freddie worried that the firms could suffer future distress under the pressure of the 10% dividend obligations to Treasury. Nick Timiraos, *Fannie, Freddie Stuck in a Dividends Circle*, Wall St. J. (Mar. 1, 2011), http://www.wsj.com/articles/SB10001424052748704615504576172420039570798. Both Fannie and Freddie had repeatedly increased their obligations to Treasury by borrowing funds to keep current on the dividend obligation. Badawi & Casey, *supra* note 15, at 451–53. The actions of 2012 addressed this by eliminating that obligation and putting in place a resolution plan that would protect creditors while the firms were wound down. *Id.* at 469.

140 *See, e.g.*, Complaint, Fairholme Funds, Inc. v. United States, No.13-465 C (Fed. Cl. July 9, 2013); Complaint, Wash. Fed. v. United States, No. 13-385 C (Fed. Cl. June 10, 2013); Complaint, Perry Capital LLC v. Lew, No. 13-1025 (D.D.C. Sept. 20, 2013); Complaint, Cacciapelle v. Fed. Nat'l Mort. Ass'n, No. 13-1149 (D.D.C. July 29, 2013).

141 *See* William Poole, *Moral Hazard: The Long-Lasting Legacy of Bailouts*, 65 Fin. Analysts J. 17 (2009).

Unfairness concerns and potential for political abuse are the subjects of current litigation over the net-income sweep.[142] Plaintiffs claim that the government took value from equity in violation of their legal rights because creditors were fully compensated.[143] Other critics of the bailouts argued that the government should have provided support to homeowners rather than to financial institutions.[144]

From the standpoint of process, one can argue that the bailouts were procedurally fair because they were publicly debated in Congress. On the other hand, litigants challenging the bailout allege that "[t]he Government's conservatorship plan was hatched in secrecy and gave the Companies no choice but to accept Government control."[145] They argue that public statements surrounding the passage of HERA suggested that the entities were financially sound.[146] And then the government sprung the bailout package on the companies. The CEO of Fannie stated, "[W]e were given 24 hours to accede to a government takeover—or else the government would effectively go to war against the company."[147] These claims are subject to litigation.[148] The litigation itself serves process values by forcing the government to provide a public defense of its bailout choices.

2. Banks, Investment Banks, and Related Institutions

FDIC insurance. Most commercial banks pay for deposit insurance from the FDIC. When banks fail, the FDIC compensates depositors. This type of compensation is not a "bailout" because the banks and depositors pay for an ex ante insurance scheme and the banks submit to regulation.[149] However, the FDIC also possesses statutory authority to cover depositors above the insurance limit (which was then $100,000) in emergencies.[150] The FDIC used that authority to raise the limit to $250,000 for existing deposits, and to guarantee certain other forms of bank debt.[151] Because this intervention was

142 *See, e.g.*, Complaint, *Fairholme Funds*, *supra* note 140; Complaint, *Wash. Fed.*, *supra* note 140; Complaint, *Perry Capital*, *supra* note 140; Complaint, *Cacciapelle*, *supra* note 140.

143 *E.g.*, Complaint, *Fairholme Funds*, *supra* note 140, at 2–6; Complaint, *Wash. Fed.*, *supra* note 140, at 19–20; Complaint, *Perry Capital*, *supra* note 140, at 6; Complaint, *Cacciapelle*, *supra* note 140, at 3–4.

144 *E.g.*, ATIF MIAN & AMIR SUFI, HOUSE OF DEBT (2014).

145 Complaint, *Wash. Fed.*, *supra* note 140, at 23.

146 *Id.* at 23–24.

147 *Id.* at 24.

148 *E.g.*, Complaint, *Fairholme Funds*, *supra* note 140, at 2–6; Complaint, *Wash. Fed.*, *supra* note 140, at 19–20; Complaint, *Perry Capital*, *supra* note 140, at 6; Complaint, *Cacciapelle*, *supra* note 140, at 3–4.

149 *See* Pennacchi, *supra* note 42, at 340–41.

150 Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 141(G), 105 Stat. 2236, 2275 (codified at 12 U.S.C. § 1823(c)(4)(G) (2012)).

151 *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-100, FEDERAL DEPOSIT INSURANCE ACT: REGULATORS' USE OF SYSTEMIC RISK EXCEPTION RAISES MORAL HAZARD CONCERNS AND OPPORTUNITIES EXIST TO CLARIFY THE PROVISION (2010), http://www.gao.gov/new.items/d10100.pdf.

ex post, saved many banks from runs, and prevented many bank creditors from defaults, it fits our definition of a bailout. It was an agency-led bailout rather than a congressional bailout because the FDIC relied on existing statutory authority.

Discount lending to commercial banks. The Fed has statutory authority to make loans to commercial banks.[152] During the financial crisis, the Fed made loans through its discount window and (as described below) through broad-based facilities. Fed discount-window lending is in principle routine: it is always open to banks that experience temporary liquidity difficulties. But, in the context of the crisis, discount-window lending also resembled bailout lending. Like the FDIC, the Fed lent widely to banks experiencing liquidity difficulties, and in this way rescued banks and their creditors. The loans were also ex post; like the FDIC emergency loans that exceeded the $100,000 limit, banks did not pay for them in the form of ex ante premiums. Discount-window lending was supplemented with advances from Federal Home Loan Banks, which was also a form of ex post lending.[153]

Fed broad-based facilities. The Fed also established numerous broad-based credit facilities through which it lent money to classes of borrowers that satisfied certain eligibility criteria. Some of these facilities supplied credit to commercial banks by advancing loans against CDOs.[154] Others relied on the Fed's emergency power to make loans to non-banks under section 13(3) of the Federal Reserve Act. The Primary Credit Dealer Facility advanced overnight credit to primary dealers (mostly, the major investment banks) against various types of collateral, including CDOs. Other facilities, notably the Term Asset-Backed Securities Loan Facility, enabled the Fed to advance funds for longer periods of time against toxic assets.[155] Still other facilities provided credit to money market funds and non-financial institutions that relied on the commercial paper market.[156] Virtually all of these facilities provide bailouts in the sense that the money was supplied ex post to firms that faced financial difficulties and had not paid premiums that entitled them to loans.[157]

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152 Federal Reserve Act, §§ 10B, 13(3), 12 U.S.C. §§ 347b, 343.

153 ADAM B. ASHCRAFT ET AL., FED. RESERVE BANK OF N.Y., THE FEDERAL HOME LOAN BANK SYSTEM: THE LENDER OF NEXT-TO-LAST RESORT? (Nov. 2008), http://www.newyorkfed.org/research/staff_reports/sr357.pdf.

154 Efraim Benmelech, *An Empirical Analysis of the Fed's Term Auction Facility* 6–7 (Nat'l Bureau of Econ. Research, Working Paper No. 18304, 2012), http://www.nber.org/papers/w18304.

155 James Felkerson, *$29,000,000,000,000: A Detailed Look at the Fed's Bailout by Funding Facility and Recipient* 25–28 (Levy Econ. Inst., Working Paper No. 698, 2011) http://www.levyinstitute.org/pubs/wp_698.pdf.

156 *Id.* at 21–25.

157 The Fed also provided bailout loans to Goldman Sachs and Morgan Stanley by converting them into Bank Holding Companies, which gave them access to the discount window like regular banks.

The Bear Stearns transaction. In March 2008, creditors cut off credit to Bear Stearns, a major investment bank. The Fed rescued Bear by arranging for its sale to JP Morgan. Because JP Morgan did not want to own Bear's toxic assets, the Fed set up an entity called Maiden Lane, which bought those assets, financed by a $1.15 billion loan from JP Morgan and a $28.82 billion loan from the Fed. Bear Stearns shareholders were paid $2 per share, later increased to $10.[158] The Fed relied on its section 13(3) powers. The rescue was a bailout because it was ex post, and it ensured that Bear's creditors were paid in full. Indeed, even Bear's shareholders received some value.

The AIG transaction. In September of 2008, creditors stopped lending to AIG, a large insurance company. Creditors lost confidence in AIG because it had issued credit default swaps (CDS) on CDOs, and had speculated in mortgage-based securities in its securities lending program. Under the terms of its contracts with counterparties, AIG was required to post collateral as the ratings of the CDOs declined; this in turn depleted AIG's liquidity, which caused ratings agencies to downgrade AIG. The downgrades then required AIG to post more collateral, resulting in a downward spiral. The Fed issued a series of large loans to rescue AIG.[159] It financed Maiden Lane II, which purchased the mortgage-backed securities, and Maiden Lane III, which purchased CDOs from AIG's CDS counterparties.[160] This rescue was a bailout because it was a discretionary ex post loan, and it ensured that AIG's creditors were paid in full. AIG's shareholders also retained some value in their shares.

Equity injections into banks. On October 3, 2008, President Obama signed the Emergency Economic Stabilization Act, which created the Troubled Assets Relief Plan (TARP).[161] This program made available $700 billion to purchase toxic assets or invest in financial institutions. More than $200 billion of this money was committed to the Capital Purchase Program, through which Treasury bought preferred stock or senior debt from banks, including large loan guarantees for Citibank and Bank of America.[162] Unlike earlier bailouts, the funds for these bailouts were appropriated by Congress rather than lent by the Fed or another agency. Thus, Congress itself acted ex post to rescue the banks, and in doing so ensured that their creditors were protected.

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158 THE FIN. CRISIS INQUIRY COMM'N, *supra* note 66, at 290.

159 Some of the later loans were financed from TARP, and thus was money from Treasury that had been appropriated by Congress in EESA. CONG. OVERSIGHT PANEL, June Oversight Report: The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy 70 (2010), http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT56698/pdf/CPRT-111JPRT56698.pdf.

160 *Id.* at 68–79.

161 Pub. L. No. 110-343, 122 Stat. 3765, 3767 (codified at 12 U.S.C. §§ 5211–41 (2012)).

162 U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-458, CAPITAL PURCHASE PROGRAM: STATUS OF THE PROGRAM AND FINANCIAL HEALTH OF REMAINING PARTICIPANTS 3–4 (2013), http://www.gao.gov/assets/660/654400.pdf.

Assistance to homeowners. The government put in place a number of programs to aid homeowners during the financial crisis, the most significant of which was the Home Affordable Modification Program (HAMP).[163] Treasury committed $75 billion of TARP funds to provide incentives (typically a few hundred or thousand dollars per loan) to loan servicers to renegotiate mortgages with homeowners who could not make payments, as well as to the investors who own the mortgages, and to the homeowners themselves if they made payments under the renegotiated mortgages.[164] Under the terms of the program, the loan servicer reduces mortgage payments, plus taxes and insurance, to 31% of the homeowner's income by cutting the interest rate, extending the period of the loan, and/or shifting payments to the conclusion of the loan in the form of a balloon payment.[165] So far, about one million homeowners have benefited from HAMP loans.[166] Although HAMP was not described as a bailout in public debates, it fits the definition of a bailout, albeit only a partial bailout. HAMP indirectly (and partially) bailed out qualified homeowners by reducing their liability and extending the loan term so that they do not default because of liquidity problems.

Treasury showed little enthusiasm for bailing out homeowners; it was prodded to do so by Congress.[167] The reason appears to be that Treasury believed that bailing out financial institutions was a simpler and more direct way of addressing the financial crisis.[168] Once credit was flowing again, lenders and homeowners would voluntarily renegotiate their loans. Thus, the government would directly bail out banks but homeowners would receive indirect bailouts. Whether or not Treasury was correct, this approach was politically controversial. The public viewed banks as wrongdoers (even though many banks had done nothing wrong) and homeowners as victims (even though many homeowners had deliberately agreed to risky and expensive mortgages). Under HAMP, the government provided direct (partial) bailouts to both creditors and homeowners.

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163 12 U.S.C. § 5219(a).

164 CONG. OVERSIGHT PANEL, OCTOBER OVERSIGHT REPORT: AN ASSESSMENT OF FORECLOSURE MITIGATION EFFORTS AFTER SIX MONTHS 38–42 (2009), http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT52671/pdf/CPRT-111JPRT52671.pdf.

165 *Id.*

166 *See* U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE: PROGRAM PERFORMANCE REPORT THROUGH THE SECOND QUARTER OF 2014, at 6 (2014), http://www.treasury.gov/initiatives/financial-stability/reports/Documents/2Q14%20Quarterly%20MHA%20Report%20Final.pdf.

167 Sarah Binder, *Geithner's Unicorn: Could Congress Have Done More to Relieve the Mortgage Crisis?*, WASH. POST: THE MONKEY CAGE (May 19, 2014), http://www.washingtonpost.com/blogs/monkey-cage/wp/2014/05/19/geithners-unicorn-could-congress-have-done-more-to-relieve-the-mortgage-crisis/; Paul Kiel & Olga Pierce, *Dems: Obama Broke Pledge to Force Banks to Help Homeowners*, PROPUBLICA (Feb. 4, 2011), http://www.propublica.org/article/dems-obama-broke-pledge-to-force-banks-to-help-homeowners.

168 Atif Mian & Amir Sufi, *Why Tim Geithner is Wrong on Homeowner Debt Relief*, WASH. POST: WONKBLOG (May 14, 2014), http://www.washingtonpost.com/blogs/wonkblog/wp/2014/05/14/why-tim-geithner-is-wrong-on-homeowner-debt-relief/.

3. Automobile Companies

In the fall of 2008, the big-three American automakers—Ford, GM, and Chrysler—were in trouble. A long-term decline in their market share had been compounded by a dramatic reduction in the overall demand for cars.[169] The firms needed to be restructured or possibly liquidated. But while Ford had taken on financing prior to the financial crisis, GM and Chrysler had no realistic means of raising capital in the market once the crisis began. In order to avoid an abrupt collapse of the firms, the government provided a bailout. The arguments in favor of a bailout painted a doomsday scenario where the failure of any one of the three automakers would cause the collapse of their vast network of connected suppliers thus endangering the operations of the other two.[170] In its extreme version, this scenario would put over three million jobs at risk at a time when the economy was already struggling.[171]

The government's initial response in late 2008 was a stopgap measure.[172] GM, Chrysler, and their financing arms received over $24.8 billion in TARP funds.[173] The more systematic bailout came in 2009 in the structured reorganization of the firms through the formal process of the federal Bankruptcy Code with tens of billions of dollars of financing provided by the U.S. and Canadian Governments.[174] The total investment by the U.S. Treasury approximated $80 billion.[175]

The auto payments are plain bailouts. The government injected capital to prop up insolvent firms where no legal entitlement existed. The debate over whether they were "good" bailouts has focused on the themes that are now familiar. First, critics claim that the bailouts were unnecessary support for two failed companies that did not present real systemic risk.[176] Under

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169 Austan D. Goolsbee & Alan B. Krueger, *A Retrospective Look at Rescuing and Restructuring Chrysler and General Motors*, 29 J. ECON. PERSPECTIVES (forthcoming).

170 *Id.*; Sean McAlinden et al., *CAR Research Memorandum: The Impact on the U.S. Economy of a Major Contraction of the Detroit Three Automakers*, CTR. FOR AUTO. RESEARCH (CAR) (Nov. 2008), http://www.cargroup.org/?module=publications&event=View&pubID=24; Robert E. Scott, ECON. POLICY INST., *When Giants Fall* (2008), http://s4.epi.org/files/page/-/pdf/bp227.pdf.

171 Goolsbee & Krueger, *supra* note 169; McAlinden et al., *supra* note 170, at 4; Scott, *supra* note 170, at 4.

172 CANIS & WEBEL, *supra* note 66, at 5–6.

173 *Id.*

174 *See* Douglas G. Baird, *Lessons from the Automobile Reorganizations*, 4 J. LEGAL ANALYSIS 271, 271–72 (2012); Ralph Brubaker & Charles Jordan Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of* Chrysler *and* GM, U. ILL. L. REV. 1375 (2010) (providing the detailed government investment structure in the auto bailouts); Roe & Skeel, *supra* note 15, at 733–34.

175 *Auto Industry: Program Overview*, U.S. DEP'T OF THE TREASURY (Jan. 8, 2015, 4:46 PM), http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/automotive-programs/Pages/default.aspx.

176 *See, e.g.*, Richard A. Epstein, *The Deadly Sins of the Chrysler Bankruptcy*, FORBES (May 12, 2009), http://www.forbes.com/2009/05/11/chrysler-bankruptcy-mortgage-opinions-

this view the government bailed out insolvent firms with no strong rationale. Like the other bailouts, the bite of this critique is once again softened by subsequent events.[177] The auto industry has experienced a major recovery and Treasury has recovered a sizeable portion of its investment.[178] To say that the government was not fully compensated addresses profitability but does not answer the efficiency question. Returns to other stakeholders may have offset any loss the government took on the transaction. Even conservative estimates suggest that if viewed merely as a jobs program, the bailout was inexpensive.[179]

Critics also argued that the bailouts created moral hazard.[180] Ford planned and obtained market financing for its restructuring earlier and did not ask for bailouts.[181] Chrysler and GM did not. And so, strong arguments can be made that GM and Chrysler failed not because of the financial crisis, but because they had been mismanaged. The rescue might then discourage managers in the future from making painful adjustments to financing or operations.

The government tried to address this problem by wiping out equity and imposing steep haircuts on senior creditors (who may also have been in a position to force the firms to restructure themselves). But it also protected employees by ensuring that the union pensions received valuable equity in the reorganized firms and significant compensation for many of their claims.

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columnists-epstein.html ("[L]ong ago Chrysler and GM should have been allowed to bleed to death under ordinary bankruptcy rules, without government subsidy or penalty."); John Tamny, *Memo to Washington: Let GM Fail*, FORBES (July 10, 2008), http://www.forbes.com/2008/07/09/gm-washington-detroit-oped-cx_jt_0710tamny.html (arguing that "GM's vitality is increasingly irrelevant when it comes to the health and size of the U.S. economy"); Todd Zywicki, *The Auto Bailout and the Rule of Law*, NAT'L AFF., Spring 2011, at 66, http://www.nationalaffairs.com/publications/detail/the-auto-bailout-and-the-rule-of-law.

177 We do not mean to suggest that just because a firm recovers that the decision to bail it out was efficient at the time the decision was made. We recognize the risk of hindsight bias. But the subsequent success of the company is relevant evidence and is often invoked in response to efficiency critics.

178 According to their webpage they have recovered $69.2 billion of the $80 billion invested. U.S. DEP'T OF THE TREASURY, *supra* note 175.

179 Goolsbee & Krueger, *supra* note 169 (estimating the cost of the bailout at $14,000 per job, based on a conservative estimate of 800,000 jobs saved).

180 *Lasting Implications of the General Motors Bailout: Hearing Before the H. Subcomm. on Regulatory Affairs, Stimulus Oversight and Gov't Spending of the H. Comm. on Oversight and Gov't Reform*, 112th Cong. 100–01 (2011) (written testimony of Shikha Dalmia, Reason Foundation Senior Analyst); Poole, *supra* note 141, at 23.

181 *Lasting Implications of the General Motors Bailout: Hearing Before the H. Subcomm. on Regulatory Affairs, Stimulus Oversight and Gov't Spending of the H. Comm. on Oversight and Gov't Reform*, 112th Cong. (2011) (written testimony of Shikha Dalmia, Reason Foundation Senior Analyst) ("[T]he bailout rewarded GM's irresponsible, reckless behavior and penalized Ford's prudent, forward-looking one. Given such precedent, any company that feels that it is too big to fail, or is a national icon, or is deeply enmeshed in the broader U.S. economy, or is a major regional employer, will wonder whether it makes more sense for it to save for an economic downturn or hold out for taxpayer assistance."); Goolsbee & Krueger, *supra* note 169.

The union employees, through the Voluntary Employment Beneficiary Association (VEBA), were well compensated for the claims. The VEBA received a large stake (in the form of 17.5% of common stock and additional preferred stock and warrants) in the new reorganized GM and had a large chunk of its claims assumed by the new entity.[182] For Chrysler, the outcome was similar. Chrysler was sold to an entity controlled by Fiat and financed by the United States. Chrysler's private secured creditors received cash amounting to about twenty-nine cents on the dollar. Many general unsecured creditors received little or nothing while the Chrysler VEBA had many of its claims assumed by the new entity and received a 55% equity stake in the new firm.[183]

This decision raised howls. During the years leading up to the bailouts, one of the main competitive disadvantages for the big-three automakers was their labor costs. Compared with the production of transplant firms—foreign firms with production operations in the United States—the American labor costs were 45% higher.[184] The incentives for the unions to bargain with other stakeholders to avoid failure are dramatically reduced when they are immune to the costs of the failure. Unions have no incentive to avoid deals that put the firm in a precarious position.[185]

Critics of the bailouts also complained about their fairness. They argued that GM and Chrysler were chosen for bailouts because of political motivations rather than any assessment that bailing them out was socially optimal.[186] Even supporters of the bailout suggest that the necessity of the

182 Goolsbee & Krueger, *supra* note 169.

183 Under the terms of the plan, the VEBA stake was reduced to 41.5% after Fiat met specified performance milestones. *Chrysler Group LLC Completes Final Performance Event; Fiat S.p.A. Ownership Rises to 58.5 Percent; Fuel-Efficient Dodge Dart to be Revealed at NAIAS on Jan. 9*, PR NEWSWIRE (Jan. 5, 2012), http://www.prnewswire.com/news-releases/chrysler-group-llc-completes-final-performance-event-fiat-spa-ownership-rises-to-585-percent-fuel-efficient-dodge-dart-to-be-revealed-at-naias-on-jan-9-136720393.html. Then in 2014, the remaining VEBA equity was sold to Fiat. The transaction was structured so that VEBA received $1.9 billion in cash from Chrysler, $1.75 billion in cash from Fiat, and a promise from Chrysler to pay it $700 million per year for the next four years. *Fiat Reaches Deal with UAW Trust to Buy Rest of Chrysler*, REUTERS (Jan. 1, 2014), http://mobile.reuters.com/article/idUSBREA000FK20140101?irpc=932.

184 That included 25% in higher hourly compensation and additional costs from legacy retiree benefits.

185 Trade creditors also received favorable treatment in the bankruptcies. This has been less controversial—likely for two reasons. First, the practice of assuming trade credit is one we often see in reorganizations that do not involve bailouts or government involvement. Second, the trade creditors are assumed by most to have less political influence on the bailout process.

186 *See, e.g.*, Todd Zywicki, *Economic Uncertainty, the Courts, and the Rule of Law*, 35 HARV. J.L. & PUB. POL'Y 195, 200–02 (2012); Richard A. Epstein, *The Libertarian's Dilemma*, HOOVER INSTITUTION (Nov. 4, 2012), http://www.hoover.org/research/libertarians-dilemma ("The auto bailout snatched Chrysler out of the hands of its creditors in order to dump it into the hands of the president's close union confederates—who, not coincidentally, are the largest contributors of dollars and services to his campaign."); Paul Roderick Gregory, *Obama Didn't Save Union Jobs, He Saved Union Pay*, FORBES (June 21, 2011), http://www.forbes.com/2011/06/21/bailout-autoworkers-unions.html?feed=rss_home (describ-

bailout was questionable at the time.[187] These general objections fold into general process criticisms against TARP in general. The decisions to use TARP funds were made by the executive branch behind closed doors without full public vetting and the motivations for those decisions were difficult for outside observers to assess.

Critics also argued that the government acted unfairly by protecting the claims of union employees at the expense of senior creditors and other unsecured creditors.[188] In both the GM and Chrysler bankruptcies the companies were sold in "363 sales" (the bankruptcy term for the common sale or auction of assets)[189] where the procedures essentially required any bidder to agree to the payout structure as a condition to participating in the auction. In a 363 sale, there are bidding procedures that dictate how the auction will be run and who will be allowed to participate.[190] For both GM and Chrysler, those procedures specified that to participate in the auction a bidder had to agree to assume specified liabilities and agree to grant the VEBAs the prescribed equity stake. In response to objections, the bidding procedures were amended to allow bids from any firm that "after consultation with the Creditors' Committee, the U.S. Treasury and the UAW, [was] determined by the Debtors in the exercise of their fiduciary duties to be a Qualified Bid."[191] This was a hollow exception. No potential outside bidder would have access to the full information about the assets necessary to make a firm offer to trigger a duty to be considered.[192] No bidder requested to be excused from the procedures.

In the Chrysler case, a dissenting member of the senior lending group objected to the sale process.[193] The secured loans had been made through a loan syndicate. The relationship between the participating lenders, as is common, was governed by an agreement that provided for certain decisions

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ing the bailouts as a precedent that "fosters corruption and political favoritism"); Rich Lowry, *Misplaced Bailout Pride*, NAT'L REV. ONLINE (June 3, 2011), http://www.nationalreview.com/article/268720/misplaced-bailout-pride-rich-lowry (describing the auto bailouts as "shot through with lawlessness and political favoritism").

187 *See* Goolsbee & Krueger, *supra* note 169. This is especially the case for Chrysler. *See* Ryan Lizza, *Inside the Crisis: Larry Summers and the White House Economic Team*, THE NEW YORKER (Oct. 12, 2009), http://www.newyorker.com/magazine/2009/10/12/inside-the-crisis (noting an internal advisor's opposition to the Chrysler bailout).

188 *See, e.g.*, Barry E. Adler, *A Reassessment of Bankruptcy Reorganization after Chrysler and General Motors*, 18 AMER. BANKR. INST. L. REV. 305, 306–10 (2010); Baird, *supra* note 174, at 279–81; Brubaker & Taab, *supra* note 174, at 1391; Roe & Skeel, *supra* note 15, at 746–49, 758–59.

189 11 U.S.C. § 363 (2012); Douglas E. Deutsch & Michael G. Distefano, *The Mechanics of a § 363 Sale*, 30 AMER. BANKR. INST. J. 48 (2011).

190 *Id.* at 49.

191 *In re* Chrysler LLC, 405 B.R. 84, 109 n.25 (Bankr. S.D.N.Y. 2009) (alteration in original), *aff'd*, 576 F.3d 108 (2d Cir. 2009), *cert. granted, judgment vacated sub nom.*, Ind. State Police Pension Tr. v. Chrysler LLC, 558 U.S. 1087 (2009) and *vacated sub nom.*

192 *See* Adler, *supra* note 188, at 309.

193 *In re Chrysler LLC*, 405 B.R. at 109. GM's secured credit was held by Government entities and so there was no creditor to bring the claim.

to be made by a vote and for actions to be carried out by an appointed representative of the group (the administrative agent). An overwhelming majority of participating lenders voted in favor of supporting the Chrysler sale. Thus, the loan group did not object.

The wrinkle was that the majority of participating lenders who voted in favor of the reorganization had also received TARP funds from Treasury. The dissenting creditors alleged that the government's influence over these TARP recipients discouraged the latter from raising objections to the government's plan.[194] These objections of the dissenting creditors, however, failed to stop the sale from being consummated.[195]

The best defense of these structures is that no other bidder existed and so the bidding procedures had no real effect.[196] The counterargument is a procedural one: the entire point of having an auction is to test such claims about the market. Bankruptcy law places a large premium on market tests[197] and procedures that exclude market participants defeat the purpose of the test. Because of the process followed, the critics argue, we will never know the answers to questions about other bidders.[198]

A more general defense of the bankruptcy process is that the government intervention made no one worse off. GM and Chrysler would have collapsed without government intervention and the government bought these firms. Like any buyer, the government was free to do what it wanted with firms it bought.[199] When the government gave the VEBA a 55% stake in Chrysler, the action had no impact on the rights of other creditors.

That argument has some weight if the question is one of proper bankruptcy procedure. Perhaps a buyer is free to give away value to anyone it chooses.[200] Things are less clear, however, when the government intervenes

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194 *Id.* at 103.

195 The bankruptcy court and later the Second Circuit rejected the objections. By the time the issue reached the Supreme Court, the sale had been consummated and the Court determined that the issue was moot. The Court then vacated the opinion, Ind. State Police Pension Tr. v. Chrysler LLC, 558 U.S. 1087 (2009), under a doctrine that allows it to do so "to prevent a judgment, unreviewable because of mootness, from spawning any legal consequences." United States v. Munsingwear, Inc., 340 U.S. 36, 41 (1950).

196 Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L.J. 531, 532 (2009).

197 *See, e.g.*, Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 457–58, 460 (1999) (discussing desirability of a market test).

198 Roe & Skeel, *supra* note 15, at 746–49.

199 Baird, *supra* note 174, at 279–81 (exploring the merits and flaws of this argument).

200 The question is a subject of a deep debate in bankruptcy law and scholarship. *See In re* DBSD N. Am., Inc., 634 F.3d 79, 93–101 (2d Cir. 2011) (holding that gifting violates the absolute priority rule); *In re* Armstrong World Indus., Inc., 432 F.3d 507, 513–15 (3d Cir. 2005) (holding that gifting violates the absolute priority rule); *In re* SPM Mfg. Corp., 984 F.2d 1305, 1311–15 (1st Cir. 1993), *reh'g denied*, 984 F.2d 1305 (1st Cir. 1993) (holding that gifting does not violate the absolute priority rule); *see generally* Harvey R. Miller & Ronit J. Berkovich, *The Implications of the Third Circuit's* Armstrong *Decision on Creative Corporate Restructuring: Will Strict Construction of the Absolute Priority Rule Make Chapter 11 Consensus Less Likely?*, 55 AM. U. L. REV. 1345 (2006).

in an emergency. The government will always be the dominant and essential creditor in a bailout (thus, the lender of last resort label). Bailout policy is then a question of how the government should exercise its power when it has that leverage as a monopolist. An optimal bailout policy will prevent the government from abusing its power. Through that lens, the complaints of political favoritism are more troubling.

These questions bleed into the fourth area of concern: process. These bailouts were orchestrated by the administration under the general TARP authority, not by Congress. There was no legislation from Congress in favor of an auto bailout—to the contrary an initial auto bailout legislation proposal died in the Senate on December 11, 2008.[201] The bailouts were negotiated in secret. While approval by the bankruptcy courts was necessary, the courts were confronted with a negotiated deal that they were reluctant to disturb in the midst of a crisis.

Litigation after the crisis has, however, given courts an opportunity to revisit the government's actions. Auto dealers, whose agreements with Chrysler and GM were terminated in the bankruptcy, brought a lawsuit against the government.[202] These dealers claim that the government used its leverage to force GM and Chrysler to terminate many of their dealership agreements. The termination of those agreements is unquestionably legal under the bankruptcy code.[203] The question is whether that termination becomes an unconstitutional taking when the government forces the private party to take the action. The Federal Circuit recently held that a coerced termination that caused damage would be a taking.[204] But the court's language suggests that a high burden awaits plaintiffs on repleading:

> Absent an allegation that GM and Chrysler would have avoided bankruptcy but for the government's intervention and that the franchises would have had value in that scenario, or that such bankruptcies would have preserved some value for the plaintiffs' franchises, the terminations actually had no net negative economic impact on the plaintiffs because their franchises would have lost all value regardless of the government action.[205]

This standard might block the worst forms of government abuse—for example, where the government used its influence over stakeholders to force the companies into bankruptcy and then structured the bankruptcy to favor certain parties. But it leaves open more subtle forms of abuse. For example, imagine that the government offered to finance a reorganization of the firms on the condition that certain stakeholders benefit at the expense of others. Even if the disfavored stakeholders receive a higher payout than they would have in bankruptcy, such favoritism would be objectionable. And, of course,

201 Randall W. Forsyth, *Failure Is an Option as Senate Kills Auto Bailout*, BARRON'S (Dec. 12, 2008), http://online.barrons.com/articles/SB122908223411301599?tesla=Y.

202 A & D Auto Sales, Inc. v. United States, 748 F.3d 1142, 1147 (Fed. Cir. 2014).

203 *See* 11 U.S.C. § 365 (2012).

204 *A & D Auto Sales*, 748 F.3d at 1158.

205 *Id.*

the dealers' legal theory provides courts with no authority to question the wisdom of the decision to bail out.

F. Lessons

Many commentators believed that the bailouts rewarded risky investments and depleted the public treasury without creating any benefits. Were these beliefs correct? To answer this question, we disaggregate the various complaints.

1. Ex Post Efficient

One question raised by a bailout is whether it is necessary—whether it advances a public goal. The usual justification for bailouts is that they create a macroeconomic benefit: the avoidance of the social costs associated with unemployment and underuse of capital. The usual complaint is that they are mere transfers to favored groups. Thus, a necessary (but not sufficient) condition for a socially desirable bailout is a plausible pie-expanding macroeconomic benefit, or what we have called ex post efficiency.

Let us start with financial institutions, which provide a better case for bailouts than non-financial institutions do. Economists divide struggling financial institutions into two categories: solvent firms that face a liquidity crisis and insolvent firms. A solvent firm faces a liquidity crisis when it cannot borrow enough money to fund its operations, and so must sell off assets at fire-sale prices. The returns on these sales may be low enough to drive the firm into insolvency. For more than a century, it has been basic doctrine, attributed to the British commentator Walter Bagehot, that the central bank, or other government institutions, should lend to solvent but illiquid firms.[206] The additional liquidity enables the firm to survive while it sells off its assets gradually at their true value or obtains credit from the private market. Although there is disagreement on what the terms of such a rescue loan should be, there is little doubt that such a loan is ex post efficient.[207] The reason is that the loan costs the government almost nothing, and it will be fully repaid, while the loan prevents the contagion effects of the firm's collapse. If the firm's creditors collapse as well, then they too must sell off assets at fire-sale prices, and they and other firms will stop lending. The sudden withdrawal of credit from the economy has huge macroeconomic costs.[208] Businesses stop borrowing and fire employees; consumers stop buying.

The treatment of insolvent financial firms is more complicated. Economists worry that if the government bails out insolvent firms, then creditors

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206 WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 188–89 (Hartley Withers ed., E. P. Dutton & Co. 1920) (1873).

207 For a general model of the central bank as a lender of last resort, see Xavier Freixas et al., *The Lender of Last Resort: A Twenty-First Century Approach*, 2 J. EUR. ECON. ASS'N 1085 (2004); *see also* Fischer, *supra* note 33, at 86–87.

208 *See generally* CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT (2011) (covering a quantitative and historical analysis of various financial crises).

will make excessively risky loans. But this is a problem with ex ante incentives, to be discussed below, not ex post efficiency. From an ex post perspective, the only question for the government is whether the collapse of the firm will result in contagion that produces macroeconomic costs. If the answer is yes—which usually depends on the firm being large and interconnected, or "systemically risky"—then the government should rescue the firm, or arrange that its creditors are paid in full (or at least adequately).

The case for bailing out non-financial firms is more difficult still. As a general matter, the collapse of a non-financial firm will not hurt the credit system, just because (by definition) non-financial firms are not part of the credit system. If a widget-manufacturer collapses, its creditors will lose money, but most creditors are diversified enough that their losses will not ramify throughout the financial system; and if they do, the usual response is to rescue the creditors, not the widget-manufacturer. Still, some non-financial firms may be large enough that their collapse will produce significant macroeconomic costs. If, for example, a firm with a huge number of employees and suppliers collapses, the resulting macroeconomic shock—loss of employment and spending—could have contagious effects. The employees stop spending, causing other businesses to collapse; they default on their mortgages, causing banks to collapse; and so on. The difficulty with these types of bailouts is that they can be a disguised method for making transfers to favored interests.[209] That difficulty can be seen most starkly in the 2009 auto bailouts, which were widely criticized as involving political favoritism.[210] The lesson from all of this is that the more distant the firm is from the credit markets the more skeptical we should be of a decision to bail it out.[211]

A striking fact about the 2007–2008 rescues is that nearly all of them were ex post efficient. Most of the rescues followed the Bagehot dictum: most of the financial institutions suffered liquidity shortages but were otherwise solvent. The loans to them were repaid in full.[212] The government continues to earn returns on its Fannie and Freddie bailout and is likely to come out well ahead.

However, a profitable bailout is not the same as a socially optimal bailout. Every bailout raises numerous choices as to how it is structured: what the rate of interest should be, the term, the collateral, and so on. It is appropriate to criticize even a profitable bailout if it could have been structured so as to provide a greater benefit to the public.

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209 *See, e.g.*, GRETCHEN MORGENSON & JOSHUA ROSNER, RECKLESS ENDANGERMENT 177, 302–04 (2011) (arguing that the bailouts favored connected individuals).

210 *See supra* note 186.

211 Indeed, in 1999 and 2000, the federal government enacted legislation creating loan guarantee programs for domestic oil, gas, steel, and rural television. While these programs looked similar to the Lockheed and 1979 Chrysler bailouts, they were not bailouts. It is unlikely that the programs had anything to do with protecting viable firms, or stopping macroeconomic shocks. They were subsidies to help politically favored industries.

212 Kiel & Nguyen, *supra* note 66.

2. Fairness/Discrimination

A second source of controversy for bailouts is that they often seem arbitrary and unfair. In every case study that we examined, a critic of the bailout asked why one firm—Lockheed or Chrysler, for example—received a bailout while thousands of other firms in financial distress did not. During the financial crisis in 2008, critics asked why Bear and AIG were saved but not Lehman, and why Wall Street firms were saved while most ordinary people were allowed to default on their mortgages.

Questions of fairness also arise about how bailouts are structured. Many creditors of General Motors and Chrysler believed that the government showed preference for union members. In a recent lawsuit, shareholders of AIG, whose equity was diluted by the government rescue, complained that AIG was treated more harshly than the other rescued firms, which were not required to disgorge equity to the government. Even critics of AIG wonder whether it was fair of the government to use AIG's assets to pay off its counterparties in full—leading some commentators to accuse the government of engaging in a "backdoor" (that is, hidden) bailout of the counterparties, which included Goldman Sachs, among others.[213] Indeed, critics have charged that the government showed favoritism to Goldman, Citigroup, and other Wall Street firms with which government officials had close ties.[214]

3. Moral Hazard

The major worry about bailouts is that they can produce socially undesirable incentives. If bailouts occur with regularity, then private agents will predict that they will occur whenever the conditions associated with bailouts occur. If agents can predict who will receive bailouts, and under what conditions, with reasonable accuracy, then they will change their behavior in various ways.

The prospect of bailouts can lead to different types of bad behavior. If the market anticipates that, consistently with Bagehot, solvent but illiquid firms will receive bailouts, then creditors will not take into account the liquidity risk of borrowers—that is, including both the liquidity of borrowers' assets and the care with which management handles liquidity issues. If the market anticipates that the government will bail out insolvent firms, then creditors will also not concern themselves with credit risk. A derivative worry is that borrowers will maneuver themselves into the position in which they are likely to be rescued because this reduces their cost of credit. The "too-big-to-fail" problem is one manifestation of this concern. If everyone knows that the government will bail out only large firms, then creditors will reduce credit

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213 Office of the Special Inspector Gen. for the Troubled Asset Relief Program, SIGTARP-10-003, Factors Affecting Efforts to Limit Payments to AIG Counterparties 30 (2009), http://www.sigtarp.gov/Audit%20Reports/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf.

214 Daron Acemoglu et al., The Value of Connections in Turbulent Times: Evidence from the United States 38 (2014), http://economics.mit.edu/files/9847.

costs only for large firms. To obtain the benefit of lower credit costs, firms will grow beyond an efficient scale. Finally, if government lending is too generous, borrowers will be reluctant to switch to private lenders as the credit markets improve.

Worries about moral hazard played a significant role in the government's response to the financial crisis, but the government acted inconsistently. The government allowed Lehman to fail and imposed harsh terms on AIG at least in part—according to some—to counter moral hazard.[215] But the government also gave generous terms—low interest rates—to numerous other financial institutions.[216] While some authors make a virtue of the government's inconsistency by arguing that uncertainty about whether one will receive a bailout reduces moral hazard,[217] the proper method for inducing uncertainty is to randomize rather than favor the politically connected, who know who they are. Moreover, inconsistency will harm the primary goal of the government, which is to restore confidence in the financial system. That was the lesson of the failure of Lehman, which was unexpected because the government had earlier saved Bear Stearns, and precipitated the massive flight to liquidity that almost destroyed the financial system.

Bagehot counsels a relatively high rate of interest to deter moral hazard, but central banks have generally disregarded this advice because they worry that if they charge high rates, borrowers will refuse to borrow, or will wait too long before borrowing.[218] This worry might seem paradoxical since it implies that borrowers would voluntarily turn down loans in the middle of a liquidity crisis, when credit is tight. But there is a reason for this. Banks and other financial institutions worry that if they accept an emergency loan, the market will infer that they are insolvent or on the brink of insolvency.[219] So while the government may lend to them in the short-term, they will lose access to private credit in the medium- and long-term. During the 2007–2008 financial crisis, banks dealt with the problem of stigma by refusing loans from the discount window and instead borrowing in more hidden ways—by seeking more depositors protected by the FDIC, borrowing from Federal Home Loan Banks, and relying on the Fed's broad-based facilities.[220]

215 *See* Abigail Field, *Lehman Report: Why the U.S. Balked at Bailing Out Lehman*, DAILY FIN. (Mar. 15, 2010), http://www.dailyfinance.com/2010/03/15/why-the-u-s-balked-at-bailout-out-lehman/; Andrew Ross Sorkin, *What Timothy Geithner Really Thinks*, N.Y. TIMES MAG. (May 8, 2014), http://www.nytimes.com/2014/05/11/magazine/what-timothy-geithner-really-thinks.html; Andrew Zajac & Christie Smythe, *AIG's Risks Seen by Geithner as Requiring Tough Terms*, BLOOMBERG BUS. (Oct. 8, 2014), http://www.bloomberg.com/news/2014-10-08/geithner-blames-aig-management-for-2008-financial-woes.html.

216 Dean Baker, *TARP Give Aways*, AM. PROSPECT (Mar. 18, 2010), http://prospect.org/article/tarp-give-aways.

217 *See* Anabtawi & Schwarcz, *supra* note 17, at 123–24.

218 Jenny Corbett & Janet Mitchell, *Banking Crises and Bank Rescues: The Effect of Reputation*, 32 J. MONEY, CREDIT & BANKING 474, 476–77 (2000).

219 *Id.* at 477 (exploring the reputation incentive for firms to reject beneficial bailout offers).

220 *See, e.g.*, Kathryn Judge, *Three Discount Windows*, 99 CORNELL L. REV. 795 (2014).

But all this suggests that the moral hazard problem is partly self-correcting and largely exaggerated. If firms are penalized with stigma, they will not use emergency loans except as a last resort, and most likely only when there is a full-blown financial crisis.[221] And the probability of a full-blown financial crisis itself appears exceedingly small. There have been only two in the United States over the last 80 years. The latest financial crisis was anticipated by no one. If the probability that emergency loans will be needed is exceedingly small, then the availability of such loans can only trivially affect the ex ante incentives of banks.

4. Process

Bailouts almost always take place in emergency conditions, with the result that they occur in a rush, with little public debate and deliberation, and often no transparency. This is understandable but it also raises concerns. Critics of bailouts worry that the government will abuse its powers in all the ways described above—by rescuing firms that should fail, by discriminating against the politically weak, and by creating moral hazard problems for the future.[222] Transparency may be the only way to mollify them and to maintain public support for the bailout process.

During the financial crisis, it was often difficult to understand why the government made certain decisions—why it rescued Bear but let Lehman fail, for example. The official reasons were often legalistic and not credible. For example, officials explained that the Fed could not rescue Lehman because it lacked legal authority to lend to an insolvent firm,[223] yet the Fed did lend (indirectly) to Bear Stearns.[224] In the AIG lawsuit, the plaintiffs argued that if the government really sought to punish AIG for its reckless conduct (as government officials have sometimes said), then the government should have brought legal proceedings against AIG, which would have occurred with due process and independently of any Fed loan.[225] Critics complained that Treasury Secretary Henry Paulson's initial draft for EESA gave Treasury almost unlimited authority, and that the later, more precisely written draft was misleading (it suggested that Treasury would buy toxic

221 Of course the availability of hidden borrowing reduces the power of stigma to correct for moral hazard. This supports our suggestion below at Section IV.B for favoring transparency whenever other factors allow.

222 *See, e.g.*, Taylor, *supra* note 8, at 63 (noting the moral hazard and uncertainty introduced by bailouts); John B. Taylor, Opinion, *How to Avoid a 'Bailout Bill'*, WALL ST. J. (May 3, 2010), http://www.wsj.com/articles/SB10001424052748703871904575216633061219378 (noting the danger that bailout discretion will create moral hazard and other problems).

223 James B. Stewart & Peter Eavis, *Revisiting the Lehman Brothers Bailout That Never Was*, N.Y. TIMES (Sept. 29, 2014), http://www.nytimes.com/2014/09/30/business/revisiting-the-lehman-brothers-bailout-that-never-was.html.

224 *Id.*

225 *See* Second Amended Verified Class Action Complaint at 10–11, Starr Int'l Co. v. United States, 109 Fed. Cl. 628 (Fed. Cl. Mar. 11, 2013) (No. 1:11CV00779).

assets, when in fact Treasury used most of the funds to buy preferred stock in banks). Courts played virtually no role in constraining the government during the crisis, and have been only modestly more important in adjudicating post-crisis disputes.[226]

Similar complaints were leveled at the 2009 auto bailouts.[227] The courts were involved through the bankruptcy process. But the outcome was determined through private negotiations. At best the judicial process ensured that the bailout plan designed by the White House met with technical requirements of the Bankruptcy Code.[228] But the bankruptcy court had no power to review whether or not the government financing of the GM and Chrysler firms prior to, throughout, and after bankruptcy filings was an appropriate use of TARP funds. Treasury was nothing more than a large secured creditor that was financing the bankruptcy proceedings—how that came to be is not a question with which bankruptcy law is concerned. Additionally, the bankruptcy court permitted the sales under a process that foreordained the payouts to certain stakeholders, foreclosing a market test of the government's claims that no alternative was available.[229]

But at the other end of the spectrum is the Lockheed bailout. There, Congress had an open debate and the bill almost failed. This highlights the most vexing concern with bailouts. The general preference is for bailouts that are efficient in a broad sense. But people have temporally inconsistent preferences. Ex ante, the public may view an optimal bailout as one that is good policy taking into account moral hazard, fairness, and ex post efficiency. During the crisis, the public view will be skewed by the salience of the immediate losses, by questions about whether those losses will be borne by certain constituencies, and by a general lack of information about the true risk. Ex post, their views will be skewed by hindsight and other biases. These problems are prevalent in all crises. Information and biases change continuously.[230] The shifting public and political response to the threat of Ebola in the fall of 2014 provides a recent example.[231]

In sum, process matters. The government needs discretion when it structures bailouts, but it also can abuse that discretion. Procedural constraints are a tried-and-true approach for limiting such abuse.

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226 *See* Zaring, *supra* note 10, at 1406.

227 *See* Brubaker & Tabb, *supra* note 174, at 1406–07; Roe & Skeel, *supra* note 15, at 766–67.

228 Perhaps it did not even provide that. *See* Ind. State Police Pension Tr. v. Chrysler LLC, 558 U.S. 1087 (2009) (citing United States v. Munsingwear, Inc., 340 U.S. 36, 41 (1950)) (vacating and remanding lower court ruling to dismiss the appeal as moot).

229 *See* Adler, *supra* note 188, at 307; Roe & Skeel, *supra* note 15, at 733–34.

230 *See, e.g.*, Daniel Bennett et al., *Learning During a Crisis: The SARS Epidemic in Taiwan*, 112 J. DEV. ECON. 1, 2 (2015).

231 *See, e.g.*, Helene Cooper, *In Homeland, Liberia Native Finds Resilience Amid Horror*, N.Y. TIMES (Oct. 19, 2014), http://www.nytimes.com/2014/10/20/world/africa/in-homeland-liberia-native-finds-resilience-amid-horror-.html.

IV. Principles for Governing Bailouts

Our diagnosis of the problems with bailouts suggests some principles for reform. We are mindful of the paradox of regulating bailouts. Because bailouts occur ex post, Congress can always change the rules of any statute that attempts to regulate them. But this paradox should not be exaggerated. First, in practice, Congress has delegated bailout power to regulators like the Fed and FDIC, and may be reluctant to revise the statutes that govern those agencies in the midst of a crisis. Second, even in a crisis a statute can be sticky. Congress may not want to repeal it, and if it does not, a court may interpret Congress's actions in light of that statute. Finally, even if statutory constraints are infeasible, it may be useful to state principles that enable the public and press to evaluate an ongoing bailout. The principles thus serve a political function.[232]

A. *Substantive Principles*

1. Ex Post Efficiency

Financial bailouts. Virtually all bailouts of *illiquid but solvent* financial firms are ex post efficient. The reason is that the Fed can create as much liquidity as it wants, and it is certain to be repaid if the firm is solvent. Thus, a bailout has zero cost—indeed, may be profitable—for the taxpayer.[233] On the benefit side, a loan to an illiquid firm enables it to avoid failing. While the sale of goods at fire-sale prices is not itself an efficiency loss because the buyer gains what the seller loses, the collapse of a firm can produce contagion that ultimately sucks credit from the economy, causing macroeconomic harms. Even if it does not, the loss of organizational capital is likely to be severe.[234] For these reasons, bailouts of illiquid but solvent firms are socially desirable, all else equal.

The case for bailing out insolvent firms is more difficult. The benefits are the same—the bailout reduces the risk of contagion and preserves organization capital. But now there are costs. A loan to an insolvent firm is really just a transfer of resources to the firm, and the taxpayer must pay this cost. (If the Fed makes the loan, then the cost will show up indirectly as inflation or a taxpayer bailout of the Fed, at least at the margin.) A further consideration is that sometimes it is not clear whether a firm is insolvent or merely illiquid, especially during a financial crisis; so there is a chance that a loan will be repaid. Moreover, a bailout of an insolvent firm is often just an indirect way of bailing out its creditors—which may be illiquid but solvent. To

232 Conceivably, constitutional rules could be enacted through amendment, or courts could use the principles to evaluate constitutional challenges to specific bailouts. The former seems infeasible, however. As for the latter, this is essentially the argument of the plaintiff in *Starr v. U.S.* *See supra* note 225.

233 The moral hazard costs—relating to liquidity management—are likely to be small.

234 *See generally* Ben S. Bernanke, *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 73 AM. ECON. REV. 257 (1983).

sum up, the case for bailing out an insolvent firm is weaker than the case for bailing out an illiquid but solvent firm. There should be a rebuttable presumption against such bailouts.

Non-financial bailouts. The case for bailing out non-financial firms is weaker still. The reason is that the collapse of a non-financial firm will rarely have contagion effects. Non-financial institutions typically rely much less on debt than financial firms do; so losses are spread through thousands of equity-holders rather than concentrated on a smaller number of debtors. The major argument for rescuing non-financial firms arises when there is a systemic liquidity crisis—as occurred during 2007–2008—wherein these firms cannot borrow even a modest amount of money, even when they are solvent. The bailout would be justified for purely macroeconomic reasons—the failure of thousands of firms would cause a recession. Thus, non-financial firms should be bailed out only under unusual circumstances—when they are solvent but cannot borrow as a result of systemic collapse in the credit market.

2. Moral Hazard

The major problem caused by bailouts is that they may generate perverse incentives in the future. This raises the question whether a bailout should be structured so as to minimize those effects. As we saw, if bailouts are given out too freely, then creditors may disregard the credit and liquidity risk of borrowers, and borrowers may thus be able to engage in excessive risk.

There are two ways to minimize this perversity. First, and most important, bailouts should be given out only during a systemic financial crisis—that is, a crisis where all or nearly all lending stops, in all areas of finance, probably at the global level. Financial crises of this type are probably rare enough that their effect on incentives will be small. The one exception is for firms that are too big to fail. If a firm's own collapse poses systemic financial risk, the moral hazard problem is more severe. Other remedies, such as those we discuss next, are necessary in those cases.

Second, an argument can be made that bailouts should be accompanied by haircuts,[235] high interest rates (as advocated by Bagehot), and other penalties or payments for ensuring that creditors and shareholders suffer some harm. The prospect of such losses would further deter people from taking on excessive risk. However, imposing such costs may do more harm than good. If people believe that they will not be fully compensated, then they may hoard cash. Nevertheless, it seems appropriate for our principles to allow for haircuts and related measures, particularly when firms are viewed as too big to fail.

These points suggest that bailouts of firms during normal economic times are almost always a bad idea. The government should carry a heavy burden of proof if it believes that a bailout is necessary to halt an incipient crisis. This is particularly true for non-financial firms, which typically are not systemically interconnected with the financial system, and small, non-inter-

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235 *See* Anabtawi & Schwarcz, *supra* note 17, at 124.

connected financial firms. Thus, we advocate a strong presumption against bailouts except during a liquidity crisis that affects the entire financial system. The presumption should be rebuttable where the government can make the case that the failure of a firm would have significant macroeconomic consequences, but we cannot think of any event in U.S. history that would qualify.

By contrast, bailouts should be presumptively available during a liquidity crisis for solvent firms, as Bagehot recommends. If the firms are solvent, then they cannot be faulted for taking on too much credit risk. It may be the case that firms have mismanaged liquidity. However, a true system-wide liquidity crisis will destroy firms that have managed liquidity wisely as well as those that have managed liquidity poorly. The government should not punish firms that have mismanaged liquidity by denying them bailouts or imposing haircuts because (1) it will be very difficult, during the crisis, to evaluate the quality of a firm's liquidity management, and so the government would risk punishing the wrong firms; (2) punishment is inconsistent with the major goal of restoring confidence to creditors; and (3) there is no way (short of winding down a firm) to hedge against a true liquidity crisis, so it is doubtful that bailing out firms during a full-blown liquidity crisis will affect their incentives to manage liquidity during normal times.

This leaves the category of financial firms that are insolvent during a liquidity crisis. Bagehot argued that the central bank should not lend to such firms, but most economists believe that such firms should not be allowed to collapse in a disorderly fashion. The FDIC takes over insolvent banks and pays off depositors (in effect, bailing them out) while winding down the institution. The Fed appears to have been seriously hampered during the 2007–2008 crisis by the rule that it cannot lend to insolvent non-banks like Lehman.

The major worry is that if insolvent institutions are rescued, creditors will make bad loans, knowing that the government is likely to pay them back. These loans will produce significant costs to the real economy—in the form of, for example, the construction of shopping malls that no one uses. On the other hand, if insolvent institutions are systemically connected, their collapse exacerbates a liquidity crisis. Accordingly, we suggest that there should be no presumption against lending to (or investing in) insolvent firms during a full-blown liquidity crisis. However, the government (or central bank) should be permitted to structure the loans so as to penalize shareholders.

3. Fairness

One of the most difficult problems created by bailouts is that, unavoidably, some people are benefited while others are not. During the 2007–2008 financial crisis, bailouts benefited the creditors and shareholders of Bear more than those of Lehman; the shareholders of Goldman and Morgan Stanley more than the shareholders of AIG; and Wall Street firms more than homeowners. It is very likely that numerous distributional outcomes are consistent with ex post and ex ante efficiency. For example, it may be the case that the government could quiet a crisis by bailing out firms A, B, and C; or

B, C, and D, but need not bail out all four: if so, how should it decide? The government could also impose haircuts of various sizes on different creditors of the same firm.

The danger of unfairness is particularly acute during a financial crisis. In a financial crisis, the government, as lender of last resort, effectively has a monopoly over credit. Thus, it can charge a much higher price than is justified by moral hazard concerns, and can discriminate in order to advance political aims. By contrast, during normal times, the government has no such monopoly. If a firm cannot obtain loans, that usually means it is insolvent, and there is no particular worry if the government "overcharges" the firm, since the shareholders are not entitled to any payoff.

In light of this argument, we suggest a few principles.

During financial crises, the government should set a price that reflects the relevant economic parameters rather than the price that maximizes the return to the government or taxpayers. This is simply a restatement of Bagehot's advice that government should charge a price somewhat higher than what would prevail in a normal market. The key implication, however, is that the government may not charge an even higher price, even if firms are willing to pay it. Other elements of Bagehot's approach—such as the requirement that loans be fully secured—should also be followed. Surprisingly, they are not already clearly embodied in the law.[236]

Avoid favoring politically connected firms. Many critics accused the government of favoring politically connected banks—above all, Goldman Sachs and Citigroup. Henry Paulson, the Treasury Secretary during the Bush administration, was a former Goldman CEO and hired numerous Goldman executives to work in Treasury.[237] Timothy Geithner, the New York Federal Reserve Bank president and then Treasury Secretary, admitted in his memoirs that he underestimated Citigroup's problems because his mentor, Robert Rubin, sat on its board.[238] The public perception that the government favored Wall Street complicated the government's response. The public, for example, wanted the government to cut the salaries of Wall Street executives, while the government believed that in some cases it lacked the legal authority to do so, and in other cases that such a move would deter banks from seeking help or cause the resignations of executives who were in the best position to help banks return to health. But while one can ask the government to be sensitive about this problem, it is unrealistic to propose that it refuse to bail out politically connected firms. All major firms are politically connected.

236 *See* Tucker, *supra* note 36.

237 Julie Creswell & Ben White, *The Guys from 'Government Sachs'*, N.Y. TIMES (Oct. 19, 2008), http://www.nytimes.com/2008/10/19/business/19gold.html?pagewanted=all.

238 TIMOTHY F. GEITHNER, STRESS TEST 135 (2014).

Favor ordinary people, such as homeowners. Many critics of the government's handling of the financial crisis who believed that the government favored Wall Street argued that the government should have done more for homeowners. Late in the crisis, the government responded by creating some programs to help bail out homeowners, but these had little effect, as we discussed above. We agree that, all else equal, it makes more sense for the government to bail out ordinary people than large firms. A key distinction is that ordinary people are risk-averse, while large firms are owned by diversified shareholders. Unfortunately, bailouts of ordinary people such as homeowners may be administratively infeasible. As the number of bailout recipients increases, the government must spend more money on administrative costs. These bailouts also raise other fairness questions—for example, why favor people who bought homes on credit over other kinds of debtors, like credit card debtors?

Avoid disfavoring foreigners. A politically sensitive issue during the crisis was the treatment of foreign financial institutions.[239] The Fed ended up bailing out foreign banks as well as domestic banks because the credit market is global, not national. If foreigners believe they will not be rescued, and so refuse to lend to American institutions, then the credit crisis will not be solved. But the public had no sympathy for foreigners, and the Fed tried to conceal its efforts on their behalf.[240] Here, we think the Fed was correct. As a presumption, financial bailouts should not discriminate against foreigners.

Is distributive neutrality possible? A kind of formal distributive neutrality is achievable if the government can commit itself to general eligibility standards that classes of firms satisfy.[241] If it were to do so, it would simply announce that any firm that satisfied the principle described above would be entitled to a bailout. This may not be practical, however. One problem is that the government may be overwhelmed by applications for bailouts, especially during a financial crisis; another is that the principles are malleable enough to permit favoritism at the margin.

Dodd-Frank permits only bailouts of groups of firms that satisfy broad-based eligibility requirements.[242] This would limit favoritism toward individual firms. The crisis provides some examples of what broad-based requirements could mean. The Fed set up a number of facilities that extended credit to certain classes of debtors—banks that sought to borrow against

239 *See, e.g.*, NEIL IRWIN, THE ALCHEMISTS: THREE CENTRAL BANKERS AND A WORLD ON FIRE 151–55 (2013); Neil Irwin, *How Ben Bernanke Saved Europe's Banks*, GLOBALIST (May 12, 2013), http://www.theglobalist.com/how-ben-bernanke-saved-europes-banks/; Jia Lynn Yang et al., *Fed Aid in Financial Crisis Went Beyond U.S. Banks to Industry, Foreign Firms*, WASH. POST (Dec. 2, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/12/01/AR2010120106870.html.

240 IRWIN, *supra* note 239, at 154.

241 Including auction facilities.

242 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1101, 124 Stat. 1376, 2113 (codified at 12 U.S.C. § 343 (2012)).

asset-backed securities, primary dealers, firms that rely on the commercial paper market, and so on. Broad-based requirements do not eliminate the risk of discrimination because the government can design the requirements to favor certain firms. But they do probably make favoritism toward individual firms a bit more difficult than it might otherwise be.

Whether such a principle would be justified is hard to say. The benefit, as noted, is that it would reduce discrimination, but the reduction might be minimal. The cost of such a principle is that it may sometimes be the case that rescues of individual firms are justified. The government believed (correctly or not) that if Long Term Capital Management failed, it would take numerous big banks with it.[243] During the 2007–2008 crisis, individualized loans were made to rescue Bear and AIG, and an individualized loan should probably have been made to save Lehman. The configuration of credit networks is unpredictable; broad-based eligibility requirements may thus interfere with needed rescues in future crises.

4. Administrative Costs

A last consideration is that if the government offers bailouts too freely, it will be overwhelmed by applications for money. Bagehot said that the central bank should lend to "this man and that," and section 13(3) allows the Fed to lend to anyone. But Bagehot also argued that the rate should be set high enough to deter people from applying for cheap loans who really did not need them.

These are arguments for credit rationing, and they raise anew the worry that the central bank can use arguments about administrative costs to disguise favoritism toward politically connected firms.

Worries about administrative costs might explain why Dodd-Frank requires the Fed to use broad-based programs with uniform eligibility requirements. On this approach, Fed officials do not need to weigh the benefits and costs of loans on a borrower-by-borrower basis, and instead can delegate to subordinates the mechanical process of determining whether applicants satisfy the eligibility requirements. As we noted above, we are skeptical that broad-based eligibility requirements can really constrain the Fed. While the Fed may be able to use administrative costs as an explanation for discriminating against some firms, such explanations must be evaluated carefully.

B. *Procedural Principles*

What procedural principles should govern bailouts?

Should Congress bail out firms or should regulatory agencies do so? Generally speaking, a regulator should engage in bailouts for the same reason that regulators typically engage in executive action—they can act more quickly and

243 *See* THE PRESIDENT'S WORKING GRP. ON FIN. MKTS., *supra* note 66, at 18–22.

flexibly than Congress can, and are less likely to be influenced by irrelevant political factors. The financial crisis provides the best illustration of this claim. The Fed and FDIC were able to bail out firms with great rapidity and flexibility. By contrast, when Congress was forced to act, it acted slowly and erratically; produced a statute that paid off various interest groups in order to obtain the consent of recalcitrant members of Congress and in the end gave almost unlimited discretion to Treasury. Congressional involvement may have been necessary for political legitimacy, but if it had been avoidable, it should have been avoided.[244]

Economists and central bankers seem largely in consensus that central banks should not make emergency loans to insolvent firms.[245] They believe that central banks occupy a precarious position in a democracy because they must be given independence so that they can resist short-term political pressures—for example, to use inflation to stimulate the economy before an election. To avoid a political backlash, central banks must confine themselves to the least controversial actions that are consistent with their mission. Loans that are paid back will create less political outrage than loans that are not paid back and are instead absorbed by the taxpayer.

All of this might be true, but it seems to us questionable. The political backlash against the Fed during the last crisis took place even though the Fed *did* lend only to solvent firms. The Fed's failure to lend to Lehman—which was thought at the time to be insolvent—was its greatest error. Congress punished the Fed, anyway. We suspect that the Fed will maintain legitimacy and independence just to the extent that it fulfills its mission. If it stops a financial crisis with speed and efficiency, it will retain its independence. This suggests that it should be given a broad array of tools, including the power to make loans to insolvent firms if it believes that the loans will help end a crisis.

Should regulators hold hearings before bailouts? Many people complained that regulators acted without transparency during the financial crisis. Transparency would have required some kind of public process like a hearing in which interested parties could submit arguments for or against a proposed bailout. All things equal, hearings make sense because they inform the public and may provide evidence and arguments against bailouts that are unwise. The recipients of potential bailouts should be given an opportunity to propose terms, as should affected parties (such as creditors of the recipient). However, sometimes there will not be enough time for hearings, and often it may be the case that a proposed bailout must be kept secret until the last minute. Secrecy may be necessary to facilitate private rescues or to enable the government to put off a decision until one is necessary. Still, on balance there should be a presumption in favor of a hearing.

244 A huge literature exists on the closely related question of whether the central bank should be independent or not. For a valuable, recent discussion in the context of emergency liquidity authority, see Tucker, *supra* note 36.

245 For a powerful statement, see Tucker, *supra* note 36, at 40–41.

Should courts play a role in bailout regulation? Judicial involvement is unavoidable because bailouts must obey constitutional norms and relevant state and federal law constraints on lending transactions and corporate investments. But the amount of judicial involvement is a policy choice. At one extreme, we could imagine that parties affected by a bailout could seek judicial review before the bailout is consummated. The court would approve the bailout only if it complies with our substantive principles, giving the appropriate deference to the factual determinations of the regulator. At another extreme, judicial review could be limited. Our view is that because of the inherent limitations of judicial review, courts should not be permitted to block otherwise lawful bailouts that violate the principles that we propose.[246]

However, courts could play a more significant role after the bailout and the return of normal markets. In principle, courts could determine ex post if the bailout complied with the principles that we have proposed. If a bailout imposed excessively harsh terms on a party, or was improperly denied, the affected parties might appropriately be entitled to a remedy.

The role of courts in reviewing bailouts is currently being litigated. Because no statutory bailout framework exists, the claims are based on the Takings Clause of the U.S. Constitution.[247] The vagueness of this clause renders it less than ideal for evaluating these claims. If courts decide that a judicial role in evaluating bailouts is appropriate under the Constitution, then the case for a statutory framework would be strengthened.

For example, a statute could create a specific cause of action for challenging a bailout. To allow for the discretion necessary for implementing bailouts, the challenge would have to be after the fact and provide for damages rather than injunctive relief. The particular elements of the claim could be grounded in the substantive principles laid out above. The benefit of doing so would be to direct the judicial oversight to the specific areas where government actors are most likely to abuse their discretion. This would be more precise and targeted than litigation based on vague takings claims. To cover the full scope of potential violations, standing would have to be expanded to include those who could pursue more general claims that the substantive principles have been violated.[248]

On the other hand, even ex post litigation can chill the exercise of discretion in an emergency. The more onerous the penalties imposed after the fact, the more hesitant a government actor will be to implement a bailout program. Personal liability for government actors, for example, would be too extreme. The benefit of creating damages claims against the government is that they impose a political cost along with providing transparency through judicial review. The key is to calibrate those political costs to discourage gov-

246 *See* ERIC A. POSNER & ADRIAN VERMEULE, THE EXECUTIVE UNBOUND 52–54 (2010).

247 *See* Zaring, *supra* note 10, at 1433 ("In some ways, the takings cases exemplify the advantages of ex post review . . . .").

248 *Cf. id.* at 1481 (discussing the limitations that standing requirements placed on the scope of financial crisis litigation).

ernment actors from the more capricious use of their bailout authority while not deterring them from using that authority when justified.

Conclusion: The Paradox of Bailout Regulation

Dodd-Frank's sponsors and supporters argued that the statute would make future bailouts unnecessary, and yet at the same time the statute continues to authorize the Fed to issue bailouts (albeit subject to greater restrictions than in the past) and gives the FDIC greater authority to make bailouts than under prior law. This schizophrenia has long been characteristic of bailout regulation, which does indeed have a paradoxical element to it.

The paradox is that the government wants both to commit not to make bailouts and to be able to make bailouts if they are necessary. The reason for committing not to make bailouts is that if bailouts are not available, then people will be more prudent with their finances, and thus financial crises may never occur. But the reason for making bailouts available is that even if people are prudent with their finances—or, if they are not but are able to exploit loopholes in order to circumvent regulation—then bailouts are necessary to prevent macroeconomic collapse.

Over the years, governments have attempted to solve the paradox by establishing ex ante insurance programs, under which potential bailout beneficiaries pay in advance for their bailouts and submit to regulation that requires them to behave prudently. Unfortunately, insurance systems are only as good as predictions about the future, and the crystal ball is always hazy. The paradox of bailout regulation is that because the conditions under which bailouts are issued are unpredictable, it is impossible to set up an ex ante insurance system to govern all such conditions. This means that bailouts will always be necessary, and to some extent discretionary.

This creates another problem. If the government enjoys discretion as to which firms to bail out, and how to do so, it can abuse this discretion—to reward political favorites (by offering them bailouts) and to punish others (by refraining from giving them bailouts). Thus, despite the heterogeneousness and unpredictability of the conditions that justify bailouts, there is value in confining the government's discretion, even if only at the margins, by supplying legal or political principles for evaluating the work of bailout authorities.

If our arguments are accepted, then some legal reforms would be necessary. Dodd-Frank's constraints on bailouts should be eliminated, so that the Fed can make individualized rescues as well as bailouts based on broad-based eligibility rules. Congress should also either pass laws or issue non-binding statements that encourage regulators to bail out companies only when the negative macroeconomic effects of failure are significant and the moral hazard effects are limited. Procedural constraints should also be put into effect. Perhaps, inspectors general and other watchdogs can be put on the alert for political favoritism in bailout policy. Regulators should be required to provide guidance documents that explain how they plan to administer and structure bailouts should the need arise.