No. 41
April 2009

MERCATUS ON POLICY

IMPLICATIONS AND ANALYSIS OF GOVERNMENT SHAREHOLDING IN THE FINANCIAL SECTOR

By J. W. Verret

MERCATUS CENTER
GEORGE MASON UNIVERSITY

Under the provisions of the Troubled Asset Relief Program (TARP), part of the Emergency Economic Stabilization Act, the federal government has acquired controlling interests in hundreds of the nation's largest banks as well as the insurance giant American International Group (AIG) and GMAC, the financing arm of General Motors.

While these shares, which were obtained through TARP's capital purchase program (CPP), do not carry voting rights, there are additional provisions that would give the Department of the Treasury a varying ability to influence corporate decision making. In addition, under the Capital Assistance Program (CAP), the Treasury has offered to exchange CPP preferred shares for CAP preferred shares convertible into voting common equity. Citigroup is the first bank in which the Treasury has taken direct voting common equity. This Mercatus on Policy examines lessons learned from other examples of government shareholding and explores legal implications arising from the current TARP shareholding arrangement along with possible ramifications on capital markets and the private sector.

THE SCOPE AND RIGHTS OF FEDERAL GOVERNMENT SHAREHOLDING

Under the capital purchase program, in exchange for providing capital injections to troubled financial institutions, the federal government received preferred shares that pay a 5 percent dividend for five years, after which the dividend increases to 9 percent and the government receives warrants to buy additional common shares. Participants in the capital purchase program may redeem the preferred shares after three years, and the Treasury can sell them at any time.

While current problems in the credit markets makes the Treasury's true participation in the private sector difficult to determine, we can refer to the at-cost values of TARP shares purchased from the first nine participants in the program and the remaining 206 banks. Excluding shares purchased in some of these institutions under provisions other than the capital purchase program, at the time of writing, the government has an at-cost value of $250 billion of equity in the financial sector.

As mentioned earlier, the Treasury's preferred shares do not carry the voting rights typically used to ensure the balance between shareholders and corporate management. Nonetheless, government still retains the ability to nominate two "preferred directors" to the board of directors if the participant falls behind on dividend payments for any six quarters. Additionally, the government also retains the right to vote on any mergers or acquisition activity and on the issuance of new shares. While not an explicit avenue for control, the Treasury could also influence corporate policy by using its power to waive certain corporate governance changes mandated by TARP funding provisions.

Perhaps the primary question of government's participation in financial markets is how it will act to influence corporate decision making.

In 2003 and 2007, the Securities and Exchange Commission mounted failed attempts to require shareholder nominees to appear on the corporate ballot. House Financial Services Committee Chairman Barney Frank (D-MA) has recently voiced support for this provision, indicating that the legislature may once again take up the issue. Success of any such attempt would inevitably give the government greater control over TARP participants.

GOVERNMENT'S MOTIVES AND COMPARABLE EXAMPLES

Perhaps the primary question of government's participation in financial markets is how it will act to influence corporate decision making. The Treasury's leverage over boards of directors may be influenced by various labor, consumer's rights, and environmental groups. Government deference to such constituencies, which often serve to block cross-border flows of capital and services to protect particular interests, could come at the cost of maximizing financial returns from TARP shares to taxpayers.

While the Treasury's current leverage in the financial sector is unique, there are various examples that illustrate how governments holding shares in private sector companies decided to use their power to influence decision making. One such instance occurred in the 1980s and 1990s when Western European governments sold much of their majority stakes in airlines, manufacturing groups, banks, utilities, and other industries under a push for deregulation. Nonetheless, these governments retained "golden" shares that allowed them to block mergers or acquisitions of the companies.

Many find that governments use golden shares to maintain inefficiently high levels of employment or enact other protectionist policies. Indeed, France and Germany have been the subject of extensive litigation before the European Commission over their golden shares in, for instance, Airbus and Volkswagen.

Another example of government motives comes from the California Pension Fund, or CalPERS, one of the United States' largest public investors. In a recent press release, CalPERS' CEO made its ancillary mission of helping the state of California clear: "Our ability to generate jobs, improve communities, and invigorate the California economy is an added benefit to our main mission of maximizing investment returns and minimizing reliance on members and taxpayers to fund public pensions."[1] Critics of CalPERS maintain that—similar to European governments—the institution sacrifices efficient economic outcomes to achieve a public policy agenda by investing in firms that do business exclusively in California. Ultimately CalPERS seeks to serve two masters which can often not be reconciled.

GOVERNMENT AS LEAD PLAINTIFF

Shareholders possess the right to join in and sometimes serve as lead plaintiff in private litigation against certain firms that violate securities laws pertaining to disclosure, registration requirements, fraud provisions, and other rules. This means the government's new preferred shares may prompt involvement with some of the one hundred annual federal securities cases that tend to settle for $1 billion to $6 billion.[2] Given that, as an example, CalPERS has roughly $250 billion in assets and recovered $925 million through serving as lead plaintiff in securities class action suits, Treasury participation in this area could amount to billions of dollars per year.

One important question arising from this possibility is whether the Treasury would face a conflict of interest when it has a

stake in the financial health of the defendant. Furthermore, one must question whether the Department of Justice or the SEC, which have expertise in securities fraud enforcement, will play a role in a government class-action suit. If so, it should be noted that plaintiffs typically piggyback on SEC enforcement actions: Since 1999, 20 percent of settle securities class actions have involved accompanying SEC actions.

An additional legal question is whether the Private Securities Litigation Reform Act, which governs the rights of lead plaintiffs in federal securities class actions, should be changed because the federal government may become a dominant player in securities litigation. Specifically, should there be any safe-harbors in the in light of the fact that TARP purchases are intended to ensure the health of the nation's banking system?

These legal issues are framed within a backdrop of a sort of catch-22: By exercising its shareholder litigation rights, the government would be further damaging financially troubled banks that are vital to the national economy and that it seeks to protect. But by not doing so, the government may send a signal that banks have carte blanche to violate securities laws and taxpayers' interests are subordinate to other goals. This delicate balance will need to be carefully considered by federal authorities in the wake of the acquisition of TARP shares.

LIABILITY AND ETHICS

Under state law, shareholders in control of a company become liable to other shareholders when they use their influence to enact corporate policy that hurts the minority owners. The federal government is likely immune from this control person liability, however the new influx of TARP shares gives it unprecedented amounts of ownership in the financial sector. As an ethical issue, it should be considered whether the government should retain this privilege.

Another ethical question involving government's unique position involves insider trading, a violation of federal securities laws. The government is exempt from these provisions, however it can do a great amount of damage to markets by trading its shares if it uses its knowledge from regulatory and market interactions with banks. It would be essential to ensure that the sale of preferred shares is not influenced by internal knowledge; failure to do so would erode the integrity of capital markets by leading investors to believe that the game is rigged and stop investing their assets in a market plagued by the ultimate insider.

CONCLUSION

The federal government's new position as the dominant shareholder in the financial services sector requires careful consideration of its shareholder rights vis-à-vis its position as a unique entity in the corporate realm. Federal authorities will need to examine interaction with current statutes and potential conflicts of interest to ensure efficient outcomes and avoid unintended consequences in capital markets. Doing so may involve a number changes to current provisions, however a failure to plan for the management of the governments shareholder's rights could have drastic consequences for the nation's economy.

By exercising its shareholder litigation rights, the government would be further damaging financially troubled banks that are vital to the national economy and that it seeks to protect. But by not doing so, the government may send a signal that banks have carte blanche to violate securities laws and taxpayers' interests are subordinate to other goals.

Another complication flowing from government ownership in companies participating in TARP is highlighted by the recent AIG bonus controversy. When bonuses to some AIG executives became public, Congress and the president responded to public furor by pressuring AIG executives to cancel the executive compensation contracts. Many executives at other TARP participants feared that it would encourage other companies not to contract with TARP participants, for fear that the TARP participants may be forced to violate other types of contracts after application of undue political pressure in response to the next scandal.

ENDNOTES

1. CalPers, press release, September 17, 2007, http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2007/sept/boost-ca-economy.xml

2. Securities Class Action Clearinghouse, Securities Class Action Settlements: 2007 Review and Analysis, http://securities.stanford.edu/Settlements/REVIEW_1995-2007/Settlements_Through_12_2007.pdf

The Mercatus Center at George Mason University is a research, education, and outreach organization that works with scholars, policy experts, and government officials to connect academic learning and real world practice.

The mission of Mercatus is to promote sound interdisciplinary research and application in the humane sciences that integrates theory and practice to produce solutions that advance in a sustainable way a free, prosperous, and civil society.

J.W. Verrett is an assistant professor of law at George Mason University and is a senior research fellow at the Mercatus Center, where he is a member of the Financial Markets Working Group.

Prior to joining the faculty at Mason Law, Professor Verret was an associate in the SEC Enforcement Defense Practice Group at Skadden, Arps in Washington, D.C. He has written extensively on corporate law topics, including a recent paper co-written with Chief Justice Myron T. Steele of the Delaware Supreme Court.