The U.S. Government as Control Shareholder of the Financial and Automotive Sector: Implications and Analysis

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I. Preferred Share Issuance under the Troubled Asset Relief Program ("TARP")

In order to execute its mandate under the Emergency Economic Stabilization Act to ensure the health of the nation's banking system, the Treasury Department has purchased controlling interests in hundreds of the nation's largest banks, as well as the insurance conglomerate American International Group ("AIG") and GMAC, the financing arm of General Motors.

Under the terms of the capital purchase program, a program which has become the dominant mode of TARP, banks receiving capital injections give the government preferred shares with a 5% dividend for five years which then increases to 9% after five years and warrants to purchase additional common shares.

Participants in the capital purchase program may redeem the preferred shares at face value after 3 years. In addition, the Treasury may sell them at any time.

Valuing the government' TARP share holdings is tricky, owing to the nature of the credit market freeze-up that is slowing breaking and problems in marking MBS and CDO assets to market. However, for our purposes considering them at cost will give some idea of the scale of share holdings.

The First nine banks to participate in the capital purchase program received $125 billion as follows:

Bank of America	$15 billion
Bank of New York	$3 billion
Citigroup	$25 billion
Goldman Sachs	$10 billion
JP Morgan Chase	$25 billion
Morgan Stanley	$10 billion
State Street	$2 billion
Wells Fargo	$25 billion

Merill Lynch $10 billion

The Treasury went on to lend to another 206 banks under the capital purchase program in exchange for preferred shares in those institutions, in whole making it a shareholder with an at cost value of $250 billion dollars worth of equity in the financial sector.

In addition, Treasury purchased another $20 billion worth of preferred shares from Citigroup with TARP funds not included in the capital purchase program.

The government also purchased shares representing 85% of the equity in AIG for $40 billion through the systemically significant failing institutions program, and also recently purchased preferred shares in GMAC for $5 billion. It also purchased roughly $10 billion in GM shares and $4 billion in Chrysler shares.

II. Ordinary Voting Rights given up, but Treasury retains leverage over the financial and automotive sectors

One of the basic rights afforded to shareholders is the right to vote in elections for the Board of Directors. That right establishes the basis for the balance of power between shareholders and the management of the company.

Pursuant to the purchase agreements and changes to TARP participants' charters, the preferred shares purchased through the capital purchase program are non-voting shares. However, the Treasury retains significant leverage to affect Board decisions for firms participating in TARP.

One exception to the federal government's agreement not to vote its TARP preferred shares is a provision permitting the holder of the preferred shares to nominate two "preferred directors" to the Board in the event that the participating firm falls behind on its preferred dividend payments for six successive quarters.

The Treasury preferred shares also retained the right to vote on any mergers or exchange activity and on new issuance of shares.

In addition, the government mandated certain corporate governance changes for firms participating in TARP. Assuming that Treasury maintains the legal authority to waive those provisions, it could offer to do so in exchange for other changes in corporate policy.

SEC Reform of Shareholder Access to the Corporate Ballot

In 2003 and 2007, the Securities and Exchange Commission considered proposals to include shareholder nominees on the corporate ballot. (For a summary of the battle for shareholder representation on corporate boards, and the arguments on either side, see J.W. Verret, *Pandora's Ballot Box, or a Proxy with Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined* 62 The Business Lawyer 1007 (2007)).[1] The SEC ultimately failed to come to a consensus on ballot access and the initiative failed to pass in either attempt.

Chairman Frank has indicated his support for shareholder access to the corporate ballot, increasing the chances that it may be re-considered soon either through legislative action or SEC

[1] Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=970013.

rulemaking. In that event, the Treasury may gain additional influence over banks participating in TARP. Though the Treasury has given up voting rights in the preferred shares that it holds, that does mean that it has given up the right to nominate prospective directors for other shareholders to vote on under a future SEC Proxy Access Rule. Further, Treasury will be able to vote its common shares if it exercises the warrants in the participating banks.

III. Comparable Examples: Government Ownership and Constituent Directors

The implications of government ownership in private entities depend on the criteria used to analyze the situation. Constituent directors tend to gain power when governments have equity and debt leverage over private firms. Labor is the primary constituent of the corporation that seeks influence over the corporation, but local constituencies seeking to block cross border flows of capital and services, consumer rights activists, and environmental activists also seek a role. If increasing labor and other constituent participation in corporate decisions is the objective, then government leverage over boards of directors is a benefit.

If, however, maximizing the returns to the taxpayer from TARP shares (as well as to other investors, including mutual funds and public pensions) is the objective, then the presence of constituent directors is a cost associated with the Treasury's leverage and equity position in the financial and automotive sector. A significant element of tension between shareholder wealth maximization and constituent directors is inescapable.

Europe's Golden shares

During the privatization wave of the 1980s and 90s in Western Europe, governments sold off majority stakes in airlines, automotive and other manufacturers, banks, utilities, and a variety of other industries. Many of them kept shares that included provisions permitted the holder to block any merger or acquisition of the newly privatized company. Though these shares represented minority positions in those firms, the ability to veto mergers gave state investors a powerful voice in the company's decision-making.

Many argue that those governments used their rights in golden shares to block legitimate offers to acquire those companies out of an interest in maintaining inefficiently high levels of employment or reducing cross-border flows of capital and services. France and Germany have been the subject of extensive litigation before the European Commission over their golden shares in, for instance, Airbus and Volkswagon.

Academic findings on the effect of residual governmental ownership in privatized firms have been mixed. One leading study found that when governments maintained equity positions, including golden shares, in privatized industries, those industries were twice as likely to require and obtain governmental bailouts and subsidies.[2]

Calpers and Free Trade

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[2] Bernardo Bortolotti and Mara Faccio, Government Control of Privatized Firms, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=536683.

Governments as investment entities face pressure from local interest groups to use their shareholder rights to inhibit the free flow of capital into and out of the political jurisdiction associated with the investment entity.

The California Pension Fund, one of the most active institutional investors in the United States, offers a useful comparison. In a recent press release, CalPERS' CEO highlighted the impact of CalPERS investments on the California economy with the following observation: "This research contains impressive evidence that CalPERS is a powerful economic engine in California, rivaling many of our top industries,' said CalPERS Chief Executive Officer Fred Buenrostro. '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.'"[3] Critics of the institution maintain that it is frequently willing to sacrifice the long-term value of its investment portfolio in order to encourage firms in which it invests to only do business in California. CalPERS asserts that its activism reflects a strong desire to do both.

IV. Federal Securities Class Actions

Another powerful tool shareholders possess is the right to join in, and in some cases serve as lead plaintiff in, private litigation against firms covered by the federal securities laws for violations of disclosure laws, registration requirements, fraud provisions and other rules.

According to Cornerstone Research, since 1999 roughly a hundred federal securities class actions settle every year with an aggregate value that tends to track anywhere from $1 billion to $6 billion. In some blockbuster years that amount is higher, such as in 2006 when the securities plaintiffs bar recovered $17 billion (half of which was a result of the Enron case).[4]

Institutional Investors are the lead plaintiff in 60% of securities class actions. The other plaintiffs in the class rely on the lead plaintiff to manage the litigation on their behalf and look out for their best interests. As the largest shareholder in the financial services and automotive sectors, the Treasury may have to face the prospect of getting involved in securities class actions.

To get an idea of the potential size of this activity, CalPERS provides a useful comparison. CalPERS has roughly $250 billion in assets under management, $100 billion smaller than the current cost of TARP investments. In 2008 alone CalPERS recovered $925 million through serving as lead plaintiff in securities class action litigation. Given that TARP investments could increase, and that the financial services sector is more prone to litigation risk owing to its place at the center of the economic recession, Treasury participation in federal securities class actions could potentially amount to billions of dollars per year.

One relevant question that should be considered is whether Treasury would be an appropriate lead plaintiff. Is there a conflict when the government has an interest in the long-term health of the defendant? Typically lead plaintiffs do not have an incentive to help the defendant, but the federal government's interest in prevention of systemic stress to the banking system may compromise Treasury's suitability as a lead plaintiff.

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[3] CalPers September 17, 2007 Press Release, available at http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2007/sept/boost-ca-economy.xml.

[4] Securities Class Action Clearinghouse, Securities Class Action Settlements: 2007 Review and Analysis, available at http://securities.stanford.edu/Settlements/REVIEW_1995-2007/Settlements_Through_12_2007.pdf.

Another open question is who will manage those rights? Will the DOJ or the SEC play a role? The DOJ and the SEC have expertise in securities fraud enforcement, which is a form of litigation relatively similar to private litigation, but there's a conflict here as well. Plaintiffs typically piggyback on SEC enforcement actions. For instance, 20% of settled securities class actions since 1999 have also involved companion SEC actions, and the recovery of a private action tends to double when the SEC is also involved.

Would the agency that is charged with managing these rights contract out the representation to a private plaintiff? Another interesting question is whether the Private Securities Litigation Reform Act, which governs the rights of lead plaintiffs in federal securities class actions, should be changed in light of the fact that the federal government may become the dominant player in securities litigation? Should there be any safe-harbors in light of the fact that TARP purchases are intended to ensure the health of the nation's banking system?

One argument against Treasury exercising its shareholder litigation rights would be that it would be a bad idea to sue banks that are already under severe stress such that they pose a systemic threat to the health of the nation's banking system. The counter to that argument would be a new iteration of the moral hazard argument common to banking and insurance regulation: a bank may have carte blanche to violate the securities laws if it knows that its control shareholder will not penalize the bank by instituting litigation out of fear of harm to the financial system.

One important issue worth addressing is that, in light of Section 3(c) of the Securities Exchange Act, some statutory clarification of the application of an implied private right of action under 10b-5 for the federal government may be required for the Treasury to participate in federal securities class actions.

The Delaware Court of Chancery

Shareholders are also granted certain rights by the corporate laws of a company's state of incorporation. 60% of the Fortune 500 have chose Delaware as their state of incorporation. Under Delaware law, shareholders have the right to sue the directors of a company for violations of their fiduciary duties as directors. They also have the right to seek an injunction of corporate mergers, seek appraisal of the value of their shares in certain instances, and seek inspection of the books and records of a corporation. These litigation rights will also need to be considered very carefully by the Treasury, and much of the analysis concerning participation in federal securities class actions will also apply to Treasury's exercise of its state law shareholder rights.

V. Liability and Ethics

Control Shareholders have fiduciary duties to other shareholders

Under state corporate law, shareholders that are deemed to be in control of the corporation have a fiduciary duty to other shareholders in the corporation. This means that when they use their influence over the company to cause changes in corporate policy that harm the other shareholders in the corporation, the control shareholders become liable to the other shareholders. Although a clever plaintiff may be able to argue otherwise, the federal government likely has sovereign immunity from control person liability that is not waived by the Tucker Act. But the question is should the federal government retain that immunity?

Insider Trading

Trading based on inside information is also a violation of Rule 10b-5 of the federal securities laws. Section 3 (c) of the Exchange Act exempts the U.S. Government from, among other things, insider trading laws. The Treasury would nevertheless cause tremendous damage to the financial markets if it were to trade its TARP preferred shares using the voluminous inside information is possesses through its regulatory and market interactions with the banks participating in TARP.

Though they also frequently can access inside information from companies' interaction with state regulators, state pension funds are not immune from insider trading liability. The Alabama State Pension Fund recently had to pay nearly a million dollars to the Liberty Group to settle a claim that they traded in the knowledge that Liberty was soon to receive a favorable licensing decision from another Alabama State Agency.

Whether or not the U.S. Treasury is at risk, to maintain the integrity of capital markets it should institute a program to ensure that sales of TARP preferred shares are not influenced by knowledge internal to the Treasury Department or other banking regulators that the rest of the market has not been given. The foundational justification for insider trading regulation is that the prospect of insider trading causes investors to consider the game "rigged" and they become unwilling to invest their assets in a market where insider trading is occurring.

Consider also that amending TARP and the Exchange Act to permit liability in state court for control person fiduciary duty violations and in federal court for violation of the federal insider trading laws would give private plaintiffs an incentive to monitor the decisions of the federal government with respect to TARP investments.

VI. Conclusion

The federal government's position as the dominant shareholder in the financial services and automotive sectors requires careful consideration of its shareholder rights. Governments are a very unique brand of shareholder. Without careful consideration and advance planning for how those shareholder rights and responsibilities will be managed, the unintended consequences to capital markets could be dramatic.