GOVERNMENT AS RESCUE FINANCIER: NOT JUST A PRIVATE LENDER

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In recent years, U.S. government entities have become increasingly active as commercial participants in corporate restructurings by providing rescue loans when private market funding is unavailable. Like private lenders, the government can effectively control the operations of distressed enterprises, the manner of their reorganizations, and the distribution of value to their existing stakeholders by positioning and conditioning these loans. Unlike private, purely commercial actors who act with pecuniary motives, the government intervenes to force distinctly regulatory or political outcomes. This article initially explores whether existing laws and informal restructuring standards, practices, and policies provide an appropriate framework to evaluate conduct of an ostensibly commercial government actor that in fact is not acting to maximize return on its narrow rescue investment. It concludes that the insertion of non-commercial behavior into what typically is an economic framework creates uncertainty for private investors and that both investors and the government would benefit if restructuring outcomes were more predictable. Without challenging the propriety of government policy goals, this article also offers simple and actionable ways to improve process predictability and certainty while preserving government flexibility to act as the lender of last resort.

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INTRODUCTION 51
I. GOVERNMENT USE OF COMMERCIAL CONTRACTUAL RELATIONSHIPS TO ADVANCE POLICY OR POLITICAL OBJECTIVES 58
- A. Recent bail-outs were of unprecedented size, scale and scope, leaving no private market alternative to government financing 60
- B. Investors do not expect that objections to government rescue financing terms and conditions will be successful 62
- C. Going forward 68

II. PRIVATE INVESTOR PERSPECTIVE ON PREDICTABILITY AND CERTAINTY OF PROCESS 73
- A. Government signaling during the recent financial crisis indicates greater willingness to impair private capital, and less willingness to distinguish illiquidity from balance-sheet insolvency 74
- B. Uncertainty also limits government flexibility to act 77

III. THE GOVERNMENT IS DIFFERENT THAN A PRIVATE LENDER AND SHOULD BE PRESUMED TO ACT WITH ULTERIOR MOTIVE IN AN UNCOMPETITIVE MARKET 79
- A. Restructuring rules 79
- B. State corporations law 83

IV. PROPOSED SOLUTIONS 86
- A. Proposal 1: Funded loans and unfunded lines of credit should be market tested on a vertical slice basis and be offered for public sale 87
- B. Proposal 2: All funded debt should be pre-payable, all credit lines should be cancelable, and if practicable, delivered proceeds should be callable for a reasonable period of time 90
- C. Proposal 3: The government should assign an impartial investment manager to make commercial decisions with respect to each rescue financing 93
- D. Proposal 4: Reorganization earmarks should be subject to the political process 96

CONCLUSION 98

INTRODUCTION

Every successful reorganization requires liquidity. Even a patently balance-sheet solvent enterprise cannot reorganize unless it can pay its debts as they come due, together with the current costs of financial and operational restructuring. In many complex restructurings there is immediate need to borrow substantial funds to preserve going-concern value or to enable an arms-length realization of value through orderly liquidation. Liquidity is particularly needed when the entity being reorganized is a provider of credit to customers or counterparties or when counterparties will not do business without a clear showing of liquidity and evident credit quality.

Absent unusual contractual or statutory imperatives, the general rule is that disinterested parties cannot be compelled to lend funds to an entity in exigent circumstances. Consequently, rescue lenders must be induced to provide funds. Like conventional debt, rescue loan terms will depend on the perceived riskiness of the new loan, the lender's cost of capital, and the vigor of market competition. However, rescue loans often are perceived to be extraordinarily or unusually risky, and many traditional sources of funding are not available to stressed or distressed companies. Also, the types of lenders who provide rescue financing (other than on an asset-backed basis) frequently have high return thresholds, and market competition among parties willing to price restructuring process risk is typically less robust than competition for regular-way lending. Compounding these issues, there also can be structural impediments to competition such as existing secured creditors who object to alternative sources or terms of rescue financing.

In bankruptcy, private debtor-in-possession ("DIP") lenders who are not subject to material competition often have the ability to set the contours of a restructuring through contract. DIP lenders may be able to force the sale of a company, or company assets, over creditor objection, cause a company to operate only in a permitted manner, and/or significantly adjust distribution of recovery on account of pre-existing claims and interests. At the extreme, DIP lenders may have the practical ability to compel a particular restructuring process or specific distributional outcome by conditioning financial support upon debtor acceptance and court approval. Essentially, a distressed corporate enterprise that absolutely, positively must borrow funds may have little or no bargaining power when negotiating with a well-positioned DIP lender.

Restructuring professionals understand and generally accept the proposition that when there is no better alternative even odious private rescue financing should be accepted on proffered terms. Private DIP lender

leverage is not wholly unconstrained, however. Codified and common law, coupled with informal restructuring standards, practices, and policies, have evolved over decades to limit economic overreach by private actors. Parties in interest can challenge loan terms that are not economically prudent or equitable, or which are not in-line with market conditions. They can highlight management bias, deficient decision-making, breach of fiduciary duty, and poor process. They can object to DIP lender conduct undertaken with improper commercial purpose. And, in a final line of defense, objecting stakeholders typically are given an option to substitute their own funds in lieu of proffered or approved rescue financing.[1]

The bankruptcy process (including pre-petition negotiations in anticipation of bankruptcy) creates healthy tension between DIP lenders, stakeholders, and debtors, and focuses attention on egregious DIP lender demands. In a private DIP context, both fiduciaries in control of corporate debtors and lenders are constrained by the prospect of reasoned judicial review of their conduct and in many cases by reputational risk. All parties understand that there is at least a palpable chance that a judge will blue-pencil objectionable loan terms under threat of rejection or the debtor will be compelled to reject financing and reevaluate the nature and scope of restructuring. Disinclined debtors or objecting stakeholders may not always be able to block or modify an undesired private loan but restructuring outcomes are reasonably predictable and bounded based on past pattern and practice.

In the non-corporate context, banks and thrifts are resolved in accordance with the Federal Deposit Insurance Act ("FDIA"). The FDIA confers extensive authority to the Federal Deposit Insurance Corporation ("FDIC") to sit as conservator or receiver of an intervened bank, and to provide rescue funding in support of reorganization or orderly liquidation. The FDIA is a resolution process that practitioners and investors

1. Experienced market participants will admit that the "option" to provide alternative financing is not always exercisable. Even if a deal is shopped to exhaustion, allowing for a good faith process to raise capital and sufficient time, a stakeholder may face insurmountable practical hurdles to raising capital. Disorganization, including poor coordination and disagreement among creditors, is a common impediment. The proffered DIP lender may have an insurmountable competitive edge due to asymmetric information or company support. Junior creditors may be unable to raise DIP financing on a junior lien basis, to win or afford to wage a priming fight, to accumulate enough capital to take out senior claims, or to object at all except at risk of breach of inter-creditor contract. Some senior secured creditors may find themselves excluded from and futilely fighting a DIP loan offered by a subset of the same class. Alternatively, the amount of rescue capital needed might be disproportionately large compared to the market value of the existing investment. Still, it is unusual for a DIP lender to provide funds substantially below market, and most courts likely would be hostile to a prospective DIP lender who refuses to acknowledge alternative terms and market conditions.

understand relatively well even though the statute itself allows for extensive exercise of FDIC discretion, minimal court supervision, and theoretically disparate outcomes across cases. Investors reasonably can predict how banks will be resolved because the FDIC in its capacity as banking resolution authority follows transparent rules and regulations that have been applied consistently over time. The FDIC (and the now-abolished Federal Savings and Loan Insurance Corporation ("FSLIC") and Resolution Trust Corporation ("RTC")) have set common law and regulatory precedent through the resolution of literally thousands of banks and thrifts.[2] In addition, investors expect that, as a class, domestic banks and thrifts will be subject to pervasive and industry-wide regulation, and the same statutory resolution regime.[3]

When the U.S. government[4] provides rescue financing to a corporate enterprise, whether under the supervision of a bankruptcy court in a resolution proceeding modeled after the FDIA and adapted for corporate distress, or under imminent threat of either insolvency regime, formal legal rules and protocol are followed but the process is hollow and does not materially constrain government conduct. The circumstances of public intervention and purpose of providing government-funded financing are grossly different from that in the private lender context. Strict adherence to legalistic frameworks without adjusting for different circumstances and lender motives can undermine investor confidence in resolution processes and lead to suboptimal substantive outcomes.

Initially, the terms and conditions of government loans at the magnitude and scope of too-big-to-fail or industry-wide lending programs

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2. The FDIC also has self-limited by regulation and conduct, and has developed a pattern and practice over many years. There are FDIC rules and regulations, advisory opinions, statements of policy, an "FDIC Resolution Handbook," and multiple speeches and press releases relating to interventions. *See* FED. DEPOSIT INS. CORP., https://www.fdic.gov/index.html [https://perma.cc/48YB-KEKQ]; https://www.fdic.gov/regulations/laws/rules/2000-50.html [https://perma.cc/764G-SVYR] (outlining rules and regulations); https://www.fdic.gov/regulations/laws/rules/4000-50.html [https://perma.cc/KP76-PKUY] (displaying advisory opinions); https://www.fdic.gov/regulations/laws/rules/5000-100.html [https://perma.cc/JN75-69HL] (stating FDIC statements of policy); https://www.fdic.gov/bank/historical/reshandbook/ [https://perma.cc/7TD5-6RSR] (displaying Resolutions Handbook).

3. Technically, a state chartered savings and loan association or bank may be resolved by the state regulatory authority but "state regulatory authorities virtually always request the appointment of the FDIC when a receiver is appointed." *See* FDIC, *MANAGING THE CRISIS, CHAPTER 8: THE FDIC'S ROLE AS RECEIVER,* 215, https://www.fdic.gov/bank/historical/managing/history1-08.pdf [https://perma.cc/4HXT-VNQW].

4. Rescue financing can be provided by various federal government agencies or vehicles. For purposes of this article the source of financing does not matter because authority to lend is presumed and inter-agency conflict is not at issue, except where specified.

are invariably unconstrained by private market competition.[5] The single most important constraint on lender behavior – market competition – is missing. Moreover, the very fact of government intervention presumes the recipient enterprise is of sufficient size and general importance to warrant federal attention. Government claims that disorderly business failure will lead to systemic harm, or conversely that going-concern restructuring or orderly liquidation is in the public interest, are all but impossible to rebut.

In addition, a public lender may intervene with valid policy or political objectives that override or even contradict the normal private lender's overarching goal to protect its commercial interest and maximize profitability.[6] The baseline investor expectation is that government agencies will be viewed by courts, the public, and government officials, as justifiably entitled to condition rescue financing on public policy terms. The government, as a reluctant actor and repository of the public trust, essentially has an elbow on the scale. Existing formal and informal restructuring rules are not suited to restrict government conduct in a meaningful way, or to ferret out ulterior policy or political motives behind

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5. In 2008 and 2009, when risk capital was scarce and pro-cyclically expensive, even small private rescue loans not at material risk of default were difficult to arrange at useful cost. The amount of rescue funding the government provided during the financial crisis could not have been raised in private capital or bank loan markets in a similarly short time-frame, under *any* market conditions.

6. Entities sufficiently large or systemically important to have garnered emergency government support – banks and other financial institutions, mortgage guarantors, insurance providers, and top-tier industrial corporations – presumably were worthy of intervention because disorderly liquidation might have caused material disruption to the economy, employment, or other strategic interests. Non-commercial goals furthered by the terms and conditions of government support once made could include subsidization, development, value transfer, electoral politics, signaling policy change, or any of a myriad of other policy or political goals.

At the same time, it would be unfair to say that government lends to lose money. Agencies presumably will attempt to structure rescue financing to protect taxpayers from loss or ostensibly to earn a return commensurate with risk, however risk is perceived, provided the commercial goal does not conflict with an overriding policy or political goal. In most cases the government does not appear meaningfully motivated to initiate rescue financing in order to maximize profit, as would a disinterested private lender. Although deliberately punitive DIP terms may have a wealth maximizing effect, profit motive may be incidental to policy goals (such as signaling disproportionate loss to avoid future moral hazard) or political goals. However, there is a vigorous debate and extant litigation over whether the terms of government support for the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") have been amended for the purpose of seizing assets and maximizing federal revenues. For a brief overview of the dispute surrounding the controversial "Net Worth Sweep" *see generally* BETHANY MCLEAN, SHAKY GROUND: THE STRANGE SAGA OF THE U.S. MORTGAGE GIANTS (2015) (noting in part that the Treasury may have changed the terms of its preferred stock purchase agreement with Fannie Mae and Freddie Mac in order to sweep profits and avoid debt ceiling limitations).

the terms and conditions of rescue financing.

The ordinary corporate resolution process in bankruptcy is designed to limit commercial overreach by private lenders acting to enhance their own economic self-interests. Core investor concerns about unpredictability of government loan terms and conditions are not rooted in voracity. Rather, the risks are that the government will condition funding in ways that antithetically diminish estate value or change distributions to benefit a party other than the government as lender. Unless it were in its own economic self-interest, a third-party private lender would not be expected to condition funds on a particular transfer of assets, liabilities, or value from the estate, on a change in priority of distribution, on disparate treatment of similarly situated stakeholders, or on a change in corporate governance that does not enhance value of the estate.

Investors face additional risks when a corporate group is restructured or liquidated under an agency controlled resolution scheme such as Title II of the Dodd-Frank Act,[7] rather than in bankruptcy or under threat of bankruptcy. Stakeholders lack the automatic judicial venue and transparency afforded by a bankruptcy court under restructuring constructs deliberately designed to mimic the bank resolution process. There is no court that entertains process or predetermination objections to loan terms and conditions, or notionally checks that the estate is well-served by the loan. Indeed, investors do not expect terms and conditions of rescue financing will be subject to prior objection at all, and may not even be publicly known for some time.

Worse, there is no disinterested manager or trustee in control of the borrower tasked with negotiating the terms and conditions of the loan strictly on behalf of the estate. The entity responsible for negotiating on behalf of the estate is a government agency appointed as conservator or receiver. That government conservator or receiver may be statutorily tasked with goals beyond maximization of value available to stakeholders, equitable distribution of value, or restoration to financial solvency. In addition, that government conservator or receiver may be deeply conflicted. In some cases the government agency placed in charge of the borrower actually regulates the borrowing entity and its counterparties and competitors.[8] In all cases the government agency is part of the same

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7. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, 12 U.S.C. § 5381 (2010) ("Dodd-Frank Act").

8. This is the normal dual role played by the FDIC in bank resolutions. The courts and the FDIC itself recognize this duality not just in practice but in nomenclature. *See, e.g.*, Anchor Savings Bank v. U.S.A, Fed Cl. Ct. No. 95-39 C May 18, 2015, at 28 (noting that "[t]he FDIC plays a dual role: in its corporate capacity ("FDIC-C"), it acts as insurer, regulator and supervisor of FDIC insured banks. But the FDIC also acts as receiver ("FDIC-R") for failed national banks and federal thrifts that have been seized"). Investor acceptance

federal government that both regulates the entity and provides the financing, under actual common control or the appearance of common control. And, compounding lack of transparency and accountability, statutorily-valid actions of public conservators or receivers typically are subject only to restricted judicial review and may be explicitly immune from injunctive relief.

Given this backdrop, there is a veneer of legitimacy and fairness when the government, acting in a commercial capacity as rescue financier, conditions support on a particular restructuring process or outcome. It is legally challenging (and it has been empirically unsuccessful) to argue that government loans should be examined differently than private DIP loans, despite different conditions and lender motives. Ironically, past patterns and practices leave investors with a foreseeable bankruptcy process – the government will be able to condition its loan as desired because a private DIP lender presumably could do the same – but outcomes are uncertain because there is no way to predict how the government, as a non-economic actor, will exercise discretion. Likewise, an FDIA-type resolution process for nonbank corporations may appear familiar but lack necessary informal controls, checks, and balances in a different context. In the banking context there is little need for investors to be concerned about how the FDIC will borrow from itself,[9] or for investors to expect commercial overreach beyond what already is understood from rules, regulations and precedent. Observance of formal legal process offers a veneer of investor protection but no actual safeguard against commercial overreach or pretextual government behavior.

Regardless of whether government actions in fact are legal (or simply that the government can act without meaningful opposition or judicial review), there is significant policy risk when the government conditions rescue financing as if it were a private actor. There are principled reasons to self-limit government exercise of discretion. When making rescue loans

of this dual role when resolving banks does not mean either that investors agree that the practice is appropriate for resolution of nonbank corporations or that investors understand how a dual role would or does work in practice for a non-bank, non-insurer, or non-railroad.

9. In practice, there is negligible or no negotiation over payment terms and conditions of funds advanced by the FDIC, in part because general creditors (and junior claims and interests) can only expect to receive payment if the FDIC is repaid in full. *See* 12 U.S.C. § 1821(d)(11) (setting forth the order of priority for payments in receivership); *see also* 12 U.S.C. § 1821(g) (providing for the subrogation of the FDIC to all depositor rights to the extent of payment or assumption). The real negotiations over subsidization or support typically concern the economic terms of loss-sharing with a healthy acquiring bank or asset purchaser. In addition, the FDIC is the only government agency expected to fund bank resolutions. If self-funding is inadequate, the agency, not the bailed-out entity, is backstopped by the U.S. Department of Treasury ("Treasury").

or enforcing contractual terms, government officials wear commercial hats and have commensurate commercial rights and responsibilities. Simultaneously, those government officials also wear regulatory hats and have regulatory objectives to pursue. It is unrealistic to expect that a single person or agency can be so compartmentalized in thinking and behavior that only one hat can be worn at a time, or that government officials would relinquish strategic and tactical advantages that come from being able to switch hats, in the absence of self-imposed restrictions.

Further, in the recent financial crisis, government actors seemed more willing to use commercial lending relationships in support of overtly regulatory or political goals, or to engage in what aptly has been described as "regulation by deal."[10] This practice has led to the perception among some investors that the government has created a backdoor through which opportunistic government actors can accomplish regulatory aims yet bypass normal rules of distribution and regulatory checks and balances. It is costly and economically distortive for existing stakeholders and potential private investors to try to quantify the risk that the government's non-economic agenda will impair their investments. Perversely, the very goal of encouraging private capital ahead of the taxpayer is undermined by inconsistent government conduct and uncertainty over the terms and conditions of government lending. Ideally for investors, public policy considerations (and the uncertainties they create) would be expressed through the political and administrative processes, including the decision to make the rescue loan, and not by managing the restructuring process through the loan.

There has been extensive debate over whether and when the government should invest in a distressed enterprise, at what threshold and amount, and towards which purpose. In general, there has been thoughtful consideration about rules to constrain the government's decision to invest, rules that lower the incidence of intervention, and rules that increase the likelihood of successful intervention as seen from the perspective of the

10. *See* Steven M. Davidoff and David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 468 (2009) (discussing the roles of government as "Deal Facilitator," "Dealmaker," and "Deal Machine"). From the government's viewpoint, it may be rational or necessary to force existing stakeholders to bear the costs of providing a public good. This can be done directly by conditioning support on a particular distribution of estate value, or indirectly through sale of estate assets for less than reasonably equivalent value or forced assumption of estate liabilities. In addition, the government sometimes relinquishes recovery, forgoes return, or transfers value to non-governmental entities. In a free-market economy the government is not supposed to intervene in a commercial capacity for the purpose of aggregated wealth, but deliberately acting against its own narrow pecuniary interest is something no purely commercial actor would do.

national interest. Less consideration has been paid to how specifically the government should set contractual terms and conditions of rescue loans, how it should manage investments once made, and how it should address conflicts of interest and matters of corporate governance. This article discusses the historical context of and concerns about government rescue financing, and then discusses four self-imposed limits on the government's ability to condition and manage rescue loans. Compliance with these limits is justified even though private lending might not be similarly restricted, is likely to improve predictability of process and outcome, and is not unduly restrictive of government exercise of discretion.

I. GOVERNMENT USE OF COMMERCIAL CONTRACTUAL RELATIONSHIPS TO ADVANCE POLICY OR POLITICAL OBJECTIVES

The federal government has often acted as a commercial lender or rescue financier in support of markets. Controversy over the scope and propriety of market intervention started at least as early as the dispute over the First Bank congressional charter drafted in 1791 (and abandoned in 1811). The Federal Reserve was created in 1913. The War Finance Corporation, created in 1918, provided loans to support transition to a peacetime economy after World War I. The Reconstruction Finance Corporation, created in 1932, made loans to and equity injections in distressed banks, as well as railroads and mortgage associations. The Federal Home Loan Bank has been in business since 1932. The FDIC has served a bank depositor backstop function since 1933. Fannie Mae was created in 1938 to offer federal funds in support of the residential mortgage market, and was followed by the Government National Mortgage Association in 1968 and Freddie Mac in 1970. The Student Loan Marketing Association purchased its first student loan in 1975. The Pension Benefit Guaranty Corporation issued its first pension check in 1975.

Post-New Deal bail-outs of private actors ramped up in the 1970s. Government-funded Amtrak took over intercity rail passenger service from private operators in 1971,[11] and Conrail was created in 1974 to take over

11. Amtrak's genesis can be traced to the failure of The Penn Central Transportation Company in 1970. Penn Central filed for bankruptcy after Congress refused to provide financial assistance to the railroad to meet short-term commercial paper obligations. It was the largest corporate bankruptcy in U.S. history at the time of its filing, and was not unambiguously surpassed in size (measured by inflation-adjusted assets) by a corporate filer until Texaco filed for bankruptcy in 1987. For a discussion of the circumstances surrounding the Penn Central bankruptcy and its effects on commercial paper markets *see generally* Charles Calomiris, *Is the Discount Window Necessary? A Penn-Central*

the lines of multiple bankrupt freight carriers. Lockheed Aircraft Corporation was bailed out through the Emergency Loan Guarantee Act of 1971.[12] Chrysler Corporation did not file for bankruptcy in 1980 but instead received controversial federal loan guarantees explicitly conditioned upon significant concessions from creditors.[13] On the financial institution side, in 1974 Franklin National Bank received an unprecedented bail-out loan from the Federal Reserve in order to prevent systemic economic damage predicted to occur in a disorderly wind-down.[14] Continental Illinois National Bank and Trust Company failed in 1984 and remained the biggest bank failure in U.S. history until Washington Mutual failed in 2008. (In fact, the bail-out and resolution of Continental Illinois gave rise to the term "too big to fail.")[15] The savings and loan crisis that

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Perspective, (National Bureau of Econ. Research, Working Paper No. 4573, 1993) (arguing that the principal purpose of the discount window should be to provide temporary support to certain financial markets during localized financial crises) and STAFF OF THE SEC TO THE SPECIAL SUBCOMM. ON INVESTIGATIONS, THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY (Comm. Print 1972), https://fraser.stlouisfed.org/docs/historical/house/1972house_fincolpenncentral.pdf [https://perma.cc/WRP9-UFGP] (suggesting recommendations for the SEC to avoid financial crises brought on by large bankruptcy filings).

12. *See* 15 U.S.C. § 1841 (1971) (establishing an Emergency Loan Guarantee Board). The Act is titled as if it is a broad lending program but ended up a bespoke rescue package for Lockheed, which borrowed $245 million out of the $250 million facility. *See* ELMER B. STAATS, COMP. GEN., PSAD-78-66; B-169300, IMPLEMENTATION OF THE EMERGENCY LOAN GUARANTEE ACT (1978), http://gao.gov/assets/130/121251.pdf [https://perma.cc/HL8A-MQ8E] (describing Lockheed Martin as the only business to apply for a guaranteed loan under the Emergency Loan Guarantee Act of 1971).

13. *See* Chrysler Corporation Loan Guarantee Act of 1979. Pub. L. No. 96-185, 93 Stat. 1324 (1980) (detailing the federal loan guarantees the Chrysler Corporation received in 1980); *see also* JAMES M. BICKLEY, CONG. RESEARCH SERV., R40005, CHRYSLER CORPORATION LOAN GUARANTEE ACT OF 1979: BACKGROUND, PROVISIONS, AND COST (2008), http://digitalcommons.ilr.cornell.edu/key_workplace/569/ [https://perma.cc/K69S-U6NA] (providing information on the federal loan guarantees and creditor concessions).

14. *See generally* JOAN E. SPERO, THE FAILURE OF THE FRANKLIN NATIONAL BANK: CHALLENGE TO THE INTERNATIONAL BANKING SYSTEM (1980) (describing the perceived risks of failure of the Franklin National Bank); *see also* Press Release, Federal Reserve (Oct. 8, 1974), https://fraser.stlouisfed.org/docs/historical/burns/burns_19741008.pdf [https://perma.cc/344L-FDZU] (relating how the bail-out of Franklin National Bank was in the public interest). *See also* FED. DEPOSIT INS. CORP., https://www.fdic.gov/bank/analytical/firstfifty/chapter5.html [https://perma.cc/YM7W-A49Y] (last visited Sept. 28, 2016) for a description of the largest FDIC disbursements through 1983 (noting open bank assistance related to Commonwealth Bank of Detroit in 1972 and First Pennsylvania Bank in 1980; each bank was a relatively small institution on a national scale but had geographically concentrated operations that merited intervention based on public policy reasons).

15. *See generally* Hilary Foulkes, *The Federal Deposit Insurance Corporation: The Rescue of Continental Illinois National Bank and Trust Company*, 1985 ANN. SURVEY OF AM. L. 137, 152 (1985) (describing the panic fears that prompted the U.S. to bail out banks

began in the mid-1980's culminated with the failure and resolution of over 1,000 financial institutions.[16]

This context and history is important because investors who claim that the actions of the federal government in the recent financial crisis are *wholly* without precedent overstate their case. Plainly, government actors looked to historical precedent for guidance and generally attempted to check legal boxes when formulating their responses to the crisis. To deny at least some grounding in precedent opens the door to a government retort that complainants are either disingenuous or lack generational experience. Instead, the more legitimate critique is that the financial crisis marked a watershed because of changes in the characteristics of bailed-out companies and of government exercise of discretion. Investments in highly regulated or systemically important companies are suddenly and unexpectedly subject to unprecedented political risk.

A. *Recent bail-outs were of unprecedented size, scale and scope, leaving no private market alternative to government financing*

The sheer size of U.S. government commercial intervention during the recent crisis is staggering. JPMorgan Chase received a $30 billion credit line in support of its takeover of Bear Stearns. Fannie Mae and Freddie Mac cumulatively benefitted from extension of credit lines in excess of $450 billion. American International Group ("AIG") was bailed out twice by the Federal Reserve, to the collective tune of over $120 billion (against a $180 billion credit line). $700 billion was available to be doled out under

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that were too large to fail); *see also* Renee Haltom, *Failure of Continental Illinois*, FED. RES. HIST. (May 1984), http://www.federalreservehistory.org/Events/DetailView/47 [https://perma.cc/XTY5-59HJ]; Larry D. Wall, *Ending Too Big to Fail*; *see also Lessons from Continental Illinois*, FED. RES. BANK OF ATLANTA (Apr. 2016), https://www.frbatlanta.org/cenfis/publications/notesfromthevault/1604 [https://perma.cc/Y989-4WXZ] (exploring the possible effect the Dodd-Frank Act would have had on banks that are too big to fail). Legislative reaction to the bail-out of Continental Illinois and non-impairment of general creditors illustrates just how much history rhymes. Congress attempted to limit rescues of "too big to fail" banks by passing The Federal Deposit Insurance Corporation Improvement Act of 1991, Public Law 102-242 ("FDICIA"). The law limited FDIC discretion to protect bank creditors and limited the Federal Reserve's ability to lend to troubled banks. Compare this legislative reaction to Title II of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, 12 U.S.C. § 5381-5394 (2010) ("Dodd-Frank"), which similarly seeks to restrict government capacity to act in reaction to perceived government overreach in the recent financial crisis.

16. *See* FDIC DIV. OF RESEARCH AND STATISTICS, HISTORY OF THE EIGHTIES-LESSONS FOR THE FUTURE, CHAPTER 4, THE SAVINGS AND LOAN CRISIS AND ITS RELATIONSHIP TO BANKING (1997), https://www.fdic.gov/bank/historical/history/167_188.pdf [https://perma.cc/6JY9-6Y7Q] (providing an overview of this crisis and the resulting resolution).

the Troubled Asset Relief Program ("TARP"). That amount does not include the additional $25 billion in pre-TARP low-interest loans made to companies in the auto industry in 2008 under the Automotive Industry Financing Program. At peak, there was $1.7 trillion outstanding under the Federal Reserve's liquidity facilities, in addition to TARP, FDIC and Federal Reserve support programs. Across just TARP, FDIC and Federal Reserve support programs, Citigroup and Bank of America received federal bail-out support of $476 billion and $336 billion, respectively.[17]

Contrast the size of these financial crisis bail-outs to earlier interventions. In 1970, when Penn Central defaulted on approximately $100 million in money market obligations, the Federal Reserve provided emergency reserves to commercial banks to meet redemptions. In 2008 inflation-adjusted dollars the amount of injected capital was $3.2 billion, and the congressionally rejected bail-out of Penn Central itself would have cost less than $2 billion. Lockheed received $1.4 billion in 2008 inflation-adjusted dollars. The high-profile bail-out of Chrysler in 1980 was accomplished with $4 billion in 2008 inflation-adjusted dollars.[18]

The only comparable commercial interventions in recent times related to the Continental Illinois bank failure and cumulative bail-outs or liquidations during the savings and loan crisis. Continental Illinois benefitted from a $5.5 billion private standby credit line offered by a 24-bank consortium and a $500 million private subordinated rescue loan underwritten by seven banks, yet still had to borrow $3.55 billion from the Federal Reserve Bank of Chicago and $1.5 billion more from the FDIC.[19]

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17. *See generally* CONG. OVERSIGHT PANEL, 112ND CONG., THE FINAL REPORT OF THE CONGRESSIONAL OVERSIGHT PANEL (2011) (evaluating the impact of TARP and reviewing other government efforts in response to the financial crisis), https://www.gpo.gov/fdsys/pkg/CHRG-112shrg64832/pdf/CHRG-112shrg64832.pdf [https://perma.cc/SBA9-39HP]; FINANCIAL TURMOIL TIMELINE, FED. RESERVE BANK OF N.Y., https://www.newyorkfed.org/medialibrary/media/research/global_economy/Crisis_Timeline.pdf [https://perma.cc/7NQ4-U23M] (last visited Oct. 3, 2016) (documenting the amounts and timing of federal funding during the recent financial crisis).

18. There is a scene in the comedy spoof movie *Austin Powers: International Man of Mystery*, in which a malevolent yet bumbling villain named "Dr. Evil" evaluates blackmail schemes. Dr. Evil, after having been frozen for 30 years, sinisterly declares he will demand a ransom of "one million dollars." His henchmen politely point out that things have changed since the 1960's and that "a million dollars isn't exactly a lot of money these days." In retrospect, corporate bail-outs during the 1970's and 1980's can be viewed a lot like that scene – bail-outs were controversial and outsized at the time but are laughably small and isolated compared to bail-outs starting in 2008, even adjusted for inflation, wealth, and efficiencies in capital markets. AUSTIN POWERS: INTERNATIONAL MAN OF MYSTERY (1997).

19. *See* Haltom, *supra* note 21, (providing a history of the credit line offered to Continental Illinois); *see also* FDIC, MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE, PART II, CH. 4, www.fdic.gov/bank/historical/managing/history2-04.pdf [https://perma.cc/QKK6-2W27] (giving a broader overview of crisis management). The

Very controversially, the FDIC also lifted the $100,000 per account limit on deposit insurance and offered credit support to other general creditors, and as part of its permanent assistance package the FDIC committed to purchasing up to $4.5 billion in bad loans. In the end, though, the government bail-out package ended up costing the FDIC less than $2.7 billion in inflation-adjusted dollars. The S&L crisis also could be described as comparable in size, cumulatively costing taxpayers around $200 billion in 2008 inflation-adjusted dollars. In the S&L crisis, however, funds were applied over a decade and related to multiple financial institutions which were resolved using well-established rules and procedures.

B. *Investors do not expect that objections to government rescue financing terms and conditions will be successful*

Investor expectations about resolution processes and opportunities for negotiation materially differ between private and public rescue loans. In the private loan context, corporate resolution law and practice is designed to allow time for the debtor to evaluate alternatives and permit stakeholders to object to financing beyond the minimum necessary to stabilize the distressed patient or which is offered for an improper purpose. DIP loans typically are approved on an interim basis, in amounts less than finally requested, with periods of review and opportunities to object before final approval. Ideally, acceptance of proffered financing does not prejudice the debtor's ability to seek or take replacement financing. Absent contractual restrictions (such as a "silent" lender's inter-creditor agreement), stakeholders are free to highlight structural impediments to competition such as an objecting secured lender, or the lack of exigent circumstances, or the need for more time to raise funds, all in support of objection. Management may be indicted as biased or controlled, or simply as having endorsed a deficient solicitation process. And, although it is rare for a DIP loan to be rejected as an impermissible *sub rosa* plan of reorganization, judges are highly resistant to outcome-determinative DIP terms and often will seek to edit objectionable terms through suasion and foreshadowing.

Investor expectations are completely different when government is providing rescue financing. The major distinction is that the government conduct may be unreviewable or not remediable by explicit statute or on account of sovereign immunity.[20] Even assuming judicial review and relief

amounts are quoted in 1984-dollars. The supposition that disorderly liquidation of Continental Illinois risked a systemic crisis is, at a minimum, reasonable.

20. Courts routinely are divested of authority to restrain or affect actions taken by agencies pursuant to statute. *See, e.g.*, The Emergency Economic Stabilization Act of 2008

is available, however, investor perception is that it is highly unlikely courts will reject or modify proposed emergency financing coupled with a credible government claim that disapproval will lead to cascading industry distress, widespread loss of jobs, material economic disruption, or any similar national policy problem. Basically, there is little or no prospect that government DIP terms and conditions will change as a consequence of objection.

It would take a particularly stout judge to reject government financing even if objectors could show a high but less-than-certain probability that a successful going-concern restructuring or orderly liquidation of the enterprise could be accomplished without accepting funds. Companies that warrant government bail-outs are not likely to be allowed to liquidate in a disorderly manner. Government statements about exigent circumstances and intimated soundness of deliberations underlying the decision to intervene generally are not *ex ante* disprovable. Judges will find it difficult to credibly threaten to reject financing in order to adjust terms so long as the government loan looks like a private loan and does not trip any specific codified or common law trap.

Categorization of court objections illustrates why investors perceive that government DIP terms and conditions cannot be effectively opposed. The most basic investor objections alleging deal overreach are that post-petition enterprises are not being run for the benefit of those who hold claims or interests, and that distributions are compelled to be made in violation of absolute priorities because the government is using DIP

("EESA"), 12 U.S.C. § 5229(a) (2008) (referencing TARP); *see also* Dodd-Frank, 12 U.S.C. § 5382 (referencing judicial review of Orderly Liquidation); *see also* 12 U.S.C. § 1821(j) (referencing the anti-injunction provision in the FDIA); *see also* 12 U.S.C § 4617(f) (referencing the anti-injunction provision in the Housing and Economic Recovery Act ("HERA")). Indeed, the draft bail-out proposal that became EESA originally contained language that would have eliminated judicial review of agency actions altogether, although blanket immunity never made it into the final legislation. *See Text Draft Proposal for Bail-out Plan*, N.Y. TIMES (Sept. 21, 2008), http://www.nytimes.com/2008/09/21/business/21draftcnd.html?ref=business [https://perma.cc/M5P4-2WGC] (stating that "[d]ecisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency"). Also, stakeholders routinely are divested of derivative rights that otherwise could be the basis for standing to sue or to affect corporate governance. *See, e.g.*, FDIA, 12 U.S.C. § 1821(d)(2) (providing that a conservator and receiver succeed to all "rights, titles, powers and privileges of the failed institution and its directors, officers, and stockholders"); *see also* Dodd-Frank, 12 U.S.C. § 5390(a)(1) (explaining that the receiver shall succeed to "all rights, titles, powers, and privileges of the covered financial company and its assets, and of any stockholder, member, officer, or director of such company"). Often, judicial review of agency conduct is limited to determination of whether the Administrative Procedure Act, 5 U.S.C. Ch. 7, has been violated, or if there has been a Constitutional taking. *See infra* note 34.

conditions or contractual consultative rights (read: veto) to further a public purpose.[21] Legally, these objections go absolutely nowhere because a court inquiry about commercial conduct begins and ends with whether the acceptance of terms was obtained by impermissible coercion. A private DIP lender cannot be accused of coercion based on non-existent legislative, executive or administrative authority. Similarly, a government lender that claims to wear only a commercial hat and expressly disclaims a regulatory role – "hey, that's the other guy" – lacks authority and cannot be engaging in regulatory coercion.[22]

Commercial objections to government rescue financing and behavior tend to come in three flavors: (i) payment terms; (ii) stakeholder distribution; and (iii) lack of legal authority. All are permutations of objections to "regulation by deal."[23] Payment term objections include

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21. Government actors might credibly argue that they were required in the financial crisis to act commercially precisely because regulatory options were constrained. That argument is in the nature of a justification or an expression of well-intentioned opportunistic behavior. Government actors might also argue that the financial crisis was extraordinary and not precedential except in the case of a comparable systemic crisis. That argument will fall on deaf ears, unless regulatory options become more available and more attractive in the future. Coercive terms and opportunistic use of rescue loans will be assumed to be part of the playbook, unless restricted by statute, rule or regulation, or until there is evidence of another shift in culture.

22. In fact, there can be severe actual or perceived conflicts of interest between public actors and stakeholders over disposition of assets, assumption of liabilities, and corporate governance. For example, breaking contracts with counterparties may be genuinely accretive to the bankrupt estate but may be opposed by government actors because of cascading collateral damage to other companies. Similarly, a sale of company assets, the outsourcing of jobs, or other massive operational changes may increase recovery but not be seen as good for the nation. Actions that heighten market disruption might very well improve the chances of a successful going-concern restructuring, maximize distributable value, and/or be in the individual or collective interest of affected stakeholders. In a nutshell, the government may see stabilization and subsidization where a stakeholder sees wasting of assets and improper assumption of liabilities. To date, however, courts have reviewed the terms and conditions of government loans solely by examining commercial conduct and using a commercial coercion standard.

23. Much has been written about the increasingly active participation of government in corporate restructurings, evolving regulatory and economic roles, and investor perceptions of deal overreach. *See, e.g.*, Steven D. Solomon & David Zaring, *After the Deal: Fannie, Freddie and the Financial Crisis Aftermath*, 95 B.U. L. REV. 371 (2015) (discussing how regulation by deal circumvented established regulatory precedents through forced investments and transactions); *see also* Barry E. Adler, *A Reassessment of Bankruptcy Reorganization after Chrysler and General Motors*, 18 AM. BANKR. INST. L. REV. 305 (2010) (explaining ways in which courts may disadvantageously extend regulatory precedents set by the Chrysler and General Motors bankruptcies); *see also* Steven M. Davidoff & David Zaring, *supra* note 16, 61 ADMIN. L. REV. 463 (2009) (itemizing transactions encouraged or taken by the government in the recent financial crisis). It is beyond the scope of this article to recount the circumstances of each controversial bail-out or to opine on the fairness of any particular transaction or government action. With that

complaints that cost of funding is too high for the risk, deliberately confiscatory or punitive, or that the debtor recipient is not easily permitted to replace funding should better terms be available in the future.[24] Stakeholder distribution objections can arise because of explicit terms and conditions of rescue financing, or as a consequence of post-petition government interference in corporate governance. Distribution objections most directly include challenges to payment of plan value in conflict with corporate and capital structure priorities or government earmarking of consideration to a junior class not in accord with absolute priority. They also indirectly include arguments that distributable value is reduced because of sale of assets for less than full value or imprudent assumption of liabilities.

On paper, it appears that courts will entertain claims of deficient process and commercial overreach by assuming government actors can exercise the same rights and control as private actors. As it is common for courts to acquiesce to burdensome private loans in the absence of alternative financing, government payment and distribution terms inevitably are accepted, aside from tinkering with deadlines and notice provisions. Despite some high-profile disputes over valuation of collateral

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said, it is a useful construct also to categorize government interventions based on the type of government support and the nature of potential investor objections. "Open" transactions in the absence of formal restructuring, where the government arranges acquisitions of private parties or provides capital support to private parties in support of acquisitions (*e.g.*, Wachovia Corp., Merrill Lynch, Bear Stearns, Long-Term Capital Management), present issues of voluntariness, valuation, and unfair discrimination among stakeholders. Pre-restructuring capital injections (*e.g.*, TARP) raise the same issues, along with concerns over pricing and repayment terms and explicit or implicit regulatory interference in corporate governance. FDIC intervention (*e.g.*, Washington Mutual Bank) comes with the risk that the agency will sell assets for less than reasonably equivalent value or wind-down the enterprise in a way that unduly prioritizes banking stability over financial creditor recovery. DIP or post-petition acquisition loans (*e.g.*, Chrysler Group LLC, General Motors Co., Delphi Corp.) squarely pose questions about voluntariness, valuation and corporate governance, and whether loans can be conditioned to effect unfair discrimination or earmarks. Finally, the eight-years-and-counting professed conservatorships of Fannie Mae and Freddie Mac raise issues of government conflict of interest and self-dealing in amending the terms and conditions of rescue financing, regulatory interference in corporate governance, and strategic avoidance of judicial review.

24. For example, testimony of government officials confirms that rescue financing packages provided to each of AIG, Fannie Mae and Freddie Mac deliberately were priced to be punitive and confiscatory. For a summary of testimony about the allegedly punitive terms, *see* Plaintiffs' Corrected Post-Trial Proposed Findings of Fact, *Starr Int'l Co. v. United States* (Mar. 2, 2015), Case 1:11-cv-00779, Document 430 at 225-229. Testimony from former U.S. Treasury Secretary Geithner about the financial terms exacted is clear: "[W]e forced losses on shareholders proportionate to the mistakes of the firm. And we made it clear in the GSEs and AIG that they would be dismembered, not allowed to live on as independent entities with the scope and reach they had before the crisis." *Id.* at 226.

or gifting of value, stakeholders have not had meaningful success in adjusting explicit contractual terms that mandate sale of assets, assumption of liabilities, or a particular distribution of value.[25] Beyond clearing a "best interests" hurdle and preserving liens on proceeds of asset sales,[26] there is little expectation among investors that a bankruptcy court would disapprove explicit outcome-determinative financing conditions in a government rescue loan.

In contrast, the third type of challenge – allegations that executive and independent agencies exceeded statutory authority to act – has been more successful. Unfortunately, if it is posited that authority is properly delegated to an agency and that agency does not act in derogation of a specific mandate,[27] the statutory objection does not actually reach the

25. One example of a successful objection to government-arranged financing relates to the bankruptcy of Delphi Corporation. In 2009, the debtor, General Motors and the Treasury's auto task force arranged funding for a private equity firm to purchase the debtor's assets, facilitating an "open" exit-financing transaction. The secured senior creditors in that case successfully argued that the preferred private equity firm was receiving a sweetheart deal and that the sale process should be competitive and open. Eventually, secured creditors were able to credit-bid for the assets. Here, the exception proves the rule. Although Delphi plainly was distressed when it filed for bankruptcy in 2005, the amount of needed DIP financing was contextually small (approximately $4 billion) and was privately raised in relatively healthy credit markets. By 2009, Delphi had survived a four-year bankruptcy process, implicitly negating claims of exigent circumstances, and cancellation of indebtedness allowed the raising of sufficient liquidity to maintain operations. Even so, salaried retirees who were excluded from an implicit government bail-out of other pensioners brought unsuccessful complaints about discriminatory treatment. *In re* Delphi Corp., No. 05-44481(RDD), 2009 WL 2482146 (Bankr. S.D.N.Y. July 30, 2009); *see also The Delphi Pension Bail-out: Unequal Treatment of Retirees*, Comm. on Oversight & Government Reform, 113th Cong. 1 (2013), https://www.gpo.gov/fdsys/pkg/CHRG-113hhrg81743/html/CHRG-113hhrg81743.htm [https://perma.cc/WW2S-GRWV] (hearing whether certain classes of holders of claims or interests had been discriminated against during bail-out proceedings.)

26. The only practical obstacles to bankruptcy court approval are that plan distributions must be at least equal to the amount that the objecting stakeholder would have received in a hypothetical liquidation, as estimated by the court, and that secured lenders are not involuntarily divested of property rights without compensation in the form of continuing liens and cash payments, liens on sale proceeds, or realization by such holders of the indubitable equivalent of such claims. Bankr., 11 U.S.C. §§ 1129(a)(7), (b)(2)(A) (2012). The ability of secured lenders to prevent a below-market sale of assets, to challenge the court's estimate of collateral value, or to challenge gifting is at issue in many restructurings, and was particularly at issue in the bankruptcies of Chrysler and General Motors. *See* David A. Skeel Jr., *From Chrysler and General Motors to Detroit*, 24 WIDENER L.J. 121 (2015) (discussing how transactions engineered for Chrysler's and General Motors' bankruptcies affected the outcome of Detroit's municipal bankruptcy).

27. Under the non-delegation doctrine courts will consider whether there is valid enabling legislation that offers an "intelligible principle" to limit broad agency authority, a requirement that has been violated very rarely. *See* Whitman v. Am. Trucking Ass'n, 531 U.S. 457, 474–75 (2001) (giving only two examples of when the Court has found that a

merits of discretionary agency actions. Instead, loan terms and conditions set by agency discretion will be reviewed under the highly deferential "arbitrary and capricious" standard.[28] In addition, assuming justiciability and a viable claim for exceeding statutory authority, court review and relief for investors may be limited by statute, and if available may take too long to meet some investment horizons or be too expensive to obtain.[29] At best,

statute lacks an intelligible principle). There is a stronger argument that the non-delegation doctrine operates as a canon of statutory construction and to constrain an agency to act in a manner that compares the costs and benefits of regulation. *See generally* C. Boyden Gray, *The Nondelegation Canon's Neglected History and Underestimated Legacy*, 22 GEO. MASON L. REV. 619 (2015) (stating that although the non-delegation doctrine is no longer used to completely strike down statutes, it may be used as a canon of statutory construction). It is interesting to consider whether overreaching commercial (and not facially regulatory) activity could be constrained by the application of the non-delegation doctrine. For example, could a court find that imposition of punitive terms and conditions, or adjusting priorities of distribution, are legislative functions and therefore limit agencies to "normal" commercial lending relationships, to avoid constitutional problems? *Cf.* Nat'l Cable Television Ass'n v. United States, 415 U.S. 336 (1974) (limiting the definition of "fees" that can be collected by the Federal Communications Commission to exclude fees on account of benefits to the public at large); Ass'n of Am. R.Rs. v. Dep't of Transp., 721 F.3d 666 (D.C. Cir. 2013) (holding that delegation of legislative function to a private party is per se unconstitutional), *vacated and remanded on other grounds*, 135 S. Ct. 1225 (2015) (holding that Amtrak is a governmental entity). A governmental entity that acts as a market participant but with a non-commercial purpose has some attributes of a governmental entity and some attributes of a private party. Regardless, it is hard to imagine any investor relying on the non-delegation doctrine as a serious control against commercial overreach.

28. The APA confers basic authority for courts to review agency actions in the absence of legislation specifically divesting that authority. *See* 5 U.S.C. § 706 (stating that a "reviewing court shall . . . hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."); *see also* Citizens to Preserve Overton Park. v. Volpe, 401 U.S. 402, 415 (1971) (holding that even if agency actions are entitled to a presumption of regularity, "the generally applicable standards of § 706 require the reviewing court to engage in substantial inquiry"). However, the standard of review is extremely deferential, requiring only that the agency articulates a "rational connection between the facts found and the choice made" and that the court examine "whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." Motor Vehicle Mfr. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983). *See also* Auer v. Robbins, 519 U.S. 452 (1997) (permitting deference to agency interpretation of its own regulations unless plainly erroneous or inconsistent); Perez v. Mortgage Bankers Ass'n, 135 S. Ct. 1199, 1212 (2015) (Scalia, J., concurring) (stating that "[s]o long as the agency does not stray beyond the ambiguity in the text being interpreted, deference *compels* the reviewing court to 'decide' that the text means what the agency says") (emphasis in original); *cf.* Chevron U.S.A. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 844 (1984) (explaining that when considering an express delegation of authority to an agency, "legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute").

29. From an investor's viewpoint, challenging an agency decision is an uphill battle. There may be a sufficient and articulated rational basis for an agency decision even if the

court review is slow and uncertain, and at worst, unavailable or pyrrhic.[30]

C. *Going forward*

The legislative response to the financial crisis included significant restrictions on government bail-outs. Among other things, the FDIC no longer can use a systemic risk exception to broadly guarantee banks or bank holding companies not in resolution,[31] and section 13(3) loans by the

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agency also acted for a transparently improper purpose. Even when an agency decision plainly is unsupportable, overturning that decision can take money, time, and expertise. There is a subset of investors who specialize in wagering on legal disputes, either directly through litigation or derivatively through an affected company. In general, these distressed or special-situation investors are better equipped and more willing than regular-way investors to analyze and prosecute lengthy and complicated disputes, and to take affirmative actions to enhance idiosyncratic return on investment. However, required return on invested capital for these investors typically is higher than for regular-way investors. Accordingly, existing investments often reprice lower when a company becomes distressed, whether new money actually is raised. For a brief discussion about why distressed investment opportunities exist and the different skill sets of distressed investors, *see* Stephen G. Moyer et al., *A Primer on Distressed Investing: Buying Companies by Acquiring Their Debt*, 24 JOURNAL OF APPLIED CORP. FIN., 73-75 (2012). Two excellent introductory texts that explore distressed investing and markets in more detail are STEPHEN G. MOYER, DISTRESSED DEBT ANALYSIS: STRATEGIES FOR SPECULATIVE INVESTORS (2005) and STUART C. GILSON, CREATING VALUE THROUGH CORPORATE RESTRUCTURING: CASE STUDIES IN BANKRUPTCIES, BUYOUTS, AND BREAKUPS (2001).

30. Appeals are still pending, but it is hard to envision a more pyrrhic victory than the challenge to the bail-out terms for AIG, in which plaintiffs won on the issue of illegal exaction but received nothing in damages. *See* Starr Int'l Co. v. United States, 121 Fed. Cl. 428, 436 (2015) (ruling that the Federal Reserve exceeded statutory authority when it injected capital into AIG but not awarding damages). There also are multiple pending challenges related to amendments to the terms of the rescue financing facility provided to Fannie Mae and Freddie Mac. *See generally* Richard A. Epstein, *The Government Takeover of Fannie Mae and Freddie Mac: Upending Capital Markets with Lax Business and Constitutional Standards*, 10 N.Y.U. J.L. & BUS. 379 (2014) (describing the lawsuits alleging that the government shed its obligation to junior preferred and common shareholders of Fannie Mae and Freddie Mac); *see also Significant Lawsuits Concerning Fannie Mae & Freddy Mac Net Worth Sweep* (2016), http://bankrupt.com/gselitigationsummary201608.pdf [https://perma.cc/AVX2-5F7M] (listing significant lawsuits concerning the Net Worth Sweep and highlighting that over three years have passed since the first lawsuits were filed, with none yet reaching the merits of government conduct). Courts may also abstain altogether from deciding disputes. The Delaware state courts abstained from deciding whether the Bear Stearns share exchange agreement was invalid under Delaware law on what were essentially comity grounds. *In re* Bear Stearns Cos., Inc. S'holder Litig., No. 3643-VCP, 2008 Del. Ch. LEXIS 46, at *3 (Del. Ch. Apr. 9, 2008).

31. Dodd-Frank Act, 12 U.S.C. § 5613(a) (2010) (stating that the FDIC "may not exercise its authority under section 1823(c)(4)(G)(i) of this title to establish any widely available debt guarantee program for which section 5612 of this title would provide authority").

Federal Reserve cannot be made to insolvent institutions and are limited to programs of broad-based eligibility.[32] Systemically important non-bank financial institutions are now resolved under the Orderly Liquidation Authority set forth in Title II of the Dodd-Frank Act, to avoid another Lehman-type failure or AIG-type bail-out. Broadly, this legislation and related regulation seeks to "bail-in" existing creditors by converting debt to equity (or extinguishing obligations) such that the resolved enterprise is solvent and has reasonable capital to engage in future business. In theory, bail-in reduces the chance that the government will be forced to lend to an insolvent enterprise.

The gating question is whether the untested orderly liquidation path will be followed at all. There are powerful incentives for regulators to intervene creatively to avoid receivership, or to find unusual circumstances that justify exceptions to prescribed procedure. The receivership remedy embedded in Dodd-Frank is draconian and essentially irreversible, and unanticipated problems or implementation errors carry severe consequences. In the end, orderly liquidation may be a nuclear option rarely used and circumvented in most crises by creative bail-outs or forced deal-making.[33] It may be unpalatable to provide liquidity only to

32. Federal Reserve Act, 12 U.S.C. §§ 343(3)(A), (B)(ii).

33. The risk that Title II still allows for back-door bail-outs has been highlighted by government officials. *See* Charles Plosser, President, Fed. Reserve Bank of Phila., Address at the Fourth Annual Simon N.Y.C. Conference Reform at a Crossroads: Economic Transformation in the Year Ahead (May 9, 2013) (transcript available at https://www.philadelphiafed.org/publications/speeches/plosser/2013/05-09-13_can-we-end-too-big-to-fail [https://perma.cc/JM7J-V5F4]) (arguing that "Title II resolution is likely to be biased toward bail-outs," because of the "wide range of discretionary powers" granted to the FDIC and the likely "excessive delay" in implementing the receivership procedure); *see also* Jeffrey Lacker, President, Fed. Reserve Bank of Richmond, Address at Council on Foreign Relations: Ending 'Too Big to Fail' Is Going to Be Hard Work (Apr. 9, 2013) (transcript available at https://www.richmondfed.org/press_room/speeches/president_jeff_lacker/2013/lacker_speech_20130509 [https://perma.cc/Y3YL-N2Q4]) (arguing that the FDIC's considerable regulatory discretion under Title II could encourage creditors to believe they may continue to receive protection from losses). There may be more direct ways to avoid or circumvent orderly liquidation, such as subsequent congressional authority to lend, acquiescence to creative lending by Treasury, or intentional refusal by government officials to seek appointment of the FDIC as receiver. Specific restrictions on Federal Reserve lending could be circumvented by ambiguity or delay in determination of insolvency or by defining a broad-based program in such a way that eligibility is widespread but application is narrow. Note also that in 2015, the Federal Reserve approved a final rule specifying procedures for emergency lending under section 13(3). The rule contemplates a penalty interest rate that in theory can be set by auction but ultimately is left to the discretion of the Federal Reserve Board. 12 C.F.R. § 201.51 (2015); *see also* Press Release, Bd. of Governors of the Fed. Reserve Sys. (Nov. 30, 2015), http://www.federalreserve.gov/newsevents/press/bcreg/20151130a.htm [https://perma.cc/6UDC-P4SQ] (providing a description of the final rule). Similarly, with

companies that are solvent and have sufficient collateral to fully secure the loan. To the extent the government provides rescue financing outside of orderly liquidation, investors face risk that the terms and conditions of that financing will be *ad hoc*. To the extent investors believe orderly liquidation is too inflexible to be implemented, the government has not addressed moral hazard and adverse selection.

The second question is whether there are any effective constraints on the terms and conditions of liquidity-based government lending under orderly liquidation (or alternatives such as proposed Chapter 14 to the Bankruptcy Code).[34] Other than a few specific limitations, such as a prohibition on the FDIC taking an equity interest in a covered financial company,[35] there is little to stop the government from setting onerous terms and conditions for rescue funding since there is no requirement that lending terms be tied to risk of repayment. Although the Orderly Liquidation Fund can borrow funds at a corporate index spread over treasuries,[36] there is no restriction on the terms or conditions of loans made to the covered company, or more likely, on the terms or conditions for assuming or guaranteeing the obligations of the covered company.[37] There are few constraints on how the FDIC funds a bridge corporation or purchaser in an open transaction, leaving stakeholders vulnerable to under-market disposition of assets or objectionable retention of liabilities.[38] To the contrary, legislation and regulatory guidance is strongly biased in favor of

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respect to banks, the FDIC still can invoke a systemic risk exception to provide assistance to creditors of a bank in resolution. It is not hard to envision a "pre-packaged" resolution coupled with targeted bridge bank assistance that avoids receivership of a bank holding company.

34. *See generally* Financial Institution Bankruptcy Act of 2014, H.R. 5421, 113th Cong. (2014) (proposing to amend Title 11 of the United States Code to facilitate the resolution of a "covered financial corporation" in bankruptcy); 160 CONG. REC. H8174-81 (daily ed. Dec. 1, 2014) (statement of Rep. Goodlatte), 160 CONG. REC. 144, at https://www.congress.gov/congressional-record/2014/12/01/house-section/article/H8174-4 [https://perma.cc/NFW9-W84L] (describing the rationale and testimony in support of the House Bill); ANDREW CROCKETT ET AL., BANKRUPTCY NOT BAIL-OUT: A SPECIAL CHAPTER 14 (WORKING GROUP ON ECONOMIC POLICY) (Kenneth E. Scott & John B. Taylor eds., Hoover Institution Press) (2012) (containing multiple articles relating to modification of established bankruptcy process to address government bail-outs and systemic corporate failures).

35. Dodd-Frank Act, 12 U.S.C. § 5386(6) (2010).

36. *Id*. at § 5390(n)(5)(C).

37. *Id*. at § 5384(d). Government support is likely to take the form of assumptions and guarantees rather than direct loans, other than emergency support to stabilize the covered company. That is because the maximum obligation limitation set forth in 12 U.S.C. § 5390(m)(6) is less likely to be reached through cumulated expected losses than by dollar-for-dollar funding.

38. Dodd-Frank Act, 12 U.S.C. §§ 5381–5394 (2010).

protection of the taxpayer and least cost resolution of the covered company.[39]

The third question is whether subsidiaries deliberately not placed in receivership under the adopted single point of entry ("SPOE") strategy will need government funding.[40] Simplified, the SPOE strategy envisions that covered controlled groups will be organized so that all operations are conducted by subsidiaries under an umbrella financial-holding company. Each holding company ideally will issue long-term, third-party debt (*i.e.*, incur obligations in a broad market where default is presumed not to pose systemic risk) in an amount greater than expected consolidated losses for its controlled group. The basic construct of Dodd-Frank is that the FDIC, as receiver, steps into the shoes of prior management and the board of directors, and liquidates the covered holding company in an orderly fashion. Operating subsidiaries are transferred to a bridge holding company and continue doing business in the ordinary course. In exchange for the operating subsidiaries' assets and transfer of other assets, the old holding company receives equity in the new bridge holding company. Existing holding company debt and liabilities not assumed by the bridge

39. The FDIC as receiver also will have unprecedented discretion as to how creditors are treated in resolution, including the ability to treat similarly situated creditors dissimilarly. *See* 12 U.S.C. § 5390 (b)(4), (d)(4), (h)(5)(E). *But see* Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614, 76622 (proposed Dec. 18, 2013) (requesting comments and noting that "[t]he FDIC has stated that it would not exercise its discretion to treat similarly situated creditors differently in a manner that would result in preferential treatment to holders of long-term senior debt (defined as unsecured debt with a term of longer than one year), subordinated debt, or equity holders"); 12 C.F.R. § 380.27 (indicating treatment of certain similarly situated claimants should not be preferential). This caveat still leaves the FDIC wide discretion to favor short-term creditors, operating creditors, many financial counterparties, and labor. Perhaps the most expansive provision allowing for preferential treatment of creditors is 12 U.S.C. § 5390(d)(4)(A)(1)(D)(i), which allows "additional payments or credit[s] additional amounts to or with respect to or for the account of any claimant or category of claimants of the covered financial company, if the Corporation determines that such payments or credits are necessary or appropriate to minimize losses to the Corporation as receiver from the orderly liquidation of the covered financial company under this section." One wonders whether this critical-vendor-on-steroids provision ironically could be used to prefer systemically important claimants over ordinary counterparties and small businesses, on the grounds that failure to transfer value would cause cascading disruption.

40. *See* Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614, 76622 (proposed Dec. 18, 2013) (containing the FDIC's description of the SPOE strategy), and comments received, *available at* https://www.fdic.gov/regulations/laws/federal/2013/2013-single-point-entry.html [https://perma.cc/NP4L-JCX8]. The SPOE concept is most often discussed in the context of Dodd-Frank, but equally could apply to resolution under proposed Chapter 14 of the Bankruptcy Code, or other resolution regimes.

holding company are subject to compromise. The operating subsidiaries and the new bridge holding company are solvent, in theory.

Positing solvency does not mean either the bridge holding company or operating subsidiaries have sufficient liquidity to support operations. There is no reason to presume that subsidiary creditors will roll short-term debt, that counterparties will revert to typical payment terms, or that operating cash flow will normalize while the holding company is in receivership.[41] Indeed, the opposite may be true. As in a bankruptcy, SPOE subsidiaries suffer funding infirmities such as investor differentiation and discontinuity of capital, asymmetric information and control, and lack of separation between subsidiaries and parent. There is also a risk that, prior to receivership, obligations ordinarily incurred by the parent holding company were shifted to subsidiaries. Not only is this a moral hazard problem, but it may mean that subsidiary creditors will be particularly sensitive to any risk of illiquidity or lack of government support for subsidiaries. And, even if the SPOE construct makes it more likely that subsidiaries are solvent, whether the subsidiaries are insolvent or only illiquid may itself depend on the degree of government support.

Pointedly, the subsidiaries of the covered holding company are not placed in receivership under SPOE. Those subsidiaries generally are eligible to borrow as normal companies under existing government lending programs or undefined future government lending programs. Investors perceive substantial risk that subsidiaries would be forced to accept or would acquiesce to noncommercial lending terms and conditions.[42] In addition, to the extent a government agency provides financing, either directly or through the covered holding company, there is no requirement that loan terms and conditions differentiate between holding companies and subsidiaries, or among subsidiaries. How these subsidiary loan facilities are priced and conditioned, how they are exited, and how corporate

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41. *See* John Crawford, *The Moral Hazard Paradox of Financial Safety Nets*, 25 CORNELL J.L. & PUB. POL'Y 95, 122 (2015) ("A recapitalized SIFI in Title II may, however, face a liquidity crunch even if it is fundamentally solvent. The short-term creditors of its operating subsidiaries may (out of an abundance of caution due to the opacity of the SIFI's true value) refuse to roll over their loans, and the SIFI may not have enough cash and liquid securities to pay them all back."). Creditors and counterparties might be more likely to roll debt, extend credit, and purchase product if the terms of the government's liquidity facility were predictable, transparent, and purely commercial in nature.

42. Under Dodd-Frank, the FDIC has replaced management at the holding company. There is no guarantee that subsidiaries will have functioning independent management, and in any event subsidiaries operate under omnipresent threat of receivership and regulatory action. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5384(c)(3) (2010) (providing for consultation between the receiver and regulators); 12 U.S.C. § 5390(a)(1)(E) (providing for receivership of failing subsidiaries). Essentially, there may not be a fiduciary accountable to existing subsidiary stakeholders.

governance is managed in the interim, all affect the cost of capital at the operating subsidiaries,[43] and particularly at the residual-value holding company that initially issued bail-in debt.

Prospective investors are very concerned about how the FDIC will exercise orderly liquidation authority under Title II of The Dodd-Frank Act, or how a different authority or agency will act. The basic issue is whether the exercise of agency discretion can be predicted. Superficially, it is understandable for Congress to delegate resolution authority to agencies in a manner similar to delegation of bank resolution authority under the FDIA. However, there is no precedent for how the FDIC will act in its capacity as Title II resolution authority, nor is there transparent guidance about how the Treasury, the Federal Reserve, or any other authority will set terms and conditions of prospective rescue loans in the next crisis.

II. PRIVATE INVESTOR PERSPECTIVE ON PREDICTABILITY AND CERTAINTY OF PROCESS

Investors are path-dependent, and they allocate capital based on past practice, formal rules, and informal rules and standards.[44] *Ad hoc* or *post hoc* alteration of rights and expectations is incredibly damaging to investor confidence – there is little objective about green meaning "go" and red meaning "stop" but the rule would never be switched while driving. Indeed, within reason, investors who do not know in what part of the capital structure the next investment will be made should prefer predictability of process over substantive outcome, to reduce dead-weight loss. Predictability is so valuable that sometimes an investment will trade up, not down, on news of a larger-than-expected penalty or fine because the gain in certainty is worth more than the extra realized loss.

A substantively poor rule may result in risk allocations and costs of capital that are suboptimal for individual companies or national interests.

43. Since the SPOE strategy presumes solvency at the subsidiary level, government lending to the controlled subsidiary group should be viewed as providing liquidity and not addressing balance-sheet insolvency. Accordingly, there is a strong intellectual argument that a secured subsidiary liquidity facility should be relatively low-cost and transparent, with a predictable moral hazard premium and otherwise plain-vanilla terms, analogous to practice at the Federal Reserve Discount Window.

44. Not all ambiguities need be resolved for informal practices and procedures to provide a measure of predictability for investors. For example, the term "indubitable equivalent" has been tossed around in bankruptcy case law since 1935 and is expressly incorporated in Section 1129 of the Bankruptcy Code. Although the term has meaning only as applied, general agreement among practitioners about what the term should mean reduces uncertainty of outcome to marginal disputes.

The individual investor, however, will adjust the price paid for an investment until required return on invested capital is met, within reason. For example, an investor may lend money in the U.S. and in France to materially similar companies but at dissimilar rates that reflect differing priority of labor claims in bankruptcy. Similarly, state law contractual priorities of distribution can be changed or even reversed through application of the Bankruptcy Code (*e.g.*, elevation of unsecured claims into administrative claims, disallowance or limitation of otherwise enforceable claims, conversion of non-recourse claims into recourse, nonconsensual priming liens, etc.), but these exceptions are explicit, predictable, and can be priced. The baseline expectation of investors is that net asset value will be distributed or deemed distributed in order of non-insolvency capital priority. The government is free to make exceptions to this rule of general application, but such exceptions need to be predictable and applied consistently to be accepted by investors.

A. *Government signaling during the recent financial crisis indicates greater willingness to impair private capital, and less willingness to distinguish illiquidity from balance-sheet insolvency*

For heavily regulated industries the political pendulum seems to be swinging more towards heightened regulation and protecting the taxpayer, and against private investor recovery. Investors are concerned that the government deliberately will "bail-in" more of a capital structure than necessary for rehabilitation, both to show that private capital shares the risk of business failure and to avoid perception of a windfall arising from government intervention. Many would argue there should be no complaining by stakeholders unless and until recovery is lower than if the government had not provided aid. The unstated (and sometimes stated) justification is that existing stakeholders have diminished entitlement to value created by explicit and implicit government support and bail-out. The corollary view is that because the government created value in excess of theoretical recoveries in a disorderly liquidation it may place any conditions upon distribution of that excess value.

Re-characterizing "but for" recovery as a windfall that can be re-allocated by the government is an especially pernicious position to take because it is logically wrong and because it proves too much. "But for" deposit insurance, many banks would be insolvent. Many highly regulated companies such as insurance companies and utilities could not survive "but for" regulatory tolerance and market protection. Patent-holders would not have value "but for" government enforcement of intellectual property rights. At the most basic level, "but for" pre-petition private capital, there

would not be an enterprise to bail out.[45]

No reasonable restructuring practitioner would expect to win an argument that a private rescue lender equitably is entitled to *all* excess value simply because that excess value would not exist "but for" the rescue financing. There is no absolute or controlling principle for determining how distributions in excess of disorderly liquidation should be shared between rescue financiers and existing stakeholders, and the value of a loan typically is viewed from the perspective of the debtor's estate, not that of the lender. Basically, injection of public capital by a reluctant lender of last resort is an extraordinary political event but is not a special case.

Private capital investors in rescued businesses never have enjoyed public sympathy. Even so, investor perception is that during the recent financial crisis government rescues were deliberately structured to designate "winners" and "losers" in a way not pervasive in the 1970s and 80s. To some, the government purposefully adjusted private capital recoveries or interfered in corporate governance to favor particular parties at the expense of others.[46] More generally, government action in the 2008

45. Putting aside that there is no objective way to allocate value among multiple "but for" creators of value, it can be recognized that the government has the power to create value, or through inaction to destroy value, without inferring a corresponding right to condition distribution of that value. There are many examples where government action need not be taken, but, if taken, cannot be conditioned in an unfettered manner. Few would support the proposition that just because the government acts as an employer it may condition employment on waiver of First Amendment rights. *See* Keyishian v. Bd. of Regents of Univ. of State of N.Y., 385 U.S. 589, 606 (1967) (stating that "[t]he theory that public employment which may be denied altogether may be subjected to any conditions, regardless of how unreasonable, has been uniformly rejected"). Similarly, although conditions placed on discretionary federal spending power are rarely invalidated, appropriations also are subject to "unconstitutional conditions" analysis. In many ways, analysis of "regulation by deal" is just a lower-stakes (*i.e.*, not constitutional, but policy) version of well-recognized unconstitutional conditions analysis. *See* Richard Epstein, *Foreword: Unconstitutional Conditions, State Power, and the Limits of Consent*, 102 HARV. L. REV. 4, 7 (1988) (noting that "[t]he problem of unconstitutional conditions arises whenever a government seeks to achieve its desired result by obtaining bargained-for *consent* of the party whose conduct is to be restricted") (emphasis in original).

46. It is important to distinguish between intent to advance a policy or political goal by redistributing value in favor of a favored creditor class and intent to impair recoveries of disfavored creditors for a political purpose. New York and Washington, D.C. may be on the same coast but often speak a different language, and government actors need to be careful not to create unintended perception that harm to any good-faith investor is purposeful and not incidental. Very little scares away capital faster than undermining foundational principles of state corporations law and markets that similarly-situated investors are entitled to equal treatment and application of the rule of law. Nor should offsetting biases be confused with the absence of biases. It is cold comfort to an injured investor that some other investor is reaping corresponding rewards. In addition to attempting to improve substantive outcomes, the prescriptions in Section IV, *infra*, are intended to lessen the appearance of bias and impropriety.

crisis tended to be *ad hoc* and results-oriented, and did not always conform to investors' baseline expectation that rules of general application should dictate which parties prevail and which lose.

Moreover, the government's understandable aversion to bail-out of private investors appears to have metastasized into a rejection of positive aspects of its role as liquidity provider of last resort. The government is not signaling how it intends to differentiate terms and conditions of loans made on account of illiquidity and loans made on account of balance-sheet insolvency. Instead, the government is signaling that the failure of a too-big-to-fail corporate group is unacceptable. Consider two companies in the abstract. The first is wildly solvent, with the value of illiquid assets greatly exceeding near-term liabilities. The second is wildly insolvent, with long-term liabilities greatly exceeding asset value. Both companies may fail, and each may need to borrow the same amount in order to restructure. The underlying cause of failure of the first company is duration mismatch of assets and liabilities, and capital structure will be maintained through the restructuring in the ordinary course. The underlying failure of the second company is balance-sheet insolvency and/or under-capitalization. Not only will residual stakeholders expect to be impaired in the restructuring, but the cost of rescue financing is likely to be much greater than for the first company.

When the government acts as a lender of last resort, it, too, needs to distinguish between liquidity and balance-sheet solvency in order to support markets and investor expectations. The goal should be to make government financing distasteful enough to send a message to potential borrowers that such lending should be regarded only as a last resort,[47] but not so oppressive that private markets shy away from providing capital based on risks of value destruction or being primed as a result of government intervention. This balancing act requires price differentiation based on the risk of default and recovery, ranging from a plainly covered liquidity facility to a loan made to a net asset insolvent entity highly unlikely to repay.

When the government fails to give guidance about how it intends to differentiate terms and conditions of rescue loans – and particularly when it fails to make assurances that state corporation law priorities of distribution and security interests will be respected – investors are left with few options other than to overlay a costly sovereign risk component to corporate

47. To avoid moral hazard, there is a well-understood and accepted policy that terms of government rescue loans should be less advantageous than private capital. *See* WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 197 (London: Henry S. King & Co. 1873) (articulating that lender-of-last-resort "loans should only be made at a very high rate of interest," commonly referred to as a penalty rate).

recovery analysis. This assessment of sovereign risk premium increases borrowing expenses for all systemically important or highly regulated companies, and materially increases borrowing expenses for stressed companies most in need of financing. Without predictable rules, standards, and practices to restrict government actors, capital is more expensive, and at some point prohibitively so.[48]

B. *Uncertainty also limits government flexibility to act*

The most obvious cost of ambiguity is increased risk that the to-be-rescued entity will fail and need to be bailed out. Lack of predictable terms and conditions of post-failure government intervention, coupled with opacity of agency processes, discourages formation of private capital. By increasing the risk to private investors who inject pre-failure capital, the government actually decreases the probability that much smaller amounts of private capital, timely injected, would have prevented failure in the first place.

There can be a massive multiplier effect when a distressed but not-yet-failed company receives an infusion of liquidity or capital. Consider a bank in the throes of a bank run, the archetypal emergency borrower. Relatively small (as measured against the bank's actual and contingent liabilities) injections of liquidity may kick the can until the risk of failure abates. Relatively small injections of capital, whether by new money or conversion of debt-like instruments into equity, might entice the bank's counterparties to reevaluate credit risk. Similarly, in the corporate arena, liquidity can allow a balance-sheet insolvent company to survive an exogenous shock, and at least postpone failure. Even for an insolvent company, small improvements in ability to pay and modest indications of market confidence, as a consequence of new capital, can start a virtuous cycle of working capital normalization and business stability. Uncertainty about the cost of government lending and treatment of existing private

48. The other distortive effect of failure to differentiate is that at-risk enterprises will hold more liquidity than may be optimal. For example, a small company that can access bankruptcy and private capital markets optimally might hold enough liquidity to avoid restructuring with 95% confidence. The consequence of being wrong is a predictable restructuring that respects corporate structure and capital structure priorities. On the other hand, the systemically important institution that cannot access private markets faces a binary choice: avoid restructuring entirely or risk an unpredictable process with respect to both value and distribution of value. Fear of the unknown may cause that institution to hold enough liquidity to avoid restructuring with 99%+ confidence. Reducing the incidence of business failure by deliberately forcing companies to raise and hold perfect-storm liquidity comes at a steep cost, especially if creditors cannot rely solely on credit-risk analysis to determine out how much more to charge for junior debt than senior debt.

capital makes it more difficult to attract new private capital to prevent failure, potentially in lieu of post-failure government funding.

The other problem is that *ad hoc* policies make it very difficult for the government to provide clear signals to investors, and the need to clarify or change signals may actually constrain behavior. In the most extreme case, *ad hoc* policies may force the government to change its conduct precisely in order to signal that prior government action will not be repeated (*e.g.*, refusing to stretch legal authority to bail-out Lehman Brothers in part to show the government would allow a broker-dealer to fail, in light of open-transaction assistance to save Bear Stearns and Merrill Lynch). Government officials might prefer to rely on informal guidance, but such guidance typically is not legally binding, not all investors will accept informal guidance as credible, facts and circumstances may change, and intent may change. Some investors will make unfavorable assumptions based on asymmetric information and the risk that government does not follow prior guidance. Other investors will assume the government affirmatively will seek to punish disfavored private investors or companies. To some, government decisions made post-investment inevitably will appear driven by opaque policy concerns or politics in the absence of pre-existing procedures. Private capital from these skeptical investors may be either unavailable or materially more expensive than expected by the government. Like the used car market, where asymmetry of information can mean both the buyer and seller are worse off,[49] the government loses flexibility to communicate differing intention to make a favorable, market, or above-market loan.

At first glance, strategic ambiguity appears to be a one-way option in favor of the government because the government controls outcome. However, solutions that appear to limit optionality might in fact improve policy flexibility and improve markets. It is not clear that there is a net benefit attributable to deliberate uncertainty about terms and conditions of rescue financing, or about how a loan recipient will be managed, given the many other levers the government can use to limit moral hazard and

49. *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 3 Q. J. ECON. 84, 488-500 (1970) (showing that both the buyer and seller can be better off when information is shared). The government as rescue financier has better information than the market about what it intends to do, and further has the ability to change intention or behavior in secret. This asymmetry can create problems of adverse selection and moral hazard. Even if guidance by government officials is straightforward, some investors will still assume that they are being sold a lemon and will price capital accordingly. Other investors will assume the government will always bail-out their investments and will engage in risk-seeking behavior. Market outcome can be improved if signaling of private government information is credible and likely to be followed, including setting predictable bounds on agency behavior.

adverse selection.

III. THE GOVERNMENT IS DIFFERENT THAN A PRIVATE LENDER AND SHOULD BE PRESUMED TO ACT WITH ULTERIOR MOTIVE IN AN UNCOMPETITIVE MARKET

The government justifies its commercial behavior, in part, by arguing that it is just like any other commercial lender, entitled to set terms and conditions of rescue loans in accordance with negotiating leverage. In essence, the government asks "if a hedge fund can lend on coercive terms why can't we do the same?" Suppose instead that the question is flipped around, and investors ask "would a hedge fund subject to the same legal infirmities as a government actor and acting with ulterior motives be able to lend on the same coercive terms?" It is not entirely clear that a court would, or should, approve that hypothetical private lender's terms. Both ordinary restructuring rules and state corporations law might lead to disapproval, based on the status of the lender and/or ulterior motive.[50]

A. *Restructuring rules*

The Bankruptcy Code, together with developed common law and practices, restricts many actions based on proposed conduct or identity

50. "Ulterior motive" sounds nefarious. The description almost always is intended as a pejorative. But, in the context of evaluating the actions of an actual or proposed DIP lender, ulterior need not mean improper or even unobvious. Any unstated motive other than protecting against capital loss or increasing return on the narrow rescue financing should be viewed normatively as ulterior. A private lender that injects capital to preserve a different investment, or to gain ownership or control of a business, or to block investment by another, may be acting with an ulterior motive that is both perfectly clear and ultimately judged permissible. Beyond being permissible, some rescue financings are public policy subsidies and welcomed by stakeholders. If stakeholder distributions patently do not fall as a consequence of aid, or even better, if the rescue financing is priced and conditioned to enhance stakeholder recovery, an aid package should be unobjectionable to stakeholders. In such circumstances, competitors, rather than stakeholders, may object to the loan as distortive of markets. *See, e.g.*, *GMAC Financial Services and the Troubled Asset Relief Program: Hearing on S. 111-462 Before the Cong. Oversight Panel*, 111th Cong. 2d Sess. (2010) (explaining that other leasing and auto companies complained when General Motors Acceptance Corp. ["GMAC"] was allowed to become a bank holding company because the now-bank's lower cost of funding allegedly subsidized auto sales at General Motors and Chrysler); *The Unique Treatment of GMAC Under the TARP*: Cong. Oversight Panel, March Oversight Report (Mar. 10, 2010) (discussing the bail-out of GMAC due to GM's financial ties to the bank holding company). *See also* Liam Plevin & Sudeep Reddy, *AIG's Rivals Blame Bail-out For Tilting Insurance Game*, WALL ST. J., Mar. 23, 2009, http://www.wsj.com/articles/SB123776549185209083 [https://perma.cc/T8M7-4CX3] (noting the complaints of competing insurance companies that post-rescue AIG was able to offer below-market discounts on some products because of cheap cost of capital).

(such as being an insider). There is a large body of codified and common law that restricts disguised loan-to-own facilities, roll-ups, and other DIP conditions intended to protect more than a lender's narrow economic interest in the rescue loan. There are also explicit and implicit limits on using a DIP loan to control a plan process or allocate value, including restrictions on forcing quick asset sales and taking liens on avoidance actions.[51] Creditors may relinquish plan value, but in some jurisdictions, may not gift plan value in violation of absolute priority. Generally, post-petition value transfer outside of a bankruptcy plan in exchange for a plan vote is highly suspect and likely prohibited.[52]

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51. *See, e.g.*, *In re* TMT Procurement Corp.,764 F.3d 512, 521 (5th Cir. 2014) (discussing "fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders" as "misconduct that would destroy a purchaser's good faith status"); *In re* Abbotts Dairies of Pennsylvania Inc., 788 F. 2d 143 (3rd Cir. 1986) (discussing factors that would prevent a finding of good faith for a "loan-to-own" DIP); *In re* EDC Holding Co., 676 F.2d 945 (7th Cir. 1982) (holding that a DIP lender acted in bad faith because financing was intended for the improper purpose of paying creditor legal fees); *In re* On-Site Sourcing, Inc., 412 B.R. 817, 824 (Bankr. E.D. Va. 2009) (setting forth nine criteria used to evaluate requests for expedited sale of estate assets). *Compare In re* Tex. Gen. Petroleum Corp., 58 B.R. 357, 358 (Bankr. S.D. Tex. 1986) (holding that "neither a trustee in bankruptcy, nor a debtor-in-possession, can assign, sell or otherwise transfer the right to maintain a suit to avoid a preference") *with In re* Qualitech Steel Corp., 351 F.3d 290 (7th Cir. 2003) (allowing lien on avoidance action to secure DIP financing where there is benefit to the estate). *See also American Bankruptcy Institute Commission to Study the Reform of Chapter 11: 2012-2014 Final Report and Recommendations*, 23 AM. BANKR. INST. L. REV. 1, 67-87 (2015) (discussing current law and setting forth recommendations and findings with respect to terms and timing of approval of post-petition financing, liens on proceeds of avoidance actions, and a delayed timeframe for sale of estate assets outside of the plan process).

52. Gifting of recovery is an issue that comes up in many bankruptcy cases. It is well-understood that a consenting senior class may give up value to the proximate junior class, typically done to buy peace. Not all courts agree on whether or on what terms a senior class may gift recovery to classes more junior than proximate over the objection of the intermediate class. Some courts have taken the practical view that if intermediate classes are not entitled to distributional recovery then they should not be heard to complain about how the senior creditor spends its recovery, at least in Chapter 7 liquidation. *See, e.g.*, *In re* SPM Mfr. Corp., 984 F.2d 1305, 1316-19 (1st Cir. 1993) (gifting by a fulcrum secured creditor in the context of a Chapter 7 liquidation is permissible). Other courts take the view that nonconsensual gifting over the proximate class should be difficult or prohibited, as a violation of the absolute priority rule in Chapter 11. *See, e.g.*, *In re* DBSD N. Am., Inc., 634 F.3d 79, 100 (2d Cir. 2011) (distinguishing SPM in the Chapter 11 context and holding that the absolute priority rule does not allow for "any exception for 'gifts'"); *see also In re* Armstrong World Indus., Inc., 432 F.3d 507, 512 (3d Cir. 2005) (gifting property to junior classes over objections from more senior classes violates the absolute priority rule). Though different than a gifting objection, similarly situated creditors also can complain about unfair discrimination and disparate treatment under 11 U.S.C. § 1129(b), the same Bankruptcy Code "cram-down" provision that establishes the absolute priority rule. *Id*. Whether settlement distributions inconsistent with the Code's statutory priority scheme can be fair

Other parts of the Bankruptcy Code and Rules also are designed to expose identity-based conflicts of interest and to determine ulterior motives. A creditor voting on a plan of reorganization with a motive other than its own self-interest may find its vote "designated" under Bankruptcy Code section 1126(e) and not counted.[53] Insiders who make preferential transfers are treated adversely relative to third parties who engage in the exact same conduct.[54] Even the seemingly pedestrian Rule 2019 statement, which requires greater disclosure of economic interests held by groups than required to show standing, is designed in part to allow the court and other parties to understand biases and motives.[55]

It is very difficult to apply these existing rules and standards to a loan deliberately structured by the lender to cause self-detriment and which is managed for a non-economic purpose. Other than in the few cases in which an individual or small group acts in a particularly malicious fashion to destroy value, there is little opportunity for the courts to consider how a commercial actor might purposefully engage in non-economic behavior. A private actor analogue to government lending might be a non-profit group that provides rescue funds to a disfavored company on excellent terms, not

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and equitable is likely to be addressed by the Supreme Court in the October 2016 term. *See In re* Jevic Holding Corp., 787 F.3d 173 (3d Cir. 2015), *cert. accepted*, Czyzewski, et al. v. Jevic Holding Corp. et al. (Sup. Ct. 15-649) (seeking to resolve a circuit split over the authority of a bankruptcy court to dispose of claims and distribute assets through a structured dismissal that essentially substitutes a settlement agreement for a plan of reorganization).

53. *See, e.g.*, *In re* Fed. Support Co., 859 F.2d 17, 19 (4th Cir. 1988) (stating that "each creditor is expected to cast his vote in accordance with his perception of his own self-interest, but he may not act with an ulterior or coercive purpose"); *In re DBSD N. Am., Inc.*, 634 F.3d at 102-04 (summarizing Section 1126(e) and holding that an indirect business competitor could not vote its claim for the purpose of blocking any plan that did not convey an ownership interest in the reorganized business); *see also In re* Dune Deck Owners Corp., 175 B.R. 839, 844 (Bankr. S.D.N.Y. 1995) (discussing "badges of bad faith"); *see also In re* Circus & Eldorado Joint Venture, No. 12-51156, (Bankr. D. Nev. Sept. 20, 2012) (designating votes where the creditor's true intention was to acquire operating ownership of the debtor); *see generally* Christopher W. Frost, *Bankruptcy Voting and the Designation Power*, 87 AM. BANKR. L.J. 155 (2013) (describing how courts can consider motives and implement procedural safeguards when confronted by creditors not voting to maximize claim recovery in Chapter 11 filings).

54. *See* 11 U.S.C. §547(b) (extending the bankruptcy preference period from 90 days to one year for insiders). Likewise, insider status can lower the burden of proof needed to equitably subordinate a claim under Bankruptcy Code § 510(c)(1). *In re* Epic Capital Corp., 307 B.R. 767, 772 (D. Del. 2004). Moreover, insider status can be a "badge of fraud" supporting an inference of intent to make a fraudulent transfer. MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 935 (S.D.N.Y. 1995) (finding insider status to be probative of fraudulent intent).

55. Fed. R. Bankr. P. 2019; *see also* Baron & Budd, P.C. v. Unsecured Asbestos Claimants Comm., 321 B.R. 147, 168 (D. N.J. 2005) (holding that one purpose of the rule is "to root out conflicts of interest").

explicitly in order to loan-to-own, but with the knowledge that if it gained control it would shut the company down. A superficially similar situation would be a union or pension fund that provides financing under the condition that labor contracts and pension obligations are not rejected – essentially a roll-up of unsecured claims – under threat of strike. It is not clear whether or to what degree a court would examine ulterior motive in these examples if faced with a competing DIP proposal and an objection. However, restructuring financing offered by a private lender who acts with ulterior motive can be subject to increased judicial review, and categorically rejected by that court, the borrower, or other economic stakeholders.

The other big difference is that a private lender DIP would be subject to market testing, a normal requirement in the bankruptcy process.[56] In the private lender context, the failure of a full marketing process for alternative financing can be probative of a market view that the private DIP loan is on market terms and equitable. This inference is plausible so long as the amount to be funded feasibly could be raised in the bank or capital markets and adjustments are made for structural and procedural advantages or disadvantages of prospective lenders. In any particular case the inference may be improper but across cases errors will cancel out and on average the inference is sensible. For the public lender, however, shopping the loan and proving lack of market alternative does nothing but check the box that typical process was followed, and diminishes investor confidence by rendering a generally effective practice perfunctory. For particularly large enterprises requiring large amounts of reorganization financing, it already is the case that alternative financing is not available because the government is the only entity with the capacity to lend.[57] The construct that

56. *See* Bank of Am. Nat. Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 458 (1999) (ruling that a bankruptcy court should not approve arrangements "untested by competitive choice").

57. In addition to exigent circumstances, scale of borrowing, and inadequate time, it may also be the case that the government is in a preferential position to provide financing and/or is discouraging private capital formation. The experimenter affects the experiment. A lender who is also a regulator, or who will receive special consideration from a party that can affect enterprise value, is at less risk of capital loss because that lender can limit business risk of the borrower using regulatory power. Conversely, a private lender risks destruction of value due to regulatory action. For some businesses, the government, in its many forms, has authority to create or destroy enterprise value (*e.g.*, banking, insurance or energy), or may even have the power directly to set market terms (*e.g.*, utility rates, or g-fees and loan standards for Fannie Mae and Freddie Mac). It can gently or not so gently stamp "approved" or "rejected" on a sale transaction, or pass new legislation or regulation to control the business. It is not necessary that the government intends to disadvantage private DIP lenders or purchasers, only that there is perceived risk. Anyone who doubts the government can affect value post-deal should ask shareholders of defunct savings and loans

a government DIP is evaluated the same way as a private DIP is stilted since only the private DIP realistically is subject to market testing.

B. *State corporations law*

Similarly, state corporations law often applies different rules to different actors based on the same conduct. For example, a stakeholder may be invested with a fiduciary duty owed to minority stakeholders as a consequence of exercising actual control over a corporation, or simply by owning too large a stake and creating a presumption of control. The same related party transaction that escapes review entirely under Delaware law if undertaken by a small, disinterested stakeholder might be subject to a rigorous "entire fairness" review if undertaken by a controlling stakeholder, a distinction that is based on the identity and prior conduct of the actor.[58] It is no surprise that the government routinely disclaims voting rights normally associated with a controlling equity interest and warrants (taken as a rescue consideration) to avoid designation as a controlling stakeholder.[59]

State corporations law offers other stakeholder checks and balances. Private lenders or borrowers are subject to suit for breach of fiduciary duty, breach of contract, and any other cognizable claim, under commonplace standards of review. Government actors taking materially identical financial or commercial actions may be entitled to jurisdictional protections against court review (over and above the substantial statutory protections in favor of a government agency acting as conservator or receiver for a

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to describe the effect of reversal of acquisition accounting treatment for supervisory goodwill. *See* United States v. Winstar Corp., 518 U.S. 839, 861-65 (1996) (describing how government regulators changed accounting rules to the detriment of bank acquirers that relied on prior guidance).

58. *See, e.g.*, Hamilton Partners v. Highland Capital Mgmt., No.CIV.A. 6547-VCN, 2014 WL 1813340, at *12 (Del. Ch. May 7, 2014) (explaining that the court uses the standard of entire fairness, the most rigorous standard, when reviewing stockholder challenges to the fairness of a merger between corporations and their respective controlling stockholders). Federal law makes similar distinctions based on insider status. *See, e.g.*, Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(b) (setting forth the "short-swing profit rule" that requires insiders to forfeit profits from the purchase and sale of securities within a six-month period).

59. For a discussion about the duties of controlling shareholders under Delaware law and the difficulties in holding a controlling government shareholder accountable under Delaware law, *see* Marcel Kahan & Edward Rock, *When the Government is the Controlling Shareholder: Implications for Delaware*, 35 DEL. J. CORP. L. 409 (2010) (arguing that the Delaware courts should not entertain controlling shareholder disputes involving federally controlled Delaware corporations and that abstention better protects the State's role in setting corporate law).

borrower).[60] A complainant against the government also must find a way around sovereign immunity, whether under the APA, Federal Tort Claims Acts, the Tucker Act, or otherwise. That complainant then faces a multi-year legal battle, only to have government conduct likely judged under a more deferential standard of review than conduct of a private actor.[61]

Moreover, if the government were just a private actor, it would be reasonable to expect the board of directors or management of the distressed corporation to negotiate on behalf of the enterprise and existing stakeholders. In the public rescue context, "approval" of the board does nothing except add a veneer of legitimacy to government actions.[62] At one extreme, the board may be effectively replaced by an appointed government official and immunized against claims for breach of fiduciary duty for acquiescing to appointment.[63] Judicial immunity aside, there may be significant regulatory arm-twisting or pressure on a board or

60. Review assumes in the first instance that the court is not statutorily divested of jurisdiction to evaluate government or debtor conduct or enjoin objectionable conduct. *See supra* note 26 (discussing that courts are routinely divested of authority to restrain or affect actions taken by agencies pursuant to statute).

61. *See* footnote 34, *supra*. For a discussion of the differing standards of review for evaluating regulatory takings (*i.e.*, assuming waiver of sovereign immunity under the Tucker Act, 28 U.S.C. § 1491), *see* also James E. Holloway and Donald C. Guy, *Weighing the Need to Establish Regulatory Takings Doctrine to Justify Takings Standards of Review and Principles*, 34 WM. & MARY ENVTL. L. & POL'Y REV. 315, (2010) (evaluating Takings Clause doctrine and, particularly, the fairness and justice doctrine).

62. In addition, extraordinary corporate transactions often need to be approved by shareholders, and not just agreed to by management or the board of directors (who theoretically can be coerced by a majority stakeholder or the government). Shareholders may be able to adjust consideration paid for their stakes, provided that the manner of financing transaction requires shareholder approval and that shareholders retain rights to disapprove the proposed transaction. To wit, common shareholders in Bear Stearns caused JP Morgan to raise its government-assisted acquisition bid from $2 per share to $10 per share by threatening not to approve required issuance of dilutive shares. *See* http://www.nytimes.com/2008/03/24/business/24deal-web.html?_r=0 [https://perma.cc/2WGF-NMYY]; *see also In re* Bear Stearns Cos., Inc. S'holder Litig., *supra* note 36, (describing the corporation's law dispute and requirement for issuance of new shares). Shareholder control rights notionally continue to exist in Chapter 11 bankruptcy, although control rights are severely circumscribed in application. *See* Thomas G. Kelch, *Shareholder Control Rights in Bankruptcy: Disassembling the Withering Mirage of Corporate Democracy*, 52 MD. L. REV. 264 (1993) (challenging the accepted view of shareholder rights in Chapter 11 bankruptcies). Under Dodd-Frank and similar restructuring regimes the conservator or receiver succeeds to all shareholder control rights, *see supra* note 26, and there is no need even to seek consent from affected economic stakeholders.

63. *See, e.g.*, Federal Deposit Insurance Act of 1950, 12 U.S.C. § 1821(c)(12) (2013) (providing protection from liability for directors who acquiesce in good faith to the appointment of a resolution authority, such as a conservator or receiver); *see also* Housing and Economic Recovery Act of 2008, 12 U.S.C. § 4617(a)(6) (2008) (protecting directors under these circumstances as well); *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5387(2010) (providing the same protection for directors).

management to accept funding.[64] And, even if free to act, it would be the rare director or manager, protected from most censure by the business judgment rule, who would reject government funds with alacrity and force. It is unrealistic for market participants to expect public funds to be declined by boards, whatever the terms, because the ultimate check on rescue lender overreach – alternative financing – is missing.

The point of highlighting distinctions based on identity,[65] and of illustrating judicial examination of motive and bias of a private actor, is not

64. For example, some banks allegedly were strong-armed into selling senior preferred shares to the government in 2008. Among other things, by accepting funds under the TARP Capital Purchase Program, these banks were forced to issue common stock warrants and became subject to restrictions on executive pay, dividends, and redemption of junior interests (something government agencies had difficulty accomplishing in their regulatory capacity). The account of the "October meeting" at the offices of the Treasury was widely reported. *See, e.g.*, Damian Paletta, Jon Hilsenrath & Deborah Solomon, *At Moment of Truth, U.S. Forced Big Bankers to Blink*, WALL ST. J., Oct. 15, 2008, http://www.wsj.com/articles/SB122402486344034247 [https://perma.cc/SFN9-YY7M] (describing a meeting where the government offered to take a non-negotiable $125 billion stake in the nation's big banks and imposed new restrictions on executive pay and dividend policies); *see also Application Guidelines for TARP Capital Purchase Program*, U.S. DEPT. OF TREASURY (2008), https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/bank-investment-programs/cap/Documents/application-guidelines.pdf [https://perma.cc/DK29-88SL] (setting forth the conditions with which a financial institution must comply in order to participate in the Treasury Capital Purchase Program, which include policies on executive pay and dividends).

65. Restrictions on conduct based on identity or status also arise under federal antitrust law. A dominant market participant – which the government plainly is in the context of emergency financing – may be restricted from engaging in anticompetitive behavior which a smaller competitor would be allowed or even encouraged to pursue. Antitrust law is also an area where courts grapple with distinctions between government's commercial activity and regulatory activity, in the context of evaluating the government's market participant exception to state-action immunity from the antitrust laws. *See* Parker v. Brown, 317 U.S. 341, 350-51 (1943) (distinguishing between a market participant role and a regulatory role); City of Lafayette v. La. P&L Co., 435 U.S. 389, 413 (1978) (holding that an antitrust exemption is only available with respect to conduct engaged in as an act of government by the State as sovereign) (Marshall, J., concurring); F.T.C. v. Phoebe Putney Health Sys., Inc., 133 S. Ct. 1003, 1010-11 (2013) (explaining that a sub-state authority acting as a market participant was not entitled to state-action immunity). Similarly, courts have developed standards for distinguishing between when the state is acting in a truly sovereign capacity and when it is acting as an ordinary commercial actor when evaluating the market participant exception to application of the dormant Commerce Clause doctrine. *See, e.g.*, Hughes v. Alexandria Scrap Corp., 426 U.S. 794, 812-13 (1976) (ruling that a state action that preferences in-state goods and falls within the market participant exception violates neither the Commerce Clause nor Equal Protection Clause); Reeves, Inc. v. Stake, 447 U.S. 429, 440 (1980) (confirming that state action as a market participant, in this case as a seller of goods, receives the market participant exception, and thus, its intra-state preferences do not violate the Commerce Clause); South-Central Timber Dev., Inc. v. Wunnicke, 467 U.S. 82, 97-98 (1984) (holding that permissible state preferences under the market-participant doctrine are limited to the particular market in which it is acting).

to argue a court should reject a government loan but rather to show the absence of ordinary checks and balances on government behavior. Strict adherence to rules and tradition when evaluating the propriety of massive government intervention may violate the spirit of a thing by following the letter of it. It would not be inequitable, and it would lessen investor concerns and market distortion, if the government restricted its own behavior to better separate its regulatory role from its commercial role.[66]

IV. PROPOSED SOLUTIONS[67]

The four proposals set forth below aim to lower uncertainty without severely restricting government discretion. They are simple and actionable. The first two limit market distortions by exposing government loans to market forces. The third proposal addresses potential conflicts of interest when the government acts as regulator and financier. The fourth proposal would improve transparency and accountability by restricting reorganization earmarks. One characteristic shared by the first three proposals is that they openly acknowledge the potentially conflicting roles of government as commercial actor and as sovereign. As noted throughout, uncertainty arises when the government's initial involvement purports to be commercial but its aims are policy-based or political and play out over time.[68] These proposals reverse the order of operation by having the

66. One might question the efficacy of self-imposed restrictions, but they can be effective and legally binding constraints. Agencies can self-restrict, and be bound by their own precedent. *See* Peter Raven-Hansen, *Regulatory Estoppel: When Agencies Break Their Own Laws*, 64 TEX. L. REV. 1, 2-8 (1985) (discussing "regulatory estoppel" and the enforcement of an agency's own rules and laws in federal court); Harold A. Krent, *Reviewing Agency Action for Inconsistency with Prior Rules and Regulations*, 72 CHI.-KENT L. REV. 1187, 1212-24 (1997) (discussing judicial oversight and enforcement of discretionary agency rules).

67. The focus here is on corporate bail-outs, and excludes consideration of banks and insurance companies, for two reasons. First, there have been thousands of receiverships or conservatorships of failed banks and savings institutions under the control of the FDIC, the FSLIC, and/or the RTC. FDIC pattern and practice is known, and the agency materially has self-limited its discretion through rules, regulations, and policy statements (the FSLIC effectively was merged with the FDIC in 1989 and the RTC was dissolved in 1995). Investors may not always like how banks and thrifts are resolved but the risk that the FDIC will transfer or liquidate assets at less than reasonably equivalent value is estimable. Second, insurance companies are state chartered. Despite model laws promulgated by the National Association of Insurance Commissioners, each state has a different regulatory and resolution regime, in practice if not always by statute. Also, for both banks and insurance companies, the primary expected source for emergency liquidity is pre-established government funds and credit lines and not private financing.

68. Here, it is argued that government should not act with the same rights and perspective as a private lender when providing and setting the terms of post-petition financing. Ironically, when the government injects capital as a pre-petition investor –

government enter the market to advance its policy or political aims but then pivot to a role more closely resembling a commercial actor.

A. *Proposal 1: Funded loans and unfunded lines of credit should be market tested on a vertical slice basis and be offered for public sale*

Non-governmental actors cannot provide rescue funding in the same size and in the same time frame as the government. Distressed companies or industries worthy of official intervention typically require massive injections of funds well beyond the ordinary capacity of private actors in risk markets. There rarely is time to develop robust private bank and capital lender syndicates. There often are structural impediments to raising capital, seemingly mundane but serious (such as the potential absence of capital market participants willing to accept private information and therefore be restricted from trading). Private market tolerance for risk also is pro-cyclical, whereas rescue financing typically needs to be counter-cyclical to market or industry conditions.

Simply, the slope of the supply curve for massive rescue financing is nearly vertical at needed quantities in the short-term. Without reaching the question of whether there is any price for funds at which the market will clear, it can be stated with confidence that in many cases the clearing price for private capital will be too high to be useful as rescue financing. That leaves policymakers who wish to price government loans on "market terms" in a bit of a conundrum. Comparable private pricing for a loan of the same size does not exist. Alternatively, pricing could be determined by formula, based on risk of default, recovery, and estimated risk premium. This method offers false precision because inputs, particularly estimates of appropriate risk premium, are highly subjective.[69] Both approaches can be

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distinguished from when the government intentionally provides a market distortive subsidy – the major risk is that the government may not act enough like a private actor. When the state intends to act in an entrepreneurial fashion, with expectations of return on investment, it should avoid picking winners and losers and creating market distortions. So, for example, a state-owned pension fund in theory should be mercenary in outlook, insulated from political influence. Even deliberately subsidized entities, such as the Overseas Private Investment Corporation or the Export-Import Bank of the United States, should maximize returns subject to the confines of their investment criteria. Of course, if the government directly wants to subsidize a business or industry it is free to do so, and to lose money doing it. For a discussion about state entrepreneurism and some prescriptive suggestions for reducing market distortions, *see* Benjamin Templin, *The Government Shareholder: Regulating Public Ownership of Private Enterprise*, 62 ADMIN. L. REV. 1127 (2010) (discussing state entrepreneurism and some prescriptive suggestions for reducing market distortions).

69. In the ordinary course, it may be effective to estimate risk by modeling cash flows

combined into a third amalgam, where policymakers simply punt and leave market terms to be defined by the parties, perhaps in "consultation" with the Federal Reserve or similar economic bodies, without setting standards for evaluation or review. In practice, any level ranging from just over investment-grade pricing to oppressively high could be justified as "market."

Basically, there is no empirical method to verify that the government is providing financing on non-coercive terms commensurate with credit risk. So, why not lop off zeros instead and price the loan as if it were a size that could be raised in private markets? It would not be difficult to estimate a loan size that is generically market equivalent to "very large but possible," and the consequences of estimation error are not great (*e.g.*, the pricing on a $3 billion DIP facility should be relatively close to the pricing on a $4 billion DIP facility).[70] Any risk premium associated with greater size would be ignored. The government would still be free to charge an explicit "moral hazard" premium over and above the market base rate.[71]

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and discount rates, and by surveying comparable companies. These methods fail miserably in times of distress for systemically important companies. A modeler's cash flow assumptions will self-referentially depend on whether aid is provided, how much, and for what purpose. The types of businesses that receive government support tend to be highly regulated or have operations that depend on good government relations. A private lender reasonably might see and price risk that the government, in its administrative capacity, will act in a way that impairs enterprise value needed to repay a private loan. Conversely, a government lender might reasonably assume policymakers (including in some cases the same regulatory agency making the loan) would stop short of value-destroying regulation that would unduly impair the government loan. During market dislocation private risk capital in small size will be unusually expensive and in large size unavailable, leaving discount rate and cost of capital modeling assumptions constrained only by a red-faced test. There rarely are enough data points to justify a comparable company analysis and, when there are, the controversy typically is whether a bail-out recipient is being subsidized or penalized against its peers. In any event, because the government either provides emergency aid in a size not viably raised in private bank or capital markets, or as part of a cross-industry lending program that no private actor can be expected to fund, there is no way other than through testimony to object to the government loan.

70. By analogy, a $10 billion appeals bond might be priceless at the same time a $10 million appeals bond is readily available at a competitive market price. In 1987, Texaco Inc. was unable to meet a $10 billion supersedeas bond requirement to continue its appeal of an antitrust verdict entered in favor of the Pennzoil Company. Texaco argued requiring a bond of that size was fundamentally unfair and violated due process because sufficient bonding capacity did not exist. *See* Texaco, Inc. v. Pennzoil Co., 784 F.2d 1133, 1138 (2d Cir. 1986) (noting Texaco's argument that it could not possibly post the mandatory bond given its estimate that "world-wide surety bond capacity ranges from $1 billion to $1.5 billion under the best possible circumstances"), *rev'd*, 481 U.S. 1 (1987). Ultimately, Texaco was forced to file for bankruptcy in order to continue its appeal.

71. There is no conflict with the classic principle that lender-of-last-resort loans should be made at a penalty rate, only the argument that lending should be made at a base market rate plus a deliberate, measured, and (optimally) predictable *a priori* penalty premium. It

This change in mindset, which takes squishy issues like fairness and wealth-maximization off the table, allows for a host of positive changes in government entry and exit strategies. First, entry pricing would be less subjective. Authority could be delegated to regulators and technical experts with greater confidence that loans are on market terms because market is redefined to be less ambiguous. Market participants would be more likely to accept pricing as reflective of market conditions. Overall, cost of funding is more predictable for both government and investors. From the government's perspective, optionality is lost but so is the need to calibrate or defend terms in light of political pressure or based on the perceived merit of the recipient.

Second, change in mindset allows the government flexibility to craft funding solutions that lie between providing 100% of rescue funding or none at all. Every sale or participation of the rescue loan becomes perfectly commercial; that is, government actors should always be pleased or at least economically indifferent to laying-off risk at cost. Suppose that a vertical slice of funded loans, unfunded lines of credit, and attendant equity consideration were available for sale or participation at par to private actors, for a reasonable time or continuously. It could mean the financing arrangement would be tested by competitive choice, if not immediately at inception then reasonably thereafter. The government would either reduce the size of its underwriting commitment at the outset, or divest some or all of its commitment over time. In addition, the government could realize value from a sale of the strip, which might be more liquid and valuable than each of the investment tranches sold separately.

There have been some recent attempts to match public rescue dollars with private market capital, notably the Public-Private Investment Program ("PPIP") in 2009.[72] A simple and consistent approach that allows private

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should not be an amalgamated rate that fails to distinguish risk from penalty. The Federal Reserve engages in predictable penalty cost "discount window" lending precisely to address temporary problems banks and other depository institutions may have in obtaining private funding. *See Credit and Liquidity Programs and the Balance Sheet*, BD. OF GOVERNORS OF THE FED. RES. SYS. (Feb. 12, 2012), https://www.federalreserve.gov/monetarypolicy/bst_lendingdepository.htm [https://perma.cc/23VQ-TXVE] (explaining why the Federal Reserve has a discount window and illustrating how to set predictable costs for liquidity financing).

72. It is hard to say whether PPIP was successful or not. On the one hand, the government did not raise nearly the amount of private capital initially contemplated. At inception, Treasury allocated $75 billion to $100 billion in TARP funds to the program, to be matched by an equivalent amount of new private equity capital. Despite generous subsidies to private investors in the form of non-recourse loans, the program was scaled back and raised only $7.5 billion in private capital, not nearly enough to be deemed material when compared with the amount of "toxic" assets on bank balance sheets. *See* U.S. DEPT. OF TREAS., TREASURY DEPARTMENT RELEASES DETAILS ON PUBLIC PRIVATE PARTNERSHIP

investment alongside the government on parallel terms might raise material private capital in some cases, and even a non-material but competitive private investment could be used to set market terms. Even if the entire construct turns out to be a mostly intellectual exercise and private investment is *de minimis*, the practice of excluding inordinate size from "market terms" would introduce objectivity in setting a market base rate upon which the government could overlay a fixed "moral hazard" premium.

B. *Proposal 2: All funded debt should be pre-payable, all credit lines should be cancelable, and if practicable, delivered proceeds should be callable for a reasonable period of time*

There are two cogent objections to allowing unwind of rescue financing. First, there is a financial cost. Portfolio managers should expect to have winning and losing investments. To not put too fine a point on it, winners are expected to pay for losers and the remainder should provide a positive return over cost of capital. Part of return is realizing on the upside of investments. That is why callable instruments price at a discount to non-callable instruments. If an investor allows winners to be called-away then aggregate returns on investment will be lower than initially expected.

However, the government is not a private lender and presumably acts to stabilize markets and not to maximize wealth. All else equal, government should seek to socialize rescue costs rather than surcharge one bail-out recipient to pay for the costs of an unrelated bail-out. Moreover, the government's cost of capital is very low, and market risk rates should,

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INVESTMENT PROGRAM (2009), https://www.treasury.gov/press-center/press-releases/Pages/tg65.aspx [https://perma.cc/J83U-CVDP] (announcing initial governmental contributions of TARP fund to PPIP); *see also* U.S. DEPT. OF TREAS., LEGACY SECURITIES PUBLIC-PRIVATE INVESTMENT PROGRAM (2013), https://www.treasury.gov/initiatives/financial-stability/reports/Documents/External%20Report%2013%20-9%20Final.pdf [https://perma.cc/GR4F-HWDC] (charting the underperformance of PPIP). On the other hand, the program was profitable for both private investors and the government, and there is a case to be made that PPIP was scaled back because banks were able to raise capital without selling portfolios to the program and because investors were reluctant to participate in PPIP based on addressable political concerns rather than financial risk-versus-reward concerns. *See* Fannie Chen, *Structuring Public-Private Partnerships: Implications from the "Public-Private Investment Program for Legacy Securities"*, 46 COLUM. J.L. & SOC. PROBS. 509, 530 (2013) (outlining several counterarguments to the position that PPIP's underperformance was due to financial risk-versus-reward concerns, including the political risk concern of private partners). In theory, it should be easier to raise private funds to purchase top-of-the-capital-stack loans. This is particularly so if a sale program were properly constructed to adjust for political risk and compensate for government control over minority investors, and a familiar pricing mechanism such as Dutch auction were used.

in theory, allow for positive returns on capital even if average returns slightly lag. This is particularly true if a rescue loan is provided for liquidity in a lender of last resort capacity rather than on account of balance-sheet insolvency. Overall, it should be possible to adjust loan terms to account for the costs of writing a call or to calibrate the call option so that government returns are reasonable and reflect market conditions for callable debt.

Second, allowing a quick unwind of rescue financing also poses a moral hazard problem. There would be less reluctance to borrow money if funds could be accepted on onerous terms and then repaid without penalty when private markets reopen. In addition, there would be incentives to create value for junior classes using the rescue financing ("other people's money"), which is not just a game theory problem but also a potential political problem. There is no way around moral hazard. It can be limited through regulation, incentives and penalties, and upfront underwriting charges (there also would be no assurance that the government would provide funding in the first instance), but the risk is persistent.

However, dealing with moral hazard is a balancing act.[73] Conditions for borrowing can be set to severely impair existing creditors and interests but, if value destruction is viewed as excessive by the market, then private capital for other companies will be more expensive or unavailable.

73. The debate over how to balance moral hazard with fairness and efficiency is an old one. The restructuring process itself creates moral hazard by allowing a debtor, among other things, to create involuntary liquidity. Restructuring laws, including the Bankruptcy Code and similar statutes governing bank and insurance company resolution, create liquidity by deferring or eliminating cash payment due dates, and by preserving and recovering company assets that can be used to generate cash inflows. Various sections of the Bankruptcy Code are designed to create liquidity even without new financing. *See, e.g.*, 11 U.S.C. § 362 (2012) (imposing an automatic stay on collection efforts); 11 U.S.C. § 363 (2012) (permitting sale of assets "free and clear" of encumbrances); 11 U.S.C. § 365 (2012) (allowing rejection of executory contracts and leases); 11 U.S.C. §§ 547-548 (authorizing avoidance of preferential and fraudulent transfers of property or incurrences of obligation, including avoidance of liens); 11 U.S.C. § 550 (providing for recovery of already transferred property). The Bankruptcy Code also encourages new lenders and business counterparties to provide incremental liquidity. *See, e.g.*, 11 U.S.C. § 364 (authorizing new credit secured by a priming lien); 11 U.S.C. §§ 503 & 507 (conferring administrative expense priority to claims on account of extension of post-petition credit by vendors and other counterparties). The same is true for banks and insurance companies. Banks and insurance companies are highly regulated entities resolved differently than corporate debtors, with regulatory emphasis on protection of depositors, insureds, and counterparties. Notwithstanding, these resolution regimes use conceptually similar provisions to provide liquidity indirectly through preservation of assets or avoidance of obligations, and allow for additional liquidity by indemnifying post-intervention creditors and purchasers of assets. *See, e.g.*, 12 U.S.C. § 1811 (2015) (creating the FDIC); N.Y. INS. LAW § 7401 (McKinney 2015) (governing rehabilitation, liquidation, conservation and dissolution of insurers at the state level in New York).

Similarly, there is a hidden cost when government financing is not repayable, whether financing legally is non-call or as a practical matter cannot be repaid without government consent. Private lenders are less willing to provide pre-petition emergency financing if a subsequent government loan might irrevocably impair recovery. Also, private actors have less incentive to arrange post-petition replacement financing because there is no contractual right to take out the government lender. Fundamentally, the balancing act comes down to the character of government as a lender of last resort. If the goal of intervention is stabilization, and to allow markets time to create alternative sources of liquidity, unwinding rescue financing is not a public nuisance. At least in the abstract it is hard to argue against repayment with private funding as an aspirational goal.[74]

As a discussion piece (no size fits all), suppose that a government loan can be unwound for 12 months after lending, and that at any time, funded debt can be repaid and the loan facility cancelled. Would there truly be harm if existing lenders or an alternative private syndicate were able to substitute in whole or in part for the government? The government would recover par plus on its funded investment, and would be off the hook to the extent the facility is replaced and commitment reduced. If the government received non-cash proceeds as a facility fee (*e.g.*, common stock or warrants), then those proceeds would be callable at a market price set when the loan was made. If the government still holds the proceeds then they would be called, and if proceeds were delivered away in the interim then a call is impractical. Such a repayment option, or any variant thereof, would act as a procedural safety valve. If the government is using contract leverage to influence corporate governance or the restructuring process, then one of the easiest ways to address conflict of interest is to take out the financing.[75]

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74. Apart from there being better uses of taxpayer resources than funding enterprises able to fund elsewhere, consider also that government may have a policy interest in creating lending programs that are both palatable and available to relatively healthy institutions, so as not to stigmatize recipients. Forcing an institution to take government funds on unrepayable terms may signal just the sort of non-temporary distress that causes private capital to run.

75. Banks technically were permitted to repay loans offered through the TARP Capital Purchase Plan but repayment initially was discouraged by contract (by prohibition on repayment other than through a qualified equity offering) and subsequently by the requirement that banking regulators specifically approve repayment. The paradigmatic example of an unpayable loan is the facility offered to Fannie Mae and Freddie Mac. The government has taken the position that neither company may repay its loans despite having repaid in "dividends" more than was actually borrowed from the government, and despite alleged feasibility of raising sufficient private funds. *See* merits briefing submitted in Perry Capital, LLC, et al. v. Lew, DC Appeals Court 14-5243 (on appeal from Perry Capital, LLC, et al. v. Lew, 70 F. Supp. 3d 208 (D.D.C. 2014)) (stating "[a]nd, even though the

C. *Proposal 3: The government should assign an impartial investment manager to make commercial decisions with respect to each rescue financing*

This proposal addresses the "two-hat" conflict of interest problem directly. With respect to rescue financings, each government agency or organization should be required to designate a commercial manager primarily responsible for taking the lead in commercial discussions, reasonably defined. The commercial manager would not directly supervise or regulate entities associated with the specific financing transaction, and would wear only a commercial hat.[76] The commercial manager would have authority to make decisions related to the terms and conditions of lending, subject to policy or political override by the agency. Authority would not be limited to monitoring conditions and participating in the deliberative process.

Instead, business decisions by the commercial manager would stand unless overruled by the agency. Deliberative process unambiguously would allow for overruling the commercial manager or adjusting outcomes on otherwise valid policy or political grounds. However, overruling a decision would reflect a conscious choice to wear a regulatory hat, documented and reviewable as regulatory action. Essentially, valid government policy options would not be restricted, but would have to be independently justified.

The commercial manager could be part of a separate cross-agency organization or be separated by an ethical wall from the part of the agency that makes the loan or which regulates the recipient's industry. A separate organization with the sole purpose of managing government investments in a commercially reasonable manner might be superior to an ethical wall because of clear demarcation of responsibilities and reporting lines, standardization (and predictability) of government behavior, and desirable tension and checks between and among government officials. On the other hand, it would be difficult to ensure political independence of a separate organization and purported impartiality could be a mere fig leaf, industry expertise and experience is likely to be greater within the funding agency, and it might be an insurmountable political step for an agency to relinquish

Companies have repaid Treasury's investment in full plus $43 billion, FHFA will have the Companies pay an additional $153 billion to Treasury over the next decade, and Treasury's liquidation preference will remain unchanged at $189 billion").

76. Ideally, the lead advisory person would be a disinterested government employee or consultant with market experience, gravitas, and reputational risk, who could freely participate in the deliberative process. Such a person or group could be very influential, much like an independent director who cannot carry a board vote but punches above weight.

control to an outsider. There are arguments in favor of and against variants of either approach, but the key is that an identified commercial manager would set default business terms and conditions.[77]

The process whereby the government provides or arranges rescue financing would have to be flexible enough to allow for emergency funding and exigent circumstances. In practice, over-the-weekend-type bail-outs likely would be fully consummated in essentially the same manner as today. However, companies can be in conservatorship, receivership, bankruptcy, or teetering distress for extended periods of time, and emergency funding often is staged. To the extent time permits, commercial managers could negotiate undefined market terms and conditions, implement second-stage transactions, and evaluate requests for amendments, waivers, and exits, among other things. In addition, the commercial manager could serve a signaling function, and could receive and respond to comments, concerns, and complaints of commercial overreach. This would improve transparency for both investors and legislators. Also, because investor interactions with agencies often are highly politicized, both investors and agencies might benefit from a deliberately depoliticized, more "technical" method of communication.

When the government acts only as the lender, the perfect should not be made the enemy of the good. Commercial manager functions and independence can and should vary depending on the nature of financial assistance. However, when the government acts on both sides of the rescue transaction, it is absolutely critical for market confidence that a truly disinterested commercial actor controls negotiations on behalf of the *recipient* entity. Issues of self-dealing and conflicts of interest are

77. Agencies routinely task a person or group to solicit opinions and gather information about the market and commercial reasonableness, and to make recommendations to final decision-makers. Decision-making processes can range from real-time, informal deliberations to unhurried and structured presentations at formal meetings, even at the same agency. Accordingly, agencies might offer in response to this suggestion that they already differentiate between commercial and regulatory functions when appropriate. Apart from the observation that current practice might be a useful guide to determine the manner in which commercial managers would be appointed, there are three problems unaddressed by this response. First, there is a qualitative difference between recommendations made to an agency head or board that reserves all decision-making authority and recommendations that are self-effectuating unless overruled. Second, *ad hoc* processes tend towards result-oriented analyses and lead to unpredictable signaling to investors. Third, by leaving ambiguity about whether agency actions were regulatory or commercial in nature (or both) the agency retains optionality to choose or change justifications if challenged. Agencies presumably want to preserve optionality, like most strategic actors, but from an investor and government oversight perspective the ability to change rationales after-the-fact undeservedly expands agency discretion.

unavoidable when any party, public or private, negotiates both sides of a commercial transaction. The market will not accept that agencies ostensibly negotiating against each other truly are adverse, regardless of stated agendas or nominal reporting lines. Nor will the market accept that the agency acting as conservator or receiver is immune to political pressure and extra-agency control. Further, even if the conservator or regulator walks with the angels, there is no way for investors to assess how the agency balanced regulatory concerns and commercial concerns.

Statutory resolution schemes such as HERA and Dodd-Frank expressly provide for government actors to make business decisions ordinarily made by private management, directors, and shareholders, with limited or no judicial review, and limited or no recourse for perceived malfeasance. Statutory priority schemes and pre-failure government guidance may help to mitigate risk, but it is the exercise of agency discretion that ultimately drives outcome. Investors face risk that corporate agents cannot or will not protect stakeholder interests and that regulatory or political concerns will upend long-standing expectations about recovery, timing and process.

Commercial negotiations between the Federal Housing Finance Authority ("FHFA") and Treasury over how to fund Fannie Mae and Freddie Mac are a case in point. The dispute over the legality and propriety of the August 2012 "Net Worth Sweep" turns in large part on whether the FHFA acted to preserve and conserve estate assets in its capacity as conservator (*i.e.*, commercial conduct) or whether the Net Worth Sweep pretextually advanced a regulatory or self-interested government agenda though contract. More simply, would a disinterested conservator motivated to preserve estate assets have agreed to the Net Worth Sweep? Some investors perceive that the Net Worth Sweep would have been rejected or materially changed had the FHFA negotiated contractual terms as an independent and disinterested commercial actor.

Regardless, from a market perspective, whether the FHFA exceeded statutory authority, made arbitrary and capricious decisions, breached fiduciary duties, caused breaches of contract, or acquiesced to regulatory takings, all are matters that relate to commercial independence and self-dealing. Even today, it is hard to see how the FHFA director, wearing both a regulatory and commercial hat, impartially could consider proposals to preserve or raise capital at Fannie Mae and Freddie Mac, or continue to negotiate opposite Treasury. FHFA appointment of an independent and disinterested commercial manager, ethically bound to consider options only from estate perspectives, would reduce actual or perceived conflicts of interest. It also would improve transparency and accountability, particularly if FHFA's conflicting role as commercial manager actually

were delegated to a third-party operating under clear instructions. With billions of dollars and market confidence at stake, there are strong reasons why an agency in effective control of a bail-out recipient should appoint a disinterested manager to represent the interests of the estates and stakeholders.

Going forward, it is much more likely the government will participate on both sides of a rescue transaction, and that the lines between regulatory conduct and commercial conduct will be blurred. Dodd-Frank emphasizes the purpose of receivership as "stability" and furtherance of the public good in a way not similarly emphasized in the FDIA or HERA,[78] and a receiver exercising orderly liquidation authority may argue there is express statutory support for a receiver to consider regulatory objectives. An FDIC rule that limits the terms and conditions of funds provided to the covered company would be welcomed by investors. The FDIC also may very well end up negotiating rescue financing terms on behalf of subsidiaries not in receivership, and guidelines for management of subsidiaries also would be welcome. Finally, there is no reason to believe government intervention authorized in as-yet-unwritten legislation would seek to separate commercial and regulatory functions, and recent trends imply the opposite.

It may be that the appointment of a commercial manager would not change agency behavior. Worse, it is possible that endorsement of bail-out terms and conditions by a commercial manager would validate agency actions even if the manager were not truly disinterested. On the other hand, agency optionality comes at a high cost, diffuse and difficult to quantify in the absence of a crisis, and concentrated and pro-cyclically damaging in a crisis. All else equal, disinterested exercise of discretion will lower the cost of capital, and interested exercise of discretion will increase the cost of capital or render capital unavailable at a useful cost. Investors and ultimately the government would benefit if commercial terms could be set in a more predictable, transparent and accountable process, by a disinterested actor.

D. *Proposal 4: Reorganization earmarks should be subject to the political process*

The likelihood that a private creditor will transfer value for a purpose other than its own pecuniary interest is low. On the other hand, the government may have valid policy or political reasons to "earmark" value

78. *See, e.g.*, 12 U.S.C. § 5386 (2010) (stating that "[i]n taking action under this title, the Corporation shall (1) determine that such action is necessary for purposes of the financial stability of the United States, and not for the purpose of preserving the covered financial company").

in favor of preferred stakeholders, counterparties, or labor. Direct transfers of value include new money distributions, gifting of recovery, and adjustment of recovery accomplished through control over process. Indirect transfers of value include company failure to enforce rights, purchase of assets at an inflated price, and forced assumption of liabilities, among other methods.

Two of the most troubling bail-outs in the financial crisis were the rescues of Chrysler and General Motors. The most cogent legal objections raised in those bankruptcies concerned lightning-quick Section 363 sales of all operations to shell corporations, both on procedural grounds and with respect to valuation. Less cognizable, but more easily understood, were objections that the government used the bankruptcy process and its checkbook to benefit preferred constituencies, namely union employees and retirees. At a minimum, DIP terms forced the purchasing shell companies to assume union contract and pension liabilities that some argued should be rejected. There also were allegations that preferred creditors received plan distributions in excess of legal entitlement, as a consequence of DIP terms.[79]

Whether the reorganization earmarks in Chrysler and General Motors bankruptcy were legal and appropriate is beside the point. Market perception of many was that the reorganization earmarks were not in accord with ordinary rules governing priority of recovery and distribution to similarly-situated classes of creditors. That future reorganization earmarks, the size and scope of which are beyond the predictive ability of investors, similarly would be legally approved or unreviewable *is* the source of market uncertainty and concern.

A government policy to self-restrict reorganization earmarks would add value for investors and address political concerns.[80] Banning

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79. *See* Mark J. Roe & Joo-Hee Chung, *How the Chrysler Reorganization Differed from Prior Practice*, 5 J. LEGAL ANALYSIS 399, 428 (2013) (discussing the differences between the Chrysler reorganization and previous section 363 sales in its benefit to labor unions and pension plans over other investors); *see also* A. Joseph Warburton, *Understanding the Bankruptcies of Chrysler and General Motors: A Primer*, 60 SYRACUSE L. REV. 531, 548-51 (2010) (explaining that critics of the Section 363 sales in both the Chrysler and General Motors bankruptcy proceedings focused on its preference to the company's unions over investors).

80. Reorganization earmarks pretextually created through a commercial relationship suborn the political process and may lead to outcomes deeply inconsistent with prior legislative pronouncements (*e.g.*, preferential payments to pensioners may undercut the deliberate congressional mandate to rank pension deficiency claims *pari passu* and not ahead of other general unsecured claims in bankruptcy). Checks and balances normally at play during an appropriations or policy debate are missing, political costs are reduced or eliminated, and the administrative decision-making process is not transparent. Essentially, it is difficult or impossible to hold a regulator or administrator specifically accountable for the

reorganization earmarks is politically unrealistic and may be unworkable, but an internal policy that calls for review of commercial transactions to identify, highlight, and justify reorganization earmarks on a policy basis would be very valuable. The jaundiced view is that such a policy would be dead-letter because it would be ignored or only superficially followed, and would be yet another elevation of form over substance to create the illusion of meaningful process. The more nuanced view is that such a pre-existing rule could influence decision-makers, improve predictability, give political cover to deny requests for value, and reduce lobbying. Both investors and the body politic would be better served if reorganization earmarks were called out as political and not commercial conduct.

CONCLUSION

Although investors acknowledge the inevitability that government will seek to implement policy through deal-making and delegation to agencies, they struggle to price the uncertainty this introduces. There is no way to eliminate *ad hoc* approaches to government intervention as each crisis is new, each company is different, and rubrics about whether and why to intervene can determine how to price and manage investments once made. Nor is it clear that public policy would always be served by rigid adherence to pre-existing rules and prior conduct. Still, rules of general application can be constructed in light of noncontroversial goals such as transparency, accountability, and predictability. Incremental steps can be taken to delink policy or political objectives from the terms, conditions, and management of commercial rescue loans.

Existing law and practice may lead to suboptimal results with respect to non-bank reorganization financings by the government. Unpredictable government use of contractual leverage to accomplish policy or political goals plainly upsets investor expectations, creating distortion of capital markets and dead-weight losses, and ironically increases the likelihood and magnitude of future bail-outs by discouraging private risk-taking by would-be rescue lenders. Agencies naturally want to preserve decision-making optionality, but failure to acknowledge and separate commercial and regulatory agendas also makes it more difficult for the government to intervene without creating market distortion, or to distinguish relatively

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public policy decision to confer value because that action is analyzed under the rubric of commercial activity. *See* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 468 (2009) (noting that "[g]overnment by deal is not open government, and it rejects some of the usual values of administrative law, such as predecision notice to affected parties and the public; measured, unhasty action; and comment-ventilated policymaking").

inoffensive injections of liquidity from highly distasteful injections of capital on account of balance-sheet insolvency.

From a market perspective it appears that there has been vigorous debate and discussion about government intervention up until the moment it is decided a check should be cut. However, there has been insufficient focus on agency conflict of interest, transparency and accountability. Reorganization loans should be unpleasant to the borrower and its stakeholders but terms and management of such loans should be designed to encourage private capital formation. Even when legally permissible, regulating under the façade of protecting a pecuniary interest should be seen as suspect and potentially counterproductive. A good approach is to self-limit agency discretion to make resolution processes more predictable and certain.