DEVELOPMENTS IN BANKING AND FINANCIAL LAW: 2010

I. *Fight, Flight or Acquiescence: Potential Financial Industry Responses to the Obama Bank Tax*

A. Introduction

On January 14, 2010, President Obama proposed a "Finanial Crisis Responsibility Fee" (the "Fee" or the "Bank Tax") that would require the "largest" Wall Street firms to "pay taxpayers back" for $117 billion in expected losses from the Troubled Asset Relief Program ("TARP").[1] The proposed Fee, however, would tax primarily banks that have already paid back their TARP loans with interest.[2] Proponents of the Fee argue that these banks have a continuing obligation to reimburse taxpayers for financing TARP and similar government programs.[3] Opponents argue that the Fee unfairly singles out banks that have met their TARP obligations while excluding other recipients of government aid like Fannie Mae, Freddie Mac and the automotive industry.[4] Opponents also claim that the Fee will harm taxpayers by limiting capital for bank lending and by encourging banks to pass on the Bank Tax to customers through increased fees.[5] Bank lobbyists are presently considering a constitutional challenge to the tax on the premise that it would levy an arbitrary and punitive punishment on major banks.[6] This article discusses the mechanics of the proposed Fee, presents arguments for and against the Fee, analyzes potential constitutional challenges to the Fee and argues for the appropriate financial industry response to the Fee.

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[1] U.S. DEPARTMENT OF TREASURY, FACT SHEET: FINANCIAL CRISIS RESPONSIBILITY FEE, TG-506, (Jan. 14, 2010), http://www.ustreas.gov/press/releases/tg506.htm [hereinafter FACT SHEET].
[2] Jonathan Weisman & David Enrich, *Obama Unveils $90 Billion Bank Tax With Sharp Words*, WALL ST. J., Jan. 15, 2010. At A4.
[3] David Wessel, *Why the Bank Tax Has a Chance*, WALL ST. J., Jan. 21, 2010, at A2.
[4] *Id*.
[5] Editorial, *The 'Responsibility' Tax*, WALL ST. J., Jan. 15, 2010, at A12.
[6] Eric Dash, *Wall St. Weighs a Challenge to a Proposed Tax,* N.Y. TIMES, Jan. 17, 2010, at B1.

B. Mechanics of the Responsibility Fee

The Fee would levy an annual tax on the "largest" financial institutions in order to recoup $117 billion in expected TARP losses.[7] The Obama administration expects that the Fee would cover the $117 billion TARP shortfall in twelve years, but the Fee would remain in place longer if necessary to recoup all TARP losses.[8] The Fee would apply to U.S. firms and U.S. subsidiaries of foreign firms—including insured depository institutions, banks, thrifts, insurance companies and securities broker-dealers—with more than $50 billion in consolidated assets (the "Covered Firms").[9] Covered Firms would pay roughly $1.5 million for every $1 billion in "liabilities" taxed under the Fee.[10] "Liabilities" for purposes of the Fee means total liabilities and equity of a firm, reduced by Tier-1 capital, FDIC-assessed deposits and insurance policy reserves.[11]

Importantly, the Fee is not contingent on whether firms received TARP loans or other direct government assistance.[12] Some firms that benefitted directly from TARP or other government programs are exempt from the Fee, including Fannie Mae, Freddie Mac and car manufacturers.[13] In addition, other firms could theoretically be required to pay the Fee even if they did not receive TARP money or participate directly in government assistance programs.[14]

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[7] FACT SHEET, *supra* note 1.

[8] *Id.*

[9] *Id.*

[10] Jackie Calmes, *Taxing Banks for the Bailout*, N.Y. TIMES, Jan. 15, 2010, at B1. The Fee would levy a 0.15% annual tax on "covered liabilities." FACT SHEET, *supra* note 1.

[11] FACT SHEET, *supra* note 1 ("*Covered Liabilities = Assets – Tier 1 Capital – FDIC-assessed deposits (and/or insurance policy reserves, as appropriate*.")).

[12] FACT SHEET, *supra* note 1; *see also* DAVIS POLK & WARDWELL, CLIENT NEWSFLASH, *PRESIDENT OBAMA PROPOSES TAX ON LARGE FINANCIAL FIRMS*, Jan. 15, 2010, http://www.davispolk.com/files/Publication/ec0a48f9-dee6-4920-a5db-0454ad4f7c15/Presentation/PublicationAttachment/d0a4a0ec-d9b8-4af2-9616-0617c7e47c8e/011510_Tax.html.

[13] *See* FACT SHEET, *supra* note 1; DAVIS POLK & WARDWELL, *supra* note 12.

[14] FACT SHEET, *supra* note 1 ("[Covered] institutions [include] recipients and/or indirect beneficiaries of aid provided through the TARP, the

C. Reactions to the Responsibility Fee

1. Arguments in Support of the Fee

The principle justification for the Bank Tax is fairness to taxpayers.[15] After Lehman Brothers filed for bankruptcy in September 2008,[16] some industry leaders speculated that other major U.S. financial institutions—including Morgan Stanley and Goldman Sachs—might soon follow.[17] By September 2009, the Treasury Department had distributed over $364 billion in taxpayer-funded TARP loans.[18] Analysts now project that top Wall Street firms—including Morgan Stanley and Goldman Sachs—will report roughly $450 billion in annual revenues, a 25% increase from pre-crisis levels in 2006.[19] These top firms are also expected to pay employees a record $145 billion in bonuses and other compensation for 2009.[20] At the same time, over 10% of the American workforce that helped finance TARP remains unemployed.[21] The juxtaposition of record Wall Street compensation with high unemployment rates seems intuitively unfair. As President Obama argued, if the same firms that received TARP loans can "afford massive bonuses," they can also "afford [to] pa[y] back every penny to taxpayers."[22]

Temporary Liquidity Guarantee Program, and other programs that provided emergency assistance to limit the impact of the financial crisis.").

[15] *Id.* ("[The Fee] would require . . . Wall Street firms to pay taxpayers for the[ir] extraordinary assistance . . . .").

[16] Sam Mamudi, *Lehman Folds With Record $613 Billion Debt*, MARKETWATCH , Sept. 15, 2008, http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt?siteid=rss.

[17] ANDREW ROSS SORKIN, TOO BIG TO FAIL 3 (Penguin Books 2009) (discussing J.P. Morgan CEO Jamie Dimon's belief in September 2008 that AIG, Morgan Stanley, and Goldman Sachs were candidates for bankruptcy).

[18] Press Release, Dep't of Treas., New Report Shows Higher Returns, Lower Spending Under TARP than Previously Projected, (Dec. 10, 2009) http://www.financialstability.gov/latest/tg_12092009.html.

[19] Stephen Grocer, *Banks Set for Record Pay*, WALL ST. J., Jan. 15, 2010, at A1.

[20] *Id.*

[21] Wessel, *supra* note 3.

[22] Jesse Lee, The *President to Wall Street: "We Want Our Money Back, and We're Going to Get It,"* WHITE HOUSE BLOG, Jan. 14, 2010, http://www.

Fairness to taxpayers would also support a tax on the largest financial institutions to recoup the TARP shortfall even if these firms did not need TARP loans or have repaid their TARP loans with interest.[23] Banks benefitted not only from TARP but from other market-stabilizing government programs like the "FDIC guaranteeing bank debt," "the government rescue of money-market funds" and "the backstop of the commercial paper program."[24] As a result, many firms have vaulted from potential bankruptcy to soaring revenue and record-high compensation packages.[25] These banks represent the true "winners" of the financial crisis; the benefits they received directly or indirectly from taxpayer-funded government programs far outweigh the burden of covering the TARP shortfall.[26] Moreover, the statute creating TARP stipulates that by 2013 the President must propose a plan that recoups the TARP shortfall "from the financial industry."[27] The Bank Tax fulfills this statutory requirement "three years early."[28]

Taxing bank "liabilities" may also deter excessive leveraging and increase lending.[29] Many analysts argue that overleveraging by Wall Street banks—borrowing money far in excess of capital in order to increase the size and profit impact of investment positions—perpetuated the financial crisis.[30] Since the "liabilities" taxed under the Fee exclude Tier I capital, FDIC-assessed deposits and insurance

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whitehouse.gov/blog/2010/01/14/president-wall-street-we-want-our-money-back-and-were-going-get-it.

[23] *See* Christopher Beam, *Bank Shot*, SLATE, Jan. 14, 2010, http://www.slate.com/id/2241539/.

[24] *Id*. For example, Goldman Sachs's CEO Lloyd Blankfein maintains that his firm never needed TARP loans, but Goldman Sachs used the FDIC guarantee program to raise $21.2 billion in new capital. Vipal Monga & Michael Rudnick, *What is a Bank?*, THE DEAL MAGAZINE, Feb. 5, 2010, http://www.thedeal.com/newsweekly/features/cover-stories/what-is-a-bank.php.

[25] Grocer, *supra* note 19.

[26] Wessel, *supra* note 3.

[27] FACT SHEET, *supra* note 1.

[28] *Id.*

[29] *Id.*

[30] Andy Kessler, *Bank Pay Controls Aren't the Answer,* WALL ST. J., Sept. 23, 2009 at A25 ("It wasn't risk but leverage that did in the financial system. Without that leverage, we'd have had an investment-banking profit crisis, not a credit crisis."). SORKIN, *supra* note 17, at 4 (stating that Wall Street firms in 2007 had an average debt to capital ratio of 32:1).

policy reserves, the Fee is computed primarily on the "bad debt" that leads to excessive leverage.[31] Banks may also choose to reduce their "liabilities" under the Fee by increasing lending based on the amount of insured deposits they have.[32]

2. Arguments in Opposition to the Fee

The principle argument against the Bank Tax is fairness to Covered Firms. Considerable evidence suggests that the largest U.S. banks were forced to accept TARP loans.[33] Assuming *arguendo* that some of these banks would have accepted TARP money voluntarily, five of the six largest banks have already repaid their TARP money with interest.[34] Goldman Sachs, for example, has repaid its TARP loans to the federal government with 23% interest.[35] The proposed tax, however, would require that these banks also cover $117 billion in TARP losses created by other industry segments like car manufacturers.[36] Under the terms of the plan, firms that did not receive TARP money or other direct government aid could also be forced to pay the tax.[37] Obama administration officials defend the tax's broad application by arguing that the Covered Firms "caused the crisis that doomed the auto companies."[38] Yet mortgage-lenders like Fannie Mae and Freddie Mac, which perpetuated the "housing boom and bust" that led to the credit crisis, remain exempt from the

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[31] *See* FACT SHEET, *supra* note 1.
[32] Christopher Beam, *supra* note 23.
[33] Language from Secretary Paulson's "Talking Points" memo prepared for an October 13, 2008 meeting with the heads of the largest U.S. banks suggests that these banks had no choice but to accept TARP loans: "We don't believe it is tenable to opt out [of TARP] . . . . If a capital infusion is not appealing, you should be aware your regulator will require it in any circumstance." *Paulson Gave Banks No Choice On Government Stakes: Memos*, REUTERS, May 14, 2009, http://www.reuters.com/article/idUSTRE54D0NH20090514.
[34] Weisman & Enrich, *supra* note 2. The following banks have repaid their TARP loans (in ellipses): JP Morgan ($25 billion), Bank of America ($45 billion), Goldman Sachs ($10 billion), Morgan Stanley ($10 billion), Wells Fargo ($25 billion). *Id.*
[35] Beam, *supra* note 23.
[36] FACT SHEET, *supra* note 1; DAVIS POLK & WARDWELL, *supra* note 12.
[37] FACT SHEET, *supra* note 1; DAVIS POLK & WARDWELL, *supra* note 12.
[38] Editorial, *The 'Responsibility' Tax*, *supra* note 5.

Fee.[39] As Warren Buffet argues, the Fee functions as a "guilt tax," imposing full blame on firms that contributed only partially to the financial crisis.[40]

The Fee may also harm the very taxpayers it is designed to repay. President Obama expressed concern in his State of the Union Address that "financing [has] remain[ed] difficult" for taxpayers looking to start small businesses.[41] Many Republicans argue, however, that a new Bank Tax will reduce bank profitability, which will in turn reduce bank capital available for reinvestment in new loans for small businesses.[42] Opponents of the Fee also express concern that banks will attempt to pass the Fee on to taxpayers through increased ATM fees, among other things.[43] J.P. Morgan CEO Jamie Dimon admitted as much when discussing the proposed tax: "All businesses pass their costs on to their customers. That is not unnormal."[44] If the Bank Tax will ultimately be paid through increased fees to customers, it may amount to "[n]othing more than another tax on the American public."[45]

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[39] *Id.*

[40] *Warren Buffett Blasts Obama's Bank Tax, Compares It to a 'Guilt Tax,'* HUFFINGTON POST, Jan. 30, 2010, http://www.huffingtonpost.com/2010/01/20/warren-buffetts-housing-s_n_429850.html.

[41] *Obama's State of the Union Address*, N.Y. TIMES, Jan. 27, 2010, http://www.nytimes.com/2010/01/28/us/politics/28obama.text.html.

[42] Damian Paletta et al., White House's Tax Proposal Targets Big Banks' Risks, Wall St. J., Jan. 14, 2010, at A4 (quoting Rep. Jeb Hensarling (R., TX): "How you are going to tax banks and expect them to lend more is frankly lunacy.").

[43] Peter Wallsten, *Bank Tax is Centerpiece of Party's New Populism*, WALL ST. J., Jan. 16, 2010, at A4.

[44] Rex Nutting & Robert Schroeder, *Obama Proposes Special Fee on Financial Companies*, MARKETWATCH, Jan. 14, 2010, http://www.marketwatch.com/story/obama-proposes-special-Fee-on-financial-companies-2010-01-14?pagenumber=1.

[45] Ryan McCarthy, *Obama Bank Tax Could Face Legal Battle from Wall Street*, HUFFINGTON POST, Jan. 30, 2010, http://www.huffingtonpost.com/2010/01/18/obama-bank-tax-could-face_n_426860.html (quoting Republican National Committee Chairman Michael Steele).

D. Potential Constitutional Challenges to the Responsibility Fee

Jamie Dimon argues that the Fee would "us[e] tax policy to punish" banks.[46] But is the Fee's "punishment" of banks unconstitutional? Wall Street lobbyist the Securities Industry Financial Markets Association ("SIFMA") hired a "top Supreme Court litigator" to study whether a tax singling out banks would be unconstitutionally "arbitrary and punitive."[47] Under this theory, SIFMA would have two apparent constitutional challenges available: (A) a Fifth Amendment equal protection challenge and (B) a bill of attainder challenge.

1. Fifth Amendment Equal Protection Clause Challenge

SIFMA could argue that a federal statute singling out one industry for punishment violates the equal protection of persons guaranteed implicitly by the Fifth Amendment.[48] The Supreme Court held that a "corporation" is a "person" under the Fourteenth Amendment's Equal Protection Clause."[49] By analogy, the Fifth Amendment's implicit "equal protection guarantee" would also treat a corporate entity as a "person." Since the Supreme Court has never heard a Fifth Amendment equal protection challenge to a federal tax, however, SIFMA would have to argue from analogy based on state tax challenges under the Fourteenth Amendment.

The Supreme Court held that the Fourteenth Amendment's Equal Protection Clause permits states to single out persons for taxation so long as the legislature has a "reasonable" and non-arbitrary "policy reason for the classification."[50] The Court has emphasized that its Equal Protection Clause analysis is "especially deferential in the context of classifications made by complex tax

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[46] Paletta et al., *supra* note 42.
[47] Dash, *supra* note 6.
[48] U.S. CONST. amend. V; Bolling v. Sharpe, 347 U.S. 497, 499 (1954) (holding that the Firth Amendment of the United States Constitution contains an implicit guarantee of "equal protection" under federal legislation equivalent to the Fourteenth Amendment's explicit equal protection guarantee with respect to state legislation).
[49] Metropolitan Life Insurance Co. v. Ward, 470 U.S. 869, 881 fn. 9 (1985).
[50] Nordlinger v. Hahn, 505 U.S. 11, 12 (1992).

laws."[51] The statute creating TARP (the Emergency Economic Stabilization Act or the "EEOC") requires explicitly that the President "submit a legislative proposal [by 2013] that recoups from the financial industry an amount equal to the [TARP] shortfall."[52] President Obama would use his discretion under the EEOC to tax only those members of the "financial industry" most able to absorb the Fee.[53] In addition, the Fee would tax only bank "liabilities" associated with overleveraging—arguably a cause of the financial crisis.[54] The Fee represents a policy choice that satisfies the EEOC requirement of recouping the TARP shortfall while discouraging Covered Firms from repeating practices that perpetuated the financial crisis. Therefore, the Court would likely find that the Fee functions as a "reasonable" tax policy under the Court's deferential equal protection standard.

2. Bill of Attainder Challenge

SIFMA could also argue that a federal tax singling out one industry for punishment violates the Bill of Attainder Clause of the U.S. Constitution.[55] The Bill of Attainder Clause prohibits Congress from enacting statutes that "legislatively determin[e] guilt and inflic[t] punishment" on an individual or group without a judicial trial.[56] The applicability of the Clause to corporations, however, "remains unsettled in every circuit," and the Supreme Court has

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[51] *Id.* at 12.

[52] Emergency Economic Stabilization Act, Pub.L. 110-343, § 134, 122 Stat 3765, 3798 (2008).

[53] President Obama anticipates that over 60% of the Bank Tax's revenue will be paid by the "10 largest financial institutions." FACT SHEET, *supra* note 1. The banking industry is expected to report roughly $450 billion in revenue and a record $145 billion in employee compensation and benefits for 2009. *See* Grocer, *supra* note 19. In contrast, TARP recipient General Motors—who is exempt from the Bank Tax—filed for bankruptcy in 2008, has not yet paid back its TARP loans, and saw its U.S. sales in 2009 drop 30% from the previous year. Bill Vlasic, *Chief Says G.M. Is on Road to Profits*, N.Y. TIMES, Jan. 6, 2010, at B2.

[54] FACT SHEET, *supra* note 1; *see* Kessler, *supra* note 30.

[55] U.S. CONST., art. I, § 9, cl. 1; *see* John Carney, *The Bank Tax And The Constitutional Ban On Bills Of Attainder*, BUSINESS INSIDER, Jan. 21, 2010, http://www.businessinsider.com/the-bank-tax-and-the-constitutional-ban-on-bills-of-attainder-2010-1.

[56] Nixon v. Admin. of Gen. Servs., 433 U.S. 425, 468 (1977).

never definitively addressed the question.[57] Assuming the Clause would apply to banks, the Fee would have to meet two requirements to qualify as an unconstitutional Bill of Attainder: specificity and punishment.[58]

"Specificity" is satisfied when a statute names or describes a group such that it is "readily ascertained that the law is directed at that specific group."[59] The Fee would likely satisfy the specificity requirement if the final statute, like the White House proposal, covers explicitly the "largest and most highly levered Wall Street firms" that meet the Fee's stated financial criteria.[60] SIFMA would have more difficulty, however, proving that the tax constitutes a punishment. The Court will not strike down a statute as a Bill of Attainder if the alleged punishment serves "reasonably" to "further non-punitive" legislative "policymaking."[61] SIFMA could argue from Jamie Dimon's position that the Fee's tax policy is really just a pretext for punishing banks. The EEOC requires that the "financial industry"—not just the "largest" banks—repay TARP.[62] President Obama admitted that his desire to levy the Fee was "heightened" by "reports of massive profits and obscene bonuses" at top banks.[63] Bank tax exemptions for GM, Fannie Mae and Freddie Mac also support the inference that the Fee is a pretext for punishing only big banks. The Fee, however, serves two facially valid policy goals: (1) recouping TARP loans only from firms financially stable enough to

[57] Consolidated Edison Co. v. Pataki, 292 F.3d 338, 347 (2d. Cir. 2002) (quoting South Carolina v. Katzenbach, 383 U.S. 301, 324) (explaining that the Bill of Attainder Clause provides "protections for individual persons and private groups, those who are peculiarly vulnerable to nonjudicial determinations of guilt . . . .").

[58] Nixon, 433 U.S. at 472-73; Alison C. Carrigan, *The Bill of Attainder Clause: A New Weapon to Challenge the Oil Pollution Act of 1990*, 28 B. C. ENVTL. AFF. L. REV. 119, 120 (2000).

[59] Carrigan, *supra* note 58 at 140 (*citing* U.S. v. Brown, 381 U.S. 437, 461 (1965)).

[60] FACT SHEET, *supra* note 1.

[61] Nixon, 433 U.S. at 476-478. The Supreme Court has also emphasized that the Bill of Attainder Clause "was not intended to serve as a variant of the equal protection clause" for challenging statutes that "legislatively burde[n] some . . . groups but not all other plausible individuals." *Id.* at 428.

[62] *Compare* Emergency Economic Stabilization Act, *supra* note 52, *with* FACT SHEET, *supra* note 1 (The Fee would "require the largest and most highly levered Wall Street firms to pay back taxpayers . . . .").

[63] Lee, *supra* note 22.

pay the Fee and (2) taxing banks' "liabilities" to curb the systemic risk associated with overleveraging.[64] Under these two policy rationales, SIFMA will be hard-pressed to prove that the Fee is unreasonably punitive and, hence, unconstitutional.

E. The Appropriate Financial Industry Response to the Responsibility Fee

A basic question presupposes any analysis of whether SIFMA can win a constitutional challenge to the Fee: Should the financial industry challenge the Fee at all? Several key considerations suggest that the financial industry's best response is to acquiesce to the Bank Tax.

First, the Bank Tax would not impact annual profits if firms covered the Fee through a marginal reduction in annual bonuses.[65] Some analysts estimate that the tax would consume about 5% of Wall Street profits for 2009.[66] Analysts anticipate, however, that the Fee will also be tax deductible.[67] If both compensation and the Fee are tax deductible, then banks could reduce bonuses dollar-for-dollar with the Fee and still make the same amount of annual profits.[68]

Second, the Fee could effectively "protect banks from a much more punitive damage" that is not limited to TARP repayments.[69] Some members of Congress are pushing for a "50% tax on bonuses over $50,000" for firms that received government aid during

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[64] *See* Carney, *supra* note 55 (identifying "revenue collection" and "regulation of risk" as two legislative "policy" goals of the Bank Tax which would arguably be sufficient to overcome a Bill of Attainder challenge).

[65] *See* Wessel, *supra* note 3 (presenting Larry Summers's argument that firms could pay the Fee through a marginal reduction in bonuses which, Summers implies, would not significantly affect profits).

[66] Grocer, *supra* note 19.

[67] Wessel, *supra* note 3.

[68] If the average bonus per employee is roughly $125,000, and the Bank Tax would reduce pretax profits by 5%, then by reducing the average bonus by 5% to $100,000 per employees, profits remain the same. *See* David B. Caruso and Michael Gormley, *Wall Street Bonuses Shoot Up 17 Percent in 2009*, YAHOONEWS.COM, Feb. 23, 2010, http://news.yahoo.com/s/ap/20100223/ap_on_bi_ge/us_wall_street_bonuses ("The average bonus [for Wall Street firm employees] in 2009 was $124,850.").

[69] Ezra Klein, *Obama's Bank-Friendly Bank Tax*, WASH. POST, Jan. 15, 2010, http://voices.washingtonpost.com/ezra-klein/2010/01/obamas_bank-friendly_bank_tax.html.

the financial crisis.[70] The Bank Tax would cost the financial industry $10 billion per year for the next twelve years, or roughly 6% of executive compensation and other benefits for 2009.[71] Banks' acquiescence on paying the less onerous Bank Tax could shield them from harsher tax proposals.

Third, flight from the Fee may not be a viable option. U.S. Firms could attempt to evade the Fee by increasing levels of non-taxed liabilities like "Tier-1 capital . . . relative to other funding," and U.S. subsidiaries could "move enough assets and liabilities out of the U.S. to fall below the $50 billion threshold."[72] President Obama has emphasized, however, that he will work with Congress and regulators to "design protections against avoidance by Covered Firms."[73] With banks already under so much scrutiny, flight from the Fee seems unlikely.

Finally, banks' acquiescence to the Fee would help mend Wall Street's strained relationship with the American public. President Obama has framed the Bank Tax as a "fight" against Wall Street excess in the wake of the financial crisis,[74] and more than 72% of Americans support taxing bailed-out companies for the TARP shortfall.[75] Wall Street's attempts to quell populist anger by paying a bigger percentage of bonuses in deferred shares and by requiring executives to pay a percentage of their bonuses to charitable organizations have not worked.[76] The financial industry's acquiescence to the Fee—its acceptance of "responsibility" for TARP—

[70] Weisman & Enrich, *supra* note 2.
[71] *See* FACT SHEET, *supra* note 1 (stating that the Fee would accrue $90 billion over 10 years, and $117 billion over 12); Grocer, *Banks Set for Record Pay*, *supra* note 19 (stating that the top 38 banks are projected to award employees $145 billion in compensation for 2009). ($90/10)/($145) ≈ 6.2%.
[72] DAVIS POLK & WARDWELL, *supra* note 12.
[73] FACT SHEET, *supra* note 1.
[74] *See* Michael Grunwald & Michael Scherer, *Can Bank-Bashing Help Obama?*, TIME, Feb. 8, 2010, at 28 (stating that President Obama used the word "fight" 22 times in a recent speech regarding Wall Street revenue and bonuses).
[75] *Americans Support Obama Plan to Tax Bailed-Out Banks*, RASMUSSEN REPORTS, Jan. 25, 2010 (stating that 56% of Americans also support taxing only the largest banks).
[76] See *Embarrassment of Riches*, THE ECONOMIST (Jan. 14, 2010); Louise Story, *Goldman Weighs Charity Rule for Top Earners*, N.Y. TIMES, Jan. 10, 2010, at B1.

would be a major step in restoring its credibility in the eyes of mainstream America. It would be a meaningful step in the road to recovery.

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II. The "Pay Czar" and Curbs on Executive Compensation

A. Introduction

In June of 2009, the U.S. Treasury appointed a "Pay Czar"[1] in response to public outrage over excessive bonuses paid at American International Group (A.I.G.), a company that received billions from the government bailout just months earlier.[2] To put an end to such excesses the Pay Czar, Kenneth Feinberg, was given broad authority to oversee, approve and limit compensation paid to employees at the seven companies that benefited most from the bailout.[3] Since his appointment, Feinberg has significantly curbed compensation for the 100 highest-paid employees at each company.[4] However, because the Pay Czar's restrictions are binding on only seven companies and cease to be operational after each has paid back bailout funds, some believe this to be only a temporary solution to an enduring problem.[5] It is quite possible that without permanent restrictions on bonuses at all public companies the days of excessive compensation will reign once again.

B. The Need for a Pay Czar

1. The Delaware Model of Executive Compensation

Prior to the government's implementation of the Pay Czar, each firm's board of directors made decisions concerning employee compensation.[6] As fiduciaries, boards are subject to corresponding duties, which have largely been defined and determined by the

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[1] J. Robert Brown, *The Pay Czar and Government Intervention: Further Evidence on the Need for Federal Preemption*, THE RACE TO THE BOTTOM, June 18, 2009.
[2] Marjorie Connelly, *Most Americans Condemn A.I.G. Bonuses, Poll Finds*, INT'L HERALD TRIB., Mar. 24, 2009.
[3] J. Robert Brown, *Treasury and the Regulation of Executive Compensation*, THE RACE TO THE BOTTOM, July 13, 2009.
[4] *Pay Czar Expands Salary Caps* (NPR All Things Considered broadcast Dec. 11, 2009).
[5] J. Robert Brown, *Executive Compensation and the Failing of the Pay Czar*, THE RACE TO THE BOTTOM, Jan. 17, 2010.
[6] J. Robert Brown, *The Fed Proposals and Upending the Delaware Model*, THE RACE TO THE BOTTOM, Sept. 21, 2009.

courts.[7] Delaware courts in particular have had a significant effect on determining these duties, as many large banks are incorporated and headquartered in the state. In a clear effort to encourage incorporation, Delaware courts have taken a strongly pro-management approach[8] and "have resolutely declined to impose meaningful standards on the board in determining compensation."[9] The ultimate result of such practices was compensation with nearly no limits and compensation models based on short-term benefits, as opposed to the long-term health of each company.[10] Importantly, courts failed to impose any standards that required boards to consider the relationship between compensation and risk.[11]

2. A.I.G. Bonuses

Public outrage over excessive compensation came to a head in March of 2009, when A.I.G., a company that had received over $170 billion in the government bailout, announced that it was paying $165 million in bonuses to 463 of its executives.[12] Seventy-three A.I.G. employees took home bonuses in excess of $1 million each.[13] Adding to the public furor was the fact that the employees directly benefiting from this compensation were members of the company's Financial Products subsidiary, infamously known as the unit primarily responsible for the firm's financial downfall in 2008.[14] A large majority of taxpayers believed the government should do something to recover the bonuses and to prevent similar instances of excessive compensation in the future.[15]

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[7] *Id.*
[8] J. Robert Brown, *Executive Compensation, the Delaware Model and a Proposed Solution*, THE RACE TO THE BOTTOM, Apr. 2, 2009.
[9] *The Fed Proposals and Upending the Delaware Model*, *supra* note 6.
[10] J. Robert Brown, *Goldman Sachs and Challenging the Delaware Model*, THE RACE TO THE BOTTOM, Apr. 11, 2009.
[11] *The Fed Proposals and Upending the Delaware Model*, *supra* note 6.
[12] Connelly, *supra* note 2.
[13] James Bernstein, *$1M Bonuses Went to 73*, NEWSDAY, Mar. 18, 2009.
[14] David Leonhardt, *Bonuses Shouldn't be Sacrosanct Economic Scene*, INT'L HERALD TRIB., Mar. 19, 2009.
[15] Connelly, *supra* note 2.

3. Arguments Against Government Regulation

While many Americans believed government restrictions on compensation were becoming necessary, others argued differently. Many large companies, including those who received funds in the bailout, expressed the concern that they will be unable to attract and retain top talent if the government imposes stringent limitations and restrictions on bonuses.[16] Rather than stay at companies that are subject to government regulation, the top talent will choose to work for competitors that are free from such restrictions and can pay their executives more.[17] Companies have argued that these employees possess unique knowledge in their areas of expertise and will thus be nearly impossible to replace.[18] Further, these companies have doubts that the government, which does not have specialized knowledge about each firm, could possibly know better than the board what types of incentives will be most effective.[19]

In general, Republicans object to government regulation on compensation because they claim it encroaches on the free market.[20] These individuals claim that market forces govern compensation of executives, so effectively, "CEOs are paid what they are worth."[21] Concerns from Republicans are amplified by the general increase of government involvement in the economy in recent months.[22] Since the financial disaster of 2008, the government has essentially bought companies, such as A.I.G. and General Motors, acquired significant minority stakes in others, such as Citigroup, and has pressured companies to change directors or fire CEOs.[23] Republicans believe that the additional action of restricting pay at companies is one step too far.

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[16] *Pay Czar Expands Salary Caps*, *supra* note 4.
[17] David Nicklaus, *Pay Czar May Not be Right Choice: Maybe More Democracy in Board Elections Would be a Better Way*, ST. LOUIS POST-DISPATCH, June 21, 2009, http://www.stltoday.com/business/article_0235b3bf-dbcc-56bd-b5d7-6956dd6da298.html.
[18] Leonhardt, *supra* note 14.
[19] Nicklaus, *supra* note 17.
[20] Moshe Adler, *Overthrowing the Overpaid: We Need New Laws to Check Executive Compensation*, L.A. TIMES, Jan. 4, 2010.
[21] *Id.*
[22] *The Pay Czar and Government Intervention: Further Evidence on the Need for Federal Preemption*, *supra* note 1.
[23] *Id.*

Still others have made a more general argument that the true origin of the excessive bonus problem was in fact the government bailout itself.[24] According to this argument, the U.S. would not be facing this predicament now if the government had simply let the firms fail.[25] In effect, the bailout rewarded risky behavior, just as the excessive bonuses did.

4. The Government's Response

Despite concerns about the government's involvement in the economy, Congress ultimately decided that the government should have a say on executive compensation, at least with regard to companies that most heavily relied on taxpayer money in the bailout.[26] In response to the excessive bonuses paid by A.I.G., in June of 2009, the U.S. Treasury appointed Kenneth Feinberg as the Special Master for TARP Executive Compensation, more colloquially known as the Pay Czar.[27] In his role as the Pay Czar, Feinberg became responsible for overseeing the executive compensation at the seven biggest Troubled Asset Relief Program (TARP) aid recipients.[28] These companies include A.I.G., Citigroup, Bank of America, Chrysler, General Motors, GMAC and Chrysler Financial.[29]

C. Restrictions on Executive Compensation

Among the standards that Feinberg imposed includes the requirement that compensation cannot be "inappropriate, unsound, or excessive."[30] While the terms "inappropriate" and "excessive" are left undefined, "unsound" is meant to refer to "unsound risk taking."[31] Clearly, the generalized and vague nature of this restriction means that the Pay Czar was given broad authority in his role.[32]

[24] Allison Bell, *Feinberg Looking At Execs 26 to 100*, NAT'L UNDERWRITER LIFE & HEALTH MAG., Oct. 28, 2009.
[25] *Id.*
[26] *How Curbs on Executive Pay Will Work*, The Associated Press, Aug. 13, 2009, http://www.newsobserver.com/2009/08/13/34781/how-curbs-on-executive-pay-will.html.
[27] *Treasury and the Regulation of Executive Compensation*, *supra* note 3.
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*

Further, the restrictions state that compensation at the seven companies must not reward short-term or temporary increases in value, but instead should be performance-based.[33] Also, any compensation, including bonuses, must be comparable to what similar companies award their employees.[34] The overarching goal of the government regulations is to tie executive compensation to the long-term health of the companies, which can ultimately safeguard the overall economy.[35]

In October 2009, Feinberg set dollar amounts for the compensation of each company's top 25 employees.[36] On average, total compensation for this group was cut in half compared to the previous year.[37] Salaries alone were cut by an average of 90%, with most amounting to less than $500,000.[38] In addition, Feinberg also had the responsibility of approving broader compensation formulas applied to the 75 next-highest-paid employees at each of the seven companies.[39] In December of 2009, Feinberg issued restrictions on these second-tier employees, including a $50,000 limit on cash compensation and the elimination of guaranteed bonuses.[40] Also, at least 50% of all bonuses must be paid in long-term stock held for more than three years, which ties individual compensation to the overall performance of the company.[41] Feinberg further required that cash bonuses be paid out over a two-year period[42] and that cash overall be limited to 45% of total pay.[43]

Feinberg's orders also contained an incentive for the companies to pay back the TARP money they received.[44] "Employees might get earlier access to their long-term stock grants if their

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[33] *Id.*
[34] *Id.*
[35] *Pay-Cap Plans Should be Aimed at Putting Risk Back on Business*, THE NEWS J., Oct. 23, 2009.
[36] *Pay Czar Expands Salary Caps*, *supra* note 4.
[37] Deborah Solomon & Dan Fitzpatrick, *Pay Czar to Slash Compensation at Seven Firms*, WALL ST. J., Oct. 22, 2009, at A1.
[38] *Id.*
[39] *Pay Czar Expands Salary Caps, supra* note 4.
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] Serena Ng et al., *In Battle With U.S. Over Pay, A.I.G. Chief Meets His Match*, WALL ST. J., Dec. 28, 2009, at A14.
[44] Solomon & Fitzpatrick, *supra* note 37.

companies pay back their bailout funds."[45] Under the Pay Czar law, Feinberg himself is subject to some guidelines.[46] In making his decisions, he must consider the need for TARP recipients to remain competitive and make appropriate allocations among salary, pay incentives and retirement.[47] At the same time, he must be tough enough on the companies to satisfy both Congress and the general public.[48] Finally, an important limit on Feinberg's power is his inability to "tear up pay contracts or retroactively claw back compensation already paid out."[49]

D. Performance of the Pay Czar and Alternative Solutions to the Bonus Problem

1. Performance of the Pay Czar

Reviews of Feinberg's appointment and performance have been mixed. One reaction, prevalent at the companies subject to his oversight, has been anger.[50] Most notably, A.I.G.'s CEO, Robert Benmosche, has positioned himself as a "bulwark against government intrusion into the corner office."[51] In addition to criticizing the Pay Czar's regulations, Benmosche has threatened to quit over government pay restraints, which he claims will hamper his ability to boost employee morale and keep his company competitive.[52]

The fears over losing top talent to companies free from federal oversight have materialized, to some degree.[53] In June 2009, shortly after Feinberg's appointment, several top bankers and analysts at Citigroup and Bank of America resigned, moving to similar jobs at firms without pay restrictions.[54] Among those resigning was the CEO of Citigroup's Asia Pacific Operations, a highly respected thirteen-year firm veteran.[55] In December, five senior A.I.G.

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[45] *Id.*
[46] *Pay Czar Expands Salary Caps*, *supra* note 4.
[47] *Id.*
[48] *How Curbs on Executive Pay Will Work*, *supra* note 26.
[49] *Id.*
[50] Ng et al., *supra* note 43.
[51] *Id.*
[52] *Id.*
[53] David Ellis, *Brain Drain Takes Toll at Citi and B of A*, CNNMONEY.COM, June 23, 2009.
[54] *Id.*
[55] *Id.*

executives indicated that they, too, would resign if their compensation was significantly cut.[56] Ultimately only one, A.I.G.'s general counsel, carried out this threat.[57]

Another clear effect of the Pay Czar's oversight is the hastening of TARP money payback by the firms subject to his restrictions. Eager for freedom from pay limitations. Bank of America announced in December 2009 that it would fully repay the government for the $45 billion it received in the bailout.[58] To help reach its goal, the company raised $19.29 billion by selling new shares and increased its Tier 1 Common Capital ratio from 7.3% in September to 8.4%.[59] Not all the news is good, however. As a result of the repayment, Bank of America posted a $5.2 billion loss to common shareholders in the fourth quarter of 2009.[60] Further, accounting changes are expected to bring $125 billion of off-balance-sheet assets onto the bank's balance sheet in 2010, which is likely to strain capital.[61]

Citigroup soon followed Bank of America's lead, paying back $20 billion in government bailout money in December 2009.[62] Analysts immediately expressed concern that such a move would make the bank weaker.[63] In its effort to exit TARP, Citigroup had to sell $20.5 billion in new shares, which was expected to decrease earnings per share by 20%.[64] The company's Tier 1 capital ratio was also estimated to decrease from a recent 12.8% to 11%.[65] Analysts further believed that foreign investors, who were happy with the government's former stake in Citigroup, would flee once TARP money was repaid.[66] Based on the Citigroup experience, hastily

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[56] Ng et al., *supra* note 43.
[57] *Id.*
[58] Andrew Ross Sorkin, *Bank of America Finishes TARP Repayment*, N.Y. TIMES, Dec. 10, 2009, http://deabook.blogs.nytimes.com/2009/12/10/bank-of-america-finishes-tarp-repayment/.
[59] *Id.*
[60] *Bank of America Posts $5.2 Bln Loss on TARP Repayment*, TRADINGMARKETS.COM, Jan. 20, 2010.
[61] *Ken's Last Act*, Economist.com, Dec. 3, 2009.
[62] Stephen Gandel, *Citi's TARP Repayment: The Downside for a Troubled Bank*, TIME, Dec. 15, 2009.
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Id.*

repaying bailout money in an attempt to escape the Pay Czar may have negative consequences on the financial health of companies.

2. Alternative Solutions

Feinberg himself has described his Pay Czar position as one that was created "in the hope of helping the taxpayers get their money back, not because of a belief that the government should micro-manage compensation at private companies."[67] However, much of the criticism relating to the Pay Czar has to do with the temporary nature of his authority, and many are calling for broader restrictions on a larger number of companies.[68] Certain critics have suggested some alternative solutions to the excessive compensation problem that would have more effective and long-lasting results. The argument is that the need for appointing a Pay Czar in the first place suggests an awareness that the status quo system of relying on a board of directors to determine compensation simply does not work.[69] Instead, the government must step in and impose broader restrictions.

One such proposed alternative involves preventing companies from taking advantage of a corporate tax deduction on compensation above a stated threshold.[70] The current limit sits at $1 million and applies only to base salaries, having no effect on bonuses which can account for much of an executive's total compensation.[71] Another solution has been suggested by the Federal Reserve, but has yet to be mandated.[72] According to this proposal, companies would face a penalty if they continue to pay out bonuses based on short-term profits, rather than on the long-term well-being of the firm.[73] This idea would effectively make permanent the overarching goal of the Pay Czar appointment.[74]

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[67] Bell, *supra* note 24.
[68] *The Fed Proposals and Upending the Delaware Model*, *supra* note 6.
[69] J. Robert Brown, *Government Intrusion into Executive Compensation: It's Not the Solution*, THE RACE TO THE BOTTOM, Oct. 26, 2009.
[70] Leonhardt, *supra* note 14.
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] *Pay-Cap Plans Should be Aimed at Putting Risk Back on Business, supra* note 35.

A third solution would focus on income tax reform, creating a new, higher tax bracket for the very largest incomes.[75] Currently, the tax code treats all incomes above $373,000 the same, taxing them at 35%.[76] By imposing an even heavier tax burden on incomes above, for example, $5 million, the incentive for multi-million dollar salaries and bonuses would be severely curtailed.[77] Some economists say that this tactic of higher marginal tax rates has worked in the past to hold down compensation to an acceptable level.[78] Other proposals include laws that set a maximum ratio between the highest executive compensation and the lowest worker's wage at any given company.[79] Companies could also set a ratio for the "division of income between labor and shareholders."[80]

Those who do not approve of these direct government regulations on compensation have argued that a superior alternative would focus on reforming the process inside the board of directors.[81] Experts have suggested changes such as a more democratic system in board elections, the idea being that if directors know they can be voted out, they will presumably take greater care in spending shareholders' money.[82] Increased expertise could also be required of directors, especially in the area of risk analysis.[83] Finally, the Federal Reserve could use its power to pressure any directors whose oversight proved unsatisfactory to step down from their positions on the board.[84]

E. Conclusion

While disagreement exists about what exact measures must be taken to ameliorate the problem of excessive pay, a common theme is the desire for a more permanent solution. The ultimate answer is some form of governmental presence in compensation

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75 Leonhardt, *supra* note 14.
76 *Id.*
77 *Id.*
78 *Id.*
79 Adler, *supra* note 20.
80 *Id.*
81 *Government Intrusion into Executive Compensation: It's Not the Solution*, *supra* note 69.
82 Nicklaus, *supra* note 17.
83 *The Fed Proposals and Upending the Delaware Model*, *supra* note 6.
84 *Id.*

decisions. Companies have proven that, left to their own devices, executive compensation can spin out of control. Agencies should design regulations that are broad enough to cover all public companies and that work to further the Pay Czar's ultimate goal of tying pay to the long-term health of the firm. These regulations will ensure that financial institutions will not revert back to compensation without limits following the Pay Czar's reign[85] and will help restore stability to the economy as a whole.

Leah Schubert[86]

[85] *The Pay Czar and Government Intervention: Further Evidence on the Need for Federal Preemption*, *supra* note 1.
[86] Student, Boston University School of Law (J.D. 2011).

III. Changes in Debtor-in-Possession Financing Following the Financial Collapse of 2008

A. Introduction

The financial collapse of 2008 caused nearly twice as many businesses to file for Chapter 11 bankruptcy in 2009 as filed during all of 2007.[1] A business that files a Chapter 11 bankruptcy petition often needs short-term financing in order to keep itself afloat while it works out a restructuring plan. When the credit markets tightened, bankruptcy financing became much more difficult to obtain and the terms changed substantially. This article examines how the terms and the source of bankruptcy debtor-in-possession financing changed following the financial collapse, as well as what this means for the future of debtor-in-possession financing.

B. Bankruptcy Debtor-In-Possession Basics

A business filing for bankruptcy has two options: Chapter 11 reorganization or Chapter 7 liquidation. Businesses almost always prefer to reorganize under Chapter 11 because Chapter 11 allows the owners to keep their business as going concerns. When a business files for bankruptcy, whether under Chapter 7 or 11, the business ("debtor") gets a stay against its creditors, preventing the creditors from collecting debts the business owes.[2] Under Chapter 7, the court appoints a trustee for the debtor[3] to sell off the debtor's assets.[4] Under Chapter 11, the debtor remains in possession of the business.[5] The debtor-in-possession ("DIP") then creates a plan to repay

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[1] Jean Murray, *Business Bankruptcy Filings Almost Double This Year*, ABOUT.COM US BUSINESS LAW/TAXES (Aug. 16, 2009), http://biztaxlaw.about.com/b/2009/08/16/business-bankruptcy-filings-almost-double-this-year.htm.

[2] *See* 11 U.S.C.A. § 362 (2009); David W. Marston, *DIP Financing Issues and Alternatives*, GIBBONS LAW CORP. & FIN. ALERT, Apr.7, 2009 ("[T]he automatic stay provision in Section 362(a) of the Code calls off the dogs—instantly . . . and it is in fact automatic."); Marshall S. Huebner, *Debtor-in-possession financing*, THE RMA J., Apr., 2005 ("In Chapter 11 pre-bankruptcy creditors are, for the most part, stayed from enforcement remedies . . . .").

[3] 11 U.S.C.A. § 701(a)(1) (2009).

[4] 11 U.S.C.A. § 704 (2009).

[5] 11 U.S.C.A. § 1101 (2009).

creditors and satisfy its debts subject to the bankruptcy code.[6] While the process is becoming more streamlined, it can take months or years for a debtor to work out a satisfactory plan with its creditors.[7] Although filing for bankruptcy imposes a stay against the creditors and freezes liabilities, the typical bankrupt business is financially distressed and desperately needs cash in order to operate during restructuring.[8] Without an infusion of cash, it will have to liquidate. Short term financing to keep a bankruptcy debtor afloat is called debtor-in-possession financing ("DIP financing").

C. The Collapse

In good economic times, lenders eagerly offer DIP financing because they can charge high interest rates and the loans are relatively safe (DIP lenders are paid back first, before any debt or equity holders).[9] In fact, there has been only one major incident where a debtor was unable to repay the DIP lender.[10] However, when the financial collapse took hold and credit markets froze, so did DIP financing.

DIP financing became especially difficult as a result of the financial collapse for a few reasons. First, DIP financing traditionally has been the province of investment banks and hedge funds.[11] For example, Lehman Brothers, before its collapse, was a large DIP lender,[12] as were Merrill Lynch and the investment banking side of

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[6] 11 U.S.C.A. § 1106(a)(5) (2009).

[7] Kate Haywood, *Leveraged Loans Ramp Up*, WALL ST. J, Jan. 16, 2010, at B7; *see also* Marston, *supra* note 2.

[8] Huebner, *supra* note 2 ("While most of its pre-bankruptcy liabilities are frozen, the company is likely to need cash immediately to cover payroll and the up-front costs of stabilizing the business.").

[9] Stephen A. Donato & Thomas L. Kennedy, *Trends in DIP Financing: Not as Bad as It Seems?*, THE J. OF CORP. RENEWAL, Oct 22, 2009, *available at* http://www.turnaround.org/Publications/Articles.aspx?objectId =11602 ("DIP loans traditionally were viewed as safe and profitable for lenders. . . ."); 11 U.S.C.A § 364 (2009); Michael J. de la Merced, *Bankruptcy Could Be More Costly*, N.Y. TIMES, Feb. 18, 2009, at B1; Marston, *supra* note 7 ("We never lost one penny in Chapter 11 financings in all of those years.").

[10] Merced, *supra* note 9.

[11] *See id.* (listing several DIP financers, all investment banks).

[12] Donato & Kennedy, *supra* note 9; Merced, *supra* note 9 ("One big DIP financier was Lehman Brothers . . . .").

Wachovia.[13] Investment banks and hedge funds were hit especially hard during the financial crisis, and were in no position to lend. Second, bankruptcy indicates a risk of default, and during the financial crisis lenders fled to safer investments.[14] GE capital provides a prime example. Before the financial collapse, GE Capital was the largest DIP volume lender in America.[15] In October 2008, GE Capital announced that it would freeze DIP financial services.[16] If the Lehman Brothers collapse serves as the symbolic fall of the stock market, GE Capital's decision to freeze DIP financing serves as the symbolic fall of DIP financing.[17] Third, easy and cheap credit in the years leading up to the financial collapse meant that many businesses filing for bankruptcy were highly leveraged.[18] These highly leveraged businesses didn't have enough unencumbered assets to use as collateral for a DIP loan.[19] The fact that the financial collapse caused twice as many Chapter 11 bankruptcy filings exacerbated the problem of limited DIP financing.[20]

D. Changes in DIP Financing

Increased bankruptcy filings and fewer lenders after the financial collapse put those who were willing to lend in a very favorable position. The resulting changes in DIP financing include: lenders receiving more favorable terms, the primary source of DIP loans changing from third-parties to creditors of the business, DIP lenders putting special conditions in their loans such as roll-up provisions and equity conversion, third party-lenders' changed motivation from restructuring loans to asset sales and the role of the United States and Canadian government.

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[13] Merced, *supra* note 9.

[14] *See* Marston, *supra* note 2 ("[M]any suddenly risk-averse banks are now reluctant to lend into a legal proceeding that has the word 'bankruptcy' on the first page of the pleadings . . . .").

[15] Donato & Kennedy, *supra* note 9.

[16] Jeffrey McCracken & Paul Glader, '*DIP' Loans are Scarce, Complicating Bankruptcies*, WALL ST. J., Oct. 17, 2008, at C1.

[17] *Cf.* Donato & Kennedy, *supra* note 9 (mentioning GE's decision to stop lending as an indication as a sign of a decline in DIP financing).

[18] Donato & Kennedy, *supra* note 9.

[19] Donato & Kennedy, *supra* note 9.

[20] Murray, *supra* note 1 (chronicling the rise in bankruptcy filings from 2005 to 2009).

1. Favorable Terms

After the financial collapse, DIP lenders loaned money on very favorable terms, including higher interest rates, higher fees, less leverage, a shorter period for repayment and challenging milestone provisions. The interest rates on DIP loans approximately doubled, rising to between 6.5% and 12% above LIBOR.[21] Lyondell Chemical Company paid interest rates over 20%.[22] Loan fees doubled.[23] Lenders significantly reduced their leverage on secured loans. Lenders who used to loan 85% of accounts receivable lent only 50%.[24] Lenders who used to lend 50% against inventory lent only 25%.[25] Lenders drastically shortened the period for repayment. Traditionally, DIP loans ran for twelve to eighteen months; after the financial collapse they were often shortened to just two to six months.[26] Lenders also wrote difficult to achieve milestones in to their loan agreements.[27] The borrower had to hit certain milestones throughout repayment of the loan or else default on the loan.[28] Courts rarely rewrote the lending agreement to take out milestones.[29] Even in a good economy it would be difficult to pay back large loans on such unfavorable terms. In a bad economy, it became nearly impossible. With such unfavorable terms and such a short time frame, these loans deviated from the goal of reorganization. Instead of a bridge to solvency, these loans were a plank to asset sale and liquidation.[30]

Circuit City was the largest retailer to liquidate during the economic collapse and is a prime example of how unfavorable terms can lead to liquidation. Circuit City started by filing a Chapter 11

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[21] Merced, *supra* note 9; Donato & Kennedy, *supra* note 9.
[22] Donato & Kennedy, *supra* note 9.
[23] Merced, *supra* note 9.
[24] Marston, *supra* note 2.
[25] *Id.*
[26] *Id.*
[27] *See* John J. Rapisardi & Peter M. Friedman, *Leverage and Lenders of Last Resort*, BNKR. STRATEGIST (ALM Law J. Newsletters, New York, N.Y.), Vol. 27 No. 2, Dec. 2009.
[28] David B. Stratton & Evelyn J. Meltzer, *A Year in Review: Delaware DIP Orders in 2008*, 28-3 AM. BANKR. INST. J. 32, Apr. 2009.
[29] *Id.*
[30] *See* Marston, *supra* note 2; s*ee also* John Blakeley, *The new DIPs*, DEAL MAG., Jan. 22, 2010 ("And that often serves only as a means for existing lenders to keep the lights on long enough to liquidate their collateral.").

bankruptcy petition in November of 2008.[31] Its DIP lenders gave a "package of benefits for $50 million of availability includ[ing] $30 million in loan fees, a forced timeline for sale of the company, cram-down immunization [which prevents the court from ordering a plan the lender doesn't agree with], and the ability to call a default at almost any time once the Christmas season ended."[32] Circuit City converted to a Chapter 7 soon after the conclusion of the Christmas season in January 2009.[33]

The Sharper Image provides another example of unfavorable DIP terms. Wells Fargo loaned The Sharper Image $60 million with a six-month term.[34] The company was unable to reorganize in that time period and instead sold its intellectual property at auction.[35]

2. The Debtor's Creditors As a New Loan Source

In good economic times, DIP loan often come from a third-party lender. When third-party lenders became scarce in the wake of the financial collapse, the new major source of DIP financing became the creditors of the bankrupt debtor.[36] This form of DIP is called a "defensive DIP."[37]

Although defensive DIPs are not new, they were much more prevalent after the economic collapse than loans from third-parties.[38] Why would a creditor want to provide more money to a bankrupt debtor? Because there are many ways a creditor can improve its position by offering a defensive DIP.[39]

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[31] Daniel Gross, *Liquidation Nation*, SLATE.COM, Jan. 21, 2009, http://www.slate.com/id/2209406/ (summarizing Circuit City's bankruptcy).
[32] *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Four ABI Members Testify before House Subcommittee on Commercial and Administrative Law*, 28-3 AM. BANKR. INST. J. 10, Apr. 2009.
[33] Gross, *supra* note 31.
[34] Marston, *supra* note 2.
[35] Marston, *supra* note 2.
[36] *Id.*
[37] *Id.*
[38] Merced, *supra* note 9; Donato & Kennedy, *supra* note 9.
[39] Marston, *supra* note 2.

3. Special Condition - Roll-Up Provisions

One major advantage of the defensive DIP is a "roll-up" provision. A roll-up occurs when a creditor rolls-up the pre-bankruptcy petition debt into a new loan.[40] Roll-ups give creditors more leverage.[41] Without the roll-up, even a creditor whose loan is fully secured will be subject to the automatic stay and usually will not be able to foreclose on the collateral.[42] Instead of foreclosing, the creditor will receive a promise to pay as part of a repayment plan and will have to wait for payment or default.[43] Even if the creditor doesn't like the terms of the reorganization plan, it might be forced to accept the terms in a court-sanctioned "cram down."[44] With a roll-up, the creditor receives immediate repayment of the prepetition claim.[45] The rolled-up debt is treated as an administrative expense and must be paid in full in cash on the plan's effective date.[46] This avoids a cram down. If the debtor defaults, usually the DIP lender can immediately go after the collateral without regard to the stay.[47]

The biggest limitation to a roll-up is that it usually must be offered by a fully secured creditor.[48] Unsecured or undersecured creditors have tried to secure their claims through a DIP loan. [49] This is called a cross-collateralized loan. [50] Although not specifically prohibited by the Bankruptcy Code, cross-collateralization allows a creditor to cut in line, which undermines the priority scheme of the Code.[51] It is per se invalid in the Eleventh circuit and it is disfavored in other circuits.[52] To avoid the risky realm of cross-collateralization, roll-ups typically come from a secured creditor.[53]

After the financial collapse, creditors generally rolled-up a significant portion of the debt owed to them in their DIP loan. A

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[40] Inez M. Markovich, *Can you roll-up?*, SECURED LENDER, July 1, 2003.
[41] *Id*.
[42] *See* 11 U.S.C.A. § 362 (2009); Markovich, *supra* note 40.
[43] Markovich, *supra* note 40.
[44] 11 U.S.C.A. § 1129(b) (2009); Markovich, *supra* note 40.
[45] Markovich, *supra* note 40.
[46] *Id.*
[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] *Id.*

dollar-for-dollar amount was common. [54] In other words, for every dollar of new money, a dollar of previous debt was rolled-up in the DIP loan. Through November 15, 2009, 56.5% of DIP financing was new money (excluding General Motors and Chrysler, which were largely secured by the U.S. Treasury).[55]

4. Special Condition – Equity Conversion

The difficulty of financing also led to innovative structuring of defensive DIPs. The most notable might be an equity conversion. Instead of rolling-up debt to ensure payment, Farallon Capital Management, an unsecured creditor in General Growth Properties, allowed the loan to be paid back by converting outstanding debt to equity.[56] ION Media Networks also had the option to either pay back its DIP in cash or convert the debt into a 62.5% equity stake.[57]

Although an equity conversion allows the debtor to avoid raising cash when doing so is difficult and expensive, equity conversions are "really not favored by the court because they come to the disadvantage of prepetition creditors who were hoping for some of the equity value . . . . [Equity conversions take] something off the table."[58] Because equity conversion allows low priority creditors to cut in line, it poses some of the same problems as cross-collateralization. A major difference between the equity conversion and cross-collateralization is what they each demonstrate about the creditor's opinion of the debtor's future. An equity conversion is a good sign for the debtor: it shows that the creditor is confident that the debtor will survive or even thrive after bankruptcy.[59] On the other hand, cross collateralization shows that the creditor doubts the ability of the debtor to survive or thrive after bankruptcy.

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[54] Blakeley, *supra* note 30.
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] *Cf. id.* ("The loan can be paid back by converting outstanding debt to equity, a sign that the lenders see value in a reorganized [General Growth Properties, Inc.]").

5. Third-Party Lender's New Motivation

Although many DIP loans following the financial collapse were defensive, there were some third-party DIP loans. However, these DIP loans were no closer to the goal of a short term bridge to solvency than the defensive DIPs. Third-party lenders generally had their eye on the assets of a bankrupt debtor. The goal was to force an asset sale under section 363 of the Bankruptcy Code.[60] DIP lenders conditioned their loans on very difficult to achieve milestone provisions.[61] "The milestones drafted into DIP agreements . . . allegedly allow[ed] lenders to control the bankruptcy process, ensure their claims constitute a 'deal breaker', and to run off with the debtor's assets through section 363 sales when no other bidders show up."[62] "[T]his . . . really put the dead in deadline."[63] The goal of this form of DIP loan was not to allow the debtor to restructure, but instead to "loan to own."[64]

6. Government Involvement in DIP Financing

The focus of this article to this point has been on DIP lending by private companies. However, the U.S. and Canadian governments were the largest DIP financers during the collapse. Private companies lent $12.11 billion of new money (not counting rolled-up old debt) between January 1, 2009 and November 15, 2009, while the U.S. Treasury, along with Export Development Canada, gave $38.26 billion in new money.[65] The numbers are a little misleading because the U.S. and Canada were only DIP financers in two cases, General Motors ("GM") and Chrysler, and GM alone accounted for $30 billion.[66] Interestingly, in both the GM and the Chrysler case, the

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[60] *Id.*
[61] *Bankruptcy Assets: Sales for a Song Leads to Wails*, WESTLAW BUS. CURRENTS, March 31, 2009, http://currents.westlawbusiness.com/Articles/2009/07/20090731_0020.aspx?cid=&src=WBSignon.
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] Blakeley, *supra* note 30.
[66] Kevin Helliker et al *New Era in Autos as GM Set for Bankruptcy*, WALL ST. J., June 1, 2009, at A1; Jim Puzzanghera & Martin Zimmerman, *Chrysler's bankruptcy path is uncharted, but GM could follow*, L.A. TIMES,

U.S. and Canadian governments took an equity stake in return for capital. [67] At a recent American Bankruptcy Institute Legislative Symposium, GM's chief bankruptcy counsel proposed that the federal government should be a DIP lender as a matter of course rather than just a lender of last resort.[68] It is unlikely that the government will start competing with investment banks to lend money to distressed companies.[69] So despite the size of the two deals that the government was involved with, the reality is that government DIP financing was only a factor in two of the over 400 DIP deals during 2009.[70]

E. Moving Forward

What does the nature of DIP lending following the financial collapse teach us? In the short term, DIP lenders still have a superior bargaining position. Third-party lenders can still charge very high interest rates and fees, and inside lenders may still be more interested in liquidation or acquiring cheap assets than helping the debtor survive bankruptcy. Debtors would be well served to file for bankruptcy early.[71] Tribune Co. filed for bankruptcy early and was able to negotiate a non-DIP lending deal.[72] Nortel Networks filed for bankruptcy with $2.4 billion in cash reserves.[73] At the very least, having a cash cushion allows the debtor to shop for better terms. [74]

In the long term, there is no reason to think that DIP lending won't return to where it was before the financial crisis. "[T]he DIP finance provisions of the Bankruptcy Code create extremely attrac-

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May 1, 2009, http://articles.latimes.com/2009/may/01/business/fi-chrysler-bankruptcy1.

67 Helliker et al., *supra* note 66; Puzzanghera & Zimmerman, *supra* note 65.

68 Andy Winchell, *The Federal Government as DIP Lender*, A CLEAN SLATE–THE BANKRUPTCY LAW BLOG (Nov. 17, 2009), http://bklawblog.blogspot.com/2009/11/federal-government-as-dip-lender.html.

69 *Id.*

70 Blakeley, *supra* note 30 (comparing all DIP deals that occurred in 2009).

71 *See Bankruptcy Creditors, Beware: How to Get Money from a Stone*, WESTLAW BUS. CURRENTS, Jan. 21, 2008, http://currents.westlawbusiness.com/Articles/2009/11/20091111_0027.aspx?cid=&src=&sp=; s*ee also* Donato & Kennedy, *supra* note 9.

72 Marston, *supra* note 2 ("We never lost one penny in Chapter 11 financings in all of those years.").

73 *Id.*

74 *See* Blakeley, *supra* note 30.

tive—and secure—loan opportunities. If commercial banks opt not to pursue these opportunities, other lenders undoubtedly will."[75] Mark Cohen, head of restructuring at Deutsche Bank AG agrees: "the only reason you need a rollup is that there's no third-party capital available for a DIP . . . . Rollups are a sign of a fractured market."[76] David Marston quips, "over time, it seems likely that past practices, where Chapter 11 typically produced a profitable reorganized operating company, will return. Why? Because everyone makes more money that way."[77]

Jameson Rice[78]

[75] Marston, *supra* note 2.
[76] Blakeley, *supra* note 30.
[77] Marston, *supra* note 2.
[78] Student, Boston University School of Law (J.D. 2011).

IV. *Towards a Housing Equilibrium: The Obama Administration's Supply and Demand Initiatives in the Housing Market*

A. Introduction

Battered by the mortgage-backed securities crisis and rising foreclosure rates, the U.S. housing market is imbalanced: the supply of homes far exceeds demand, a trend leading to low prices and impeding the road to economic recovery. At the peak of the foreclosure crisis, the inventory of houses on the market represented 11.2 months of supply, far in excess of what experts consider the six-month supply equilibrium. [1] The reason for this excess supply is relatively simple: foreclosure increases the supply of homes, while tightening credit decreases demand.[2] Recognizing the need for initiatives both to decrease the supply of homes and to increase demand, the Obama Administration enacted "initiatives to support access to affordable mortgage credit and housing" and "to prevent avoidable foreclosures and stabilize neighborhoods."[3] This development article discusses the initiatives instituted by the Obama Administration and their relative success and failure.

B. Reducing Supply

On February 18, 2009, President Barack Obama announced the Homeowner Affordability and Stability Plan (HASP), [4] a housing

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[1] Christopher A. Richardson, *An Economic View of the Housing Crisis*, 41 CONN. L. REV. 1133, 1135-36 (2009)

[2] *Id.* at 35.

[3] U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE PROGRAM: SERVICER PERFORMANCE REPORT THROUGH FEBRUARY 2010 2 (2010), *available at* www.makinghomeaffordable.gov/docs/Feb%20Report%2003 1210.pdf [hereinafter Servicer February Report].

[4] The acronym HASP is interchangeable with MHA, the Making Home Affordable Plan this article later references the Plan under the MHA acronym. The switch is consistent with the Obama Administration's usage. When President Obama first introduced his Administration's housing plan on February 18, 2009 the release named it the "Homeowner Affordability and Stability Plan." *See* U.S. Dep't of the Treasury, Homeowner Affordability and Stability Plan Executive Summary (Feb. 18, 2009), *available at* http://www.treas.gov/press/releases/tg33.htm. However, when the Administration announced the plan's details on March 4, 2009, the plan, which

plan aimed in part to stabilize home values by reducing the supply of homes on the market.[5] Obama estimated that HASP "could stop the slide in home prices due to neighboring foreclosures by up to $6,000 per home."[6] HASP is part of a series of Financial Stability programs passed under the Emergency Economic Stabilization Act of 2008.[7] HASP provides for three initiatives: the Home Affordable Modification Program (HAMP), which establishes a $75 billion mortgage modification program; a refinancing initiative for homeowners with mortgages owned or guaranteed by Fannie Mae and Freddie Mac (the housing Government Sponsored Entities or GSEs); and an initiative increasing funding for Fannie Mae and Freddie Mac to support lower mortgage rates.

1. MHA's Predecessors

Before the MHA, several programs attempted to reduce and prevent foreclosures via loan modification and refinancing, however none succeeded on a large-scale basis. Among these were HOPE NOW, FHASecure, Hope for Homeowners, and the FDIC's IndyMac program. Of these, HOPE NOW is the only initiative instituted by a private alliance of lenders, rather than by a federal agency, and so "participation is purely voluntary and self-regulated."[8] Consequently, HOPE Now has had little success achieving permanent reductions—about 37% of loan workouts resulted in modifications, and of those, fewer than 49% resulted in lower payments.[9]

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outlined the same initiatives first presented on February 18, 2009 in greater detail, was called "Making Homes Affordable." *See* U.S. Dep't of the Treasury, Making Home Affordable: Updated Detailed Program Description (Mar. 4, 2009), *available at* http://www.financialstability.gov/roadtostability/homeowner.html (follow "Making Home Affordable Fact Sheet" hyperlink) [hereinafter March 4 Update].

[5] Barack Obama, U.S. President, Remarks on the Homeowner Affordability and Stability Plan (Feb. 18, 2009), *in* N.Y. TIMES, Feb. 18, 2009, *available at* http://www.nytimes.com/2009/02/18/us/politics/18text-obama.html?pagewanted=2&_r=2 [hereinafter Obama February speech].

[6] *Id.*

[7] Emergency Economic Stabilization Act of 2008, 12 U.S.C.S. §,5201-5202 (2008).

[8] CONGRESSIONAL OVERSIGHT PANEL, FORECLOSURE CRISIS: WORKING TOWARD A SOLUTION: MARCH OVERSIGHT REPORT 31 (2010).

[9] *Id.* (citing Alan M. White, *Deleveraging American Homeowners: December 18, 2008 Update to August 2008 Report*, Valparaiso University

FHASecure and the Hope for Homeowners were both instituted under the Federal Housing Administration's existing mortgage insurance program. The 2008 FHASecure refinancing program was targeted at "families with strong credit histories" and implemented a risk-based adjustment premium based on the borrower's risk profile.[10] The Hope for Homeowners Program is aimed at riskier homeowners, and is premised on re-appraising the borrower's home and issuing a new mortgage not in excess of 90% of the new value.[11] FHASecure and Hope for Homeowners "failed abysmally."[12] FHASecure was too restrictive and was terminated one year after its inception, having helped only a fraction of the 240,000 homeowners it targeted.[13] Hope for Homeowners relied on the participation of servicers and faced an adverse-selection problem: lenders were given the discretion to select the loans they modified, and could sell "their worst lemons" to the FHA.[14] The program was incorporated into the HAMP Program in 2009,[15] after having refinanced only thirteen loans of the 400,000 homeowner pool targeted.[16]

School of Law, Dec. 18, 2008, *available at* www.hastingsgroup.com/ Whiteupdate.pdf; Alan M. White, *Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, 36 FORDHAM URB. L.J. 509 (2009); Sonia Garrison et al., *Continued Decay and Shaky Repairs: The State of Subprime Loans Today*, Center for Responsible Lending, Jan. 2009, *available at* www.responsiblelending.org/pdfs/continued_decay_ and_shaky_repairs.pdf)

[10] Press Release, U.S. Dep't of Hous. & Urban Dev., Bush Administration to Help Nearly
One-Quarter of a Million Homeowners Refinance, Keep Their Homes (Aug. 31, 2007), a*vailable at*
http://www.hud.gov/news/release.cfm?content=pr07-123.cfm.

[11] Press Release, Dep't of Hous. and Urban Dev., Bush Administration Launches "Hope for Homeowners" Program to Help More Struggling Families Keep Their Homes (Oct. 1, 2008) *available at* http://www. hud.gov/news/release.cfm?content=pr08-150.cfm.

[12] Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 634 (2009).

[13] *Id.*; *see also* Congressional Oversight Panel, *supra* note 8, at 36 (commenting that FHASecure was "quite restrictive in its eligibility requirements.").

[14] Levitin, *supra* note 12, at 635.

[15] U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE PROGRAM UPDATE 1 (Apr. 28, 2009), *available at* http://makinghomeaffordable. gov/pr_042809.html (follow "fact sheet" hyperlink).

[16] Congressional Oversight Panel, *supra* note 8, at 36.

The FDIC developed its model modification program after becoming the conservator for IndyMac Federal Bank in July 2008.[17] Part of the challenge to the FDIC in providing loan modifications was that IndyMac only owned 7% of the loans it serviced,[18] while the remaining loans were securitized in mortgage pools that had strict contractual obligations regarding when modification was allowable.[19] Nonetheless, the FDIC's program implemented a service-to-income ratio of 31% and provided for loan modification via interest rate reduction, term extension, and principal forbearance—measures which were later implemented in HAMP.[20]

2. How MHA works

The MHA limits the number of houses that come on to the market via foreclosures by providing for loan refinance and modification programs and establishing alternatives to foreclosure for when the former programs fail.[21] Additionally, the MHA establishes a financial funding program for the GSEs, and state housing finance agencies. This funding for the GSEs also indirectly supports the refinance program, which aims to help four to five million homeowners refinance the loans owned or guaranteed by these institutions.[22] The program does this by removing the refinancing restrictions that forbid refinancing on mortgages that exceed 80% of the home's value.[23] Removing these restrictions is predicted to cost little or nothing to taxpayers, but may allow homeowners who owe

[17] *The Private Sector and Government Response to the Mortgage Foreclosure Crisis: Hearing Before the Subcomm. on Financial Services*, 111th Cong. (2009) (statement of Michael H. Krimminger, Special Advisor for Policy, Office of the Chairman, Federal Deposit Insurance Corporation).
[18] *Id.*
[19] Based on its experience as a conservator for IndyMac, the FDIC developed a model modification program that lenders can adopt as an alternative to HAMP and still be eligible to receive loss-sharing funding from the FDIC. *See* Federal Deposit Insurance Corporation, FDIC Loan Modification Program Guide – "Mod in a Box," note 1 (2009) *available at* http://www.fdic.gov/consumers/loans/loanmod/loanmodguide.html (follow "Loan Modification Program Overview – PDF" hyperlink).
[20] Krimminger, *supra* note 17.
[21] *See* March 4 Update, *supra* note 4, at 1.
[22] *Id.*
[23] *Id.* at 2.

more on their home than its value, those who are 'underwater,' to refinance and take advantage of lower interest rates.[24]

The MHA's key initiative is the modification program, HAMP, which has a budget of $75 billion and aims to assist between three and four million homeowners who are struggling to meet their monthly mortgage payments.[25] Specifically, HAMP requires participating lenders to reduce the monthly mortgage payment to 38% of the borrower's income by extending the mortgage period to forty years, lowering the interest rate to as low as 2%, or forgiving part of the principal.[26] HAMP then uses its funds to bring down the monthly payment even further, to 31% of the borrower's income.[27] The reduced payments stay in place for five years, after which the lender may gradually increase the interest level "to the conforming loan survey rate in place at the time of the modification."[28] HAMP incentivizes lenders and borrowers to enter and stay in the program via an annual 'pay for success' payment and a payment for modifications made before the borrower misses a monthly payment.[29] Eligibility is limited to homeowners at risk of default on their mortgage payment, whose primary residence is in the mortgaged property, and whose mortgage does not exceed $729,750.[30]

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[24] "[T]he estimated cost to taxpayers would be roughly zero; while Fannie and Freddie would receive less money in payments, this would be balanced out by a reduction in defaults and foreclosures." Obama February speech, *supra* note 6.

[25] *See* March 4 Update, *supra* note 4, at 1.

[26] *Id.* at 4.

[27] *Id.*

[28] *Id.*

[29] Under the 'pay for success' incentive, borrowers may receive up to $1,000 per year for five years if they do not miss payments, and lenders may receive $1,000 upfront for modifying a loan based on HAMP guidelines, and an additional $1,000 for three years thereafter if the borrower remains in the program. Lenders and borrowers receive $500 and $1,500, respectively, for modifying the loan before the borrower misses a payment. *Id.* at 4-5.

[30] Homeowners at risk of default are defined as "those suffering serious hardships, decreases in income, increases in expenses, payment 'shock,' high combined mortgage debt compared to income, who are 'underwater' (with a combined mortgage balance higher than the current market value of the house), or who show other indications of being at risk of default. . . ." *Id.* at 3.

Even when attempts to refinance or modify the loan fail, the MHA nonetheless tries to curb the supply of foreclosed properties on the market by providing "incentives for servicers and borrowers to pursue short sales and deeds-in-lieu of foreclosure."[31]

3. MHA: Pros and Cons

The MHA has a broader scope than previous loan modification programs and also addresses several of the deficiencies of previous programs by mandating compliance and establishing uniform guidelines. Whereas the previous loan modification programs aimed to assist hundreds of thousands of homeowners, the MHA aims to assist seven to nine *million* homeowners.[32] However, as reported by the Treasury Department through February 2010, HAMP is far from its target: only 1,003,902 loan modifications are currently active, of which 835,194 are trial, rather than permanent modifications.[33] Trial modifications last three months and require borrowers to "make payments on time and meet other requirements, including documentation of their income" before they are given a permanent modification.[34]About 8% of all modifications that have been started have been cancelled in the trial stage, while about 76% of started modifications are still in the trial stage, with many expected to drop out.[35]

Unlike previous loan modification and refinance programs with voluntary participation options, the HAMP program has been successful at getting lenders to participate by making participation mandatory for recipients of TARP funds, and incentivizing lenders with cash pay-for-success payments.[36] Additionally, the Treasury has

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[31] Press Release, U.S. Dep't of the Treasury, Just Over Two Months after Release of Program Guidelines Homeowners Realizing Relief under Administration Plan Join Secretaries to Share Personal Stories (May 14, 2009), a*vailable at* http://www.treas.gov/press/releases/tg131.htm.
[32] *See* March 4 Update, *supra* note 4, at 1.
[33] *See* Servicer February Report, *supra* note 3, at 4.
[34] James R. Hagerty, *More Receive Help to Avert Foreclosures*, WALL ST. J., Feb. 18, 2010, at A7.
[35] "The program's dropout rate is likely to be high, partly because lenders allowed many people into trials without first making sure they qualified. Wells Fargo & Co. said 92,000 of the borrowers it services had made three trial payments by Jan. 31. It expects about half of them to get permanent modifications." *Id.*
[36] *See* March 4 Update, *supra* note 4, at 7.

been "prodding lenders to save more borrowers . . . [by] publishing monthly comparisons of their performance," thereby motivating them to compete against one another for better reports.[37] As a result of its participation and publication requirements, HAMP has 110 participating servicers, including some of the largest servicers, such as Bank of America, J.P. Morgan Chase, Wells Fargo Bank, and CitiMortgage.[38] The MHA has helped broaden the scope of modifications and establish more uniform guidelines for modification by cooperating with various federal and private agencies.[39]

Although HAMP has been more robust than previous loan modification programs, it still faces several challenges that prevent modifications even when homeowners meet the eligibility requirements. Of the more significant impediments are securitized loans, underwater loans, and multiple mortgages. Loans that are part of a securitized pool have higher foreclosure rates because pooling and service agreements create "contractual limitations on private mortgage modification" that are difficult to get around.[40] Underwater loans pose a challenge because underwater homeowners are disincentivized to seek a loan modification when the property's value has fallen so much so that it is more economical to default on the

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[37] Hagerty, *supra* note 34 (In January 2010, "Citigroup Inc. had provided modifications to 50% of the estimated number of eligible borrowers. Both J.P. Morgan Chase & Co. and Wells Fargo were at 38%, and Bank of America Corp. was at 22%. In a statement, Bank of America said it had made stronger gains than rivals last month in providing trial modifications and converting trials into permanent fixes.").

[38] *See* Servicer February Report, *supra* note 3, at 1, 9.

[39] *See* March 4 Update, *supra* note 4, at 7. (listing Ginnie Mae, the FHA, Treasury, Federal Reserve, FDIC, Department of Veterans' Affairs and Department of Agriculture as having agreed to apply the MHA guidelines and stating that the Office of the Comptroller of the Currency, Office of Thrift Supervision and the National Credit Union Administration are expected to do the same where applicable).

[40] Congressional Oversight Panel, *supra* note 8, at 41-42 (citing Tomasz Piskorski et al., *Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis*, 3 (Dec. 2008) (University of Chicago Booth School of Business, Working Paper No. 09-02) *available at* papers.ssrn.com/abstract=1321646. *See also* Eamonn K. Koran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 92-93 (2009).

mortgage than to repay it.[41] This problem remains unaddressed by the Obama Administration's housing reforms.[42] Another lingering problem is the issue of second, or junior mortgages: "Even if a first lien is modified to create an affordable payment, second liens can contribute to much higher foreclosure rates if not addressed."[43] Though the Obama Administration has released an MHA Second Lien Program in April 2009, the first servicer to join the program, Bank of America, has only done so in January 2010, and it remains to be seen whether this program will be "gaining momentum."[44]

Adding to the difficulty are servicers' outreach and capacity problems. Modifications require case-by-case workouts, which is a process for which many servicers are understaffed or otherwise lack the capacity to perform in a timely manner.[45] Moreover, many home-owners are unaware of the mortgage modification options available to them, while others still seek out viable modifications but fall prey to "unscrupulous vendors masquerading as government agencies."[46]

C. Increasing Demand

In addition to instituting programs that would decrease the supply of houses that come on the market due to foreclosure, the Obama Administration also instituted several initiatives to increase the demand for homes, including funding the GSEs, funding for state housing finance agencies and a tax credit for first-time and repeat homebuyers. The funding initiatives boost demand on a macro level by supporting affordable mortgage rates offered by the GSEs, and on a micro level by channeling funds to the hardest-hit areas. The MHA authorizes the Treasury Department to increase its Preferred Stock Purchase Agreements with the GSEs and to continue buying mortgage-backed securities from the two institutions in order to

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[41] *See* David Streitfeld, *No Help in Sight, More Homeowners Walk Away*, N.Y. TIMES, Feb. 3, 2010, at A1.
[42] *Id. See also* Congressional Oversight Panel, *supra* note 8, at 66 ("The Plan does not deal with mortgages that substantially exceed the value of the home.").
[43] U.S. DEP'T OF THE TREASURY, *supra* note15, at 2.
[44] Diana Golobay, *BofA First to Join HAMP Program for Second Liens*, HOUSINGWIRE, Jan. 26, 2010, *available at* http://www.housingwire.com/2010/01/26/bofa-says-its-first-to-sign-up-for-hamp-second-lien-program/.
[45] Congressional Oversight Panel, *supra* note 8, at 40.
[46] *Id.* at 37-38.

promote market "stability and liquidity" and "maintain mortgage affordability."[47] The MHA also authorizes HUD to award $2 billion in competitive Neighborhood Stabilization Program [(NSP)] grants for innovative programs that reduce foreclosure[48] and an additional $5 billion to provide renter assistance.[49]

Through targeted funding awards, HUD intends to "provide mortgages to first-time homebuyers, refinance opportunities for at-risk borrowers, and affordable rental housing."[50] On January 14, 2010, HUD allocated $1.93 billion in NSP grants to fifty-six grantees, including municipalities, states, and non-profit organizations.[51] The grantees will use the funds towards a variety of programs that will stimulate demand in their target areas.[52] Additionally, on February 19, 2010, President Obama announced in a speech that an additional $1.5 billion in funds will be made available to state housing agencies in Nevada, California, Arizona, Michigan and Florida, states that have been hard-hit by foreclosure.[53] These funds will be used to modify mortgage loans instances where homeowners are "underwater," purchase foreclosed homes and for foreclosure avoidance programs.[54]

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47 *See* March 4 Update, *supra* note 4, at 8-9.

48 *Id.* at 8.

49 *See* Servicer February Report, *supra* note 3, at 2.

50 *Id.*

51 Community Planning and Development & CPD Web Team, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, http://www.hud.gov/offices/cpd/communitydevelopment/programs/neighborhoodspg/arrafactsheet.cfm.

52 For example, the City of Boston, Massachusetts plans to used its awarded funds to buy real estate properties in order to "address the market-depressing influence of [bank-owned] properties, and simulate demand for housing in high-foreclosure areas," while the Delaware State Housing Authority plans to "increase demand for homes through the availability of financing mechanisms, improve homeownership rates, provide a stock of permanently affordable homes, stabilize the housing market to avoid further decline, and encourage further investment in the area." Dep't of Hous. and Urban Dev., Award Summaries, 1, 6 (2010) *available at* http://www.hud.gov/offices/cpd/communitydevelopment/programs/neighborhoodspg/nsp2application_award_summaries.pdf.

53 Deborah Tedford, *Obama Announces Foreclosure Rescue For 5 States*, NPR.ORG, Feb. 19, 2010, *available at* http://www.npr.org/templates/story/story.php?storyId=123897602.

54 *Id.*

Finally, the Obama Administration has also acted directly to provide stimulus for buyers to purchase houses via tax credits. On February 17, 2009, President Obama signed The American Recovery and Reinvestment Act of 2009. The Act provides an $8000 tax credit for first-time homebuyers that, unlike the previous $7,500 tax credit granted by the Bush Administration, need not be repaid.[55] The Worker, Homeownership, and Business Assistance Act of 2009, signed into law on November 6, 2009, extends the $8000 first-time homebuyer tax credit to sales with purchase agreements signed by April 30, 2010 and closed by June 30, 2010.[56] It also adds a $6500 tax credit for existing homeowners who meet certain qualifications.[57] A press release issued by the White House on the day the tax credit was extended announced that the tax credit "brought many new families into the housing market. Those buyers, in turn, have reduced the inventory of unsold homes and contributed to three months in a row of increases in home prices nationwide."[58] However, the effect of the tax credit may not be long-lasting. A National Association of Realtors report issued in January 2010 "suggests that the recent strength of housing demand is still far from becoming self-sustaining and that the housing market remains overly dependent on government support."[59]

D. Conclusion

The Obama Administration's new housing initiatives, despite leaving some issues unaddressed, offer a marked improvement over previous loan modification programs. At least in part because of

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[55] The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §1006, 123 Stat. 115 (2009).
[56] The Worker, Homeownership, and Business Assistance Act of 2009, Pub L. No. 111-92, §11, 123 Stat. 2984 (2009).
[57] Brian Faler, *Homebuyer Tax Credit, Unemployment Bill Advances in Senate*, BLOOMBERG, Nov. 2, 2009, *available at* http://www.bloomberg.com/apps/news?pid=20601103&sid=a65ONhTk4CQ.
[58] Press Release, White House, Fact Sheet: The Worker, Homeownership, and Business Assistance Act of 2009 (Nov. 6, 2009), *available at* http://www.whitehouse.gov/the-press-office/fact-sheet-worker-homeownership-and-business-assistance-act-2009.
[59] Rex Nutting, *Pending home sales index plunges 16%*, MARKETWATCH, Jan 5, 2010, *available at* http://www.marketwatch.com/story/pending-home-sales-index-plunges-16-2010-01-05 (*quoting* Anna Piretti, an economist for BNP Paribas).

these supply initiatives, the number of borrowers falling behind on their mortgage payments decreased in the last quarter of 2009 for the first time since 2006.[60] However, reducing the supply of homes is only halfway to an ideal equilibrium, and the initiatives to increase housing demand have yet to be fully realized: NSP grants have only recently been allocated, and while the tax incentives increased demand, it remains to be seen whether the demand can be sustained without government intervention. Housing prices seem to tell a consistent story. In July, home prices in twenty metropolitan areas increased, albeit very modestly, for the first time in nearly three years.[61] Likewise, the drop in housing inventory indicates that while the housing market is not in equilibrium yet, it is certainly heading in the right direction.[62]

Valentina Elzon[63]

[60] Les Christie, *Is the mortgage market starting to heal?* CNNMONEY.COM, http://money.cnn.com/2010/02/19/real_estate/bankers_delinquency_report/index.htm.
[61] Nick Timiraos & Kelly Evans, *Home Prices Rise Across the U.S.*, WALL ST. J., July 29, 2009, at A1.
[62] Lawrence Yun, *Economists' Commentary: Existing Home Sales in September*, NATIONAL ASSOCIATION OF REALTORS, Oct. 23, 2009, http://www.realtor.org/research/economists_outlook/commentaries/ehs1009
[63] Valentina Elzon, Boston University School of Law (J.D. 2011).

V. The China Bubble: Speculation and Implications for the U.S. Economy

A. Introduction

On February 12, 2010, Chinese officials grabbed the attention of international financial markets by taking bold steps to restrain bank lending and curb inflation.[1] Officials also increased capital requirements at the Nation's Central Bank.[2] This government action highlights the growing concern that China's "overheated real-estate market" is an ungrounded appreciation of asset values, or in other words, a "bubble."[3]

This article will examine China's real-estate sector and banking system, to determine whether there is a bubble and if so, what affect it will have on China's economy. Section B surveys the evidence that China is experiencing a bubble. Section C addresses whether the bubble will burst or slowly deflate and Section D analyzes why a burst likely will look nothing like the U.S. real-estate crash. Finally, Section E addresses the impact the bubble could have on U.S. markets because of the economic interdependencies between the U.S. and China.

B. Evidence that a "Bubble" Exists

Due to mounting evidence, most experts agree that China's booming economy is a bubble. [4] Steroidal growth and economic reform over the past three decades have turned China into one of the

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[1] David Pierson & Don Lee, *China, Worried About a Real-Estate Bubble, Moves to Restrain Bank Lending*, LATIMES.COM, Feb. 13, 2010, http://articles.latimes.com/2010/feb/13/business/la-fi-china-bubble13-2010feb13.

[2] *Id.*

[3] *See id.*

[4] *E.g.*, Steven Mufson, *In China, Fear of a Real Estate Bubble*, WASHINGTONPOST.COM, Jan. 11, 2010, http://www.washingtonpost.com/wp-dyn/content/article/2010/01/10/AR2010011002767.html; *see also* Vince Veneziani & Joe Weisenthal, *Why Shanghai Real Estate Is the Most Obvious Bubble Ever*, BUSINESSINSIDER.COM, Jan. 13, 2010, http://www.businessinsider.com/the-chinese-real-estate-bubble-is-the-most-obvious-bubble-ever-2010-1.

world's largest and most influential economies.[5] China's growth relies heavily on its state-owned banking system.[6] State-owned banks are largely controlled by the Chinese government, but are still able to engage in risky loan practices due to inadequate oversight.[7] This behavior was recently exacerbated by an infusion of government funds.

In response to the world wide global downturn, the Chinese government announced a massive stimulus package in November 2008.[8] The package originally contained $586 billion in stimulus funds to be spent through 2010.[9] However, in the first year after announcing the plan, some experts speculate that the Chinese government has already spent approximately $1.1 trillion. [10] The Chinese government has funneled much of these funds through State Banks.[11] Many experts highlight this package, in conjunction with low interest rates and the government's official encouragement of bank lending, as the foundation of the bubble.[12] Experts fear that the influx of government funds has encouraged irresponsible construction lending and massive overbuilding that left the banking system holding bad loans.[13] Speculators draw attention to the 32% increase in bank lending in 2009 and forecast that 2010 should see an

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[5] George Steven Swan, *The Political Economy of the Rule of Law in China*, 5 HASTINGS BUS. L. J. 309, 320 (2009).

[6] Wendy Dobson & Anil K. Kashyap, *The Contradiction in China's Gradualist Banking Reforms*, prepared for Brookings Panel on Economic Activity, at 1, 2 (2006).

[7] Patrick Chovanec, *Undoing Chinese Bank Reform*, WSJ.COM, May 7, 2009, http://online.wsj.com/article/SB124164190279492955.html.

[8] Gordon G. Chang, *China: The World's Next Great Economic Crash*, CSMONITOR.COM, Jan. 21, 2010, http://www.csmonitor.com/Commentary/Global-Viewpoint/2010/0121/China-the-world-s-next-great-economic-crash.

[9] *Id.* (referencing China's "half-trillion dollar "stimulus plan.); *see also* David Barboza, *Contrarian Investor Sees Economic Crash in China*, N.Y. TIMES, at B1, Jan. 7, 2010 (referring to the $586 billion government stimulus package that began in 2009).

[10] Chang, *supra* note 8.

[11] *Id.*

[12] *China Property Bubble May Bust US-Style*, BLOOMBERG/BEIJING, BUS. STANDARD, Jan. 1, 2010, http://www.business-standard.com/india/news/china-property-bubble-may-bust-us-style/20/37/381349/.

[13] Katie Benner, *What Happens if China's 'Bubble' Pops?*, CNNMONEY.COM, Feb. 5, 2010, http://money.cnn.com/fdcp?1265394889541.

additional 20% increase.[14] Some experts claim that this is an example of excessive credit growth and therefore, that it probably contains some misallocation of credit.[15]

In addition to the "hyper-stimulated economy," housing prices are rising dramatically due to a limited supply coupled with a strong demand.[16] The limited supply is a result of China's prior stagnant economic growth.[17] The strong demand is due in large part to historically low interest rates and the high availability of credit.[18] Homebuyers are maxing out available lines of credit in an attempt to take advantage of this unprecedented opportunity.[19] As a result, property prices are rising to record highs with no decline in sight.[20] In Shanghai, high-end real estate prices were up 54% through September 2009.[21] In November 2009, housing prices nationwide rose 194%.[22]

According to some experts, recent government action also indicates that officials are worried China's economy is stuck in a bubble.[23] In January 2010, the Chinese government increased their banks' minimum reserve requirements and took steps to curb lending.[24] Some of these steps included increasing the required down payments on second homes, increasing interest rates on third mortgages and re-imposing the sales tax on homes sold within five years.[25] The Government also ordered city authorities to speed up property developments and build more low-cost housing to meet

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[14] *Fitch Warns China Banks Face Big 'Bubble Risk,'* ASIAONE.COM, Feb. 3, 2010, http://www.asiaone.com/News/Latest%2BNews/Business/Story/A1Story20100203-196400.html.
[15] *Id.*
[16] *See generally* Veneziani & Weisenthal, *supra* note 4.
[17] Mufson, *supra* note 4.
[18] *Id.*
[19] *Id.*
[20] *China Property Bubble May Bust US-Style*, *supra* note 12.
[21] *Id.*
[22] *Id.*
[23] *China Property Market 'Bubble' Set to Burst, Xie Says (Update 2)*, BLOOMBERG.COM, Feb. 2, 2010, http://www.bloomberg.com/apps/news?pid=20601068&sid=ahn8uHc.dmcc; *see also* Mufson, *supra* note 4, at 1.
[24] *Fitch Warns China Banks Face Big 'Bubble Risk'*, *supra* note 14.
[25] *China Property Market 'Bubble' Set to Burst, Xie Says (Update 2)*, *supra* note 23; Mufson, *supra* note 4, at 2

increasing demand.[26] Additionally, officials vowed to monitor foreign capital investments to prevent speculative funds from jeopardizing the property market.[27] Given the strong support that the bubble does exist, the important matter becomes whether the government can prevent it from bursting.

C. Will the Bubble Burst or Simply Deflate?

Experts strongly disagree as to whether or not the bubble will burst.[28] Speculators highlight parallels between the China economy and the U.S. and Dubai economies prior to their downturns.[29] Some experts argue that the China bubble will not burst because of the unique features of China's economy, including the country's "mountain of savings" and "massive investments in infrastructure".[30] Those experts who do not believe the bubble will burst underscore China's rapid industrialization, rising family incomes, pent-up demand for housing, a banking system less susceptible to real estate risks and ripening long-term investments.[31] China's rapid industrialization helps promote a consistent migration of its population to cities, which provides families access to better jobs, increases the demand for housing and increases the consumption of goods.[32] These factors will help private businesses as well as the real

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[26] *China Property Prices Accelerate*, BBCNEWS.COM, Jan. 14, 2010, http://news.bbc.co.uk.go/pr/fr/-/2/hi/business/8458393.stm.

[27] Mufson, *supra* note 4, at 1.

[28] Barboza, *supra* note 9 (warning that China's economy is headed for a crash, rather than a sustained boom); Thomas L. Friedman, *Is China the Next Enron?*, N.Y. TIMES, at A31, Jan. 13, 2010 (highlighting multiple reasons why China's economy will continue to grow).

[29] Barboza, *supra* note 9 (quoting James S. Chanos, "[China] looks like 'Dubai times 1,000–or worse.'"); Chang, *supra* note 8 ("Everything Chinese is soaring. Dubai was once soaring, too."); *China Property Bubble May Bust US-Style*, *supra* note 12 ("Millions of Chinese are pursuing property with zeal once typical of house-happy Americans." and "Although parallels with other bubble markets, the China bubble is not quite so easy to understand.").

[30] Friedman, *supra* note 28; Shaun Rein, *Jim Chanos Is Wrong: There Is No China Bubble*, FORBES.COM, Jan. 11, 2010, http://www.forbes.com/2010/01/11/china-bubble-chanos-leadership-managing-rein.html.

[31] Friedman, *supra* note 28; *see also* Shaun Rein, *supra* note 30.

[32] Andrew Batson, *China Seeks to Temper Boom, Stirs Growth Fears*, WALL ST. J., Jan. 21, 2010, at A1.

estate market to sustain growth as the government gradually withdraws stimulus funds.[33]

Rising family incomes also support the argument that China's bubble will not burst. Some experts believe that household incomes are underestimated in China due to China's individual tax reporting.[34] Individual taxes are paid by companies rather than individuals, which provides an incentive for companies to report lower salaries than what they actually pay their employees.[35] Also, many companies pay for housing and cars, which should be factored into a household's income, but often are not.[36]

The extreme demand for housing is also an indicator that China's bubble is sustainable.[37] Due to the population migration and the housing shortage from years of a stagnant economy, it will likely take several more years for supply to catch up to demand.[38] The Chinese government is also intervening to limit the size of new apartments and forcing developers to build low-income housing.[39]

The structure of China's bank lending for home purchases will also help prevent a burst.[40] Banks in China are less exposed to bad residential mortgages than banks in other countries because consumers in China are required to put down 30% for a first home and 50% for a second home, regardless of net worth.[41] Furthermore, mortgages are held by the original lenders and are therefore never spliced up and securitized by major banks.[42]

Despite the aforementioned factors and China's recent announcement of 8.7% growth for 2009 (which was higher than expected) some experts still worry the bubble will burst due to overexpansion.[43] These speculators emphasize the export-intensive economy, overall consumption within China, a possible lack of government funds to sustain stimulus funding and the perceived weaknesses in the stimulus plan.[44] First, experts worry that the 16% decline in

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[33] *Id*.
[34] Rein, *supra* note 30.
[35] *Id.*
[36] *Id.*
[37] Mufson, *supra* note 4.
[38] *Id.*
[39] Rein, *supra* note 30.
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] Chang, *supra* note 8.
[44] *Id.*

exports in 2009 predicts a similar decline in 2010 due to the global economic downturn.[45] Also, consumption, which could have offset the decline in exports, dropped from 60% of the overall economy to 30%.[46] In addition to general economic concerns, speculators worry that the government's attempts to stimulate growth are unsustainable and that the $2.4 trillion China holds in foreign reserves are useless in a domestic crisis.[47] Finally, many argue that the Chinese government poorly allocated the stimulus funds and undermined competitiveness.[48]

Lastly, experts note that China's many long-term investments could propel the economy through this uncertain time.[49] China made massive long term investments in infrastructure over the past two decades this, combined with twenty seven million students, will allow an influx of "brain power" to stimulate the economy.[50]

D. The Potential Fallout of a Bubble Burst

Many believe that if the bubble bursts the fallout will be far less drastic than in the U.S. and Dubai.[51] Unlike in free-market economies, the Communist Party still controls virtually everything in China. As demonstrated by the government's stimulus package, officials are capable of moving quickly and decisively because they face no political opposition or procedural hold ups. Among the tactics the Chinese government may use if it faces a crisis are strict price controls, forced credit lending through State Banks, and limited transparency.[52] The government could implement strict price controls, thereby preventing the population from feeling the effects of imploded assets.[53] If real estate values tumble, the Government could artificially maintain prices of other consumer goods to prevent the

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[45] *Id.*
[46] *Id.*
[47] *Id.* (arguing that foreign reserves are not very helpful in a domestic crisis because the process of converting foreign reserves into Chinese currency will cause the value of renminbi to increase substantially thereby raising the costs of exports, which would in turn kill off foreign demand).
[48] *Id.*
[49] Friedman, *supra* note 28.
[50] *Id.*
[51] Benner, *supra* note 13.
[52] *Id.*
[53] *Id.*

typical domino effect caused by rapid deflation.[54] Price controls would provide only a temporary fix, but could buy the government enough time to implement other measures to stabilize the economy.

China would likely not suffer the same credit-shortage experienced in the U.S.[55] China has already demonstrated its willingness to control the flow of credit from State Banks. Because State Banks make up such a large proportion of the banking system, China can funnel money into economic sectors to keep them afloat.[56] Lastly, the Chinese government is notoriously opaque regarding reporting problems in the banking system.[57] This limited transparency allows Chinese banks to reschedule loans, which allows bad debts to surface slowly, effectively allowing the bubble to deflate over time.[58]

E. Implications of a China Bubble for the United States

"China and the U.S. are locked in a sort of economic mutually assured destruction."[59] The U.S. needs China to continue to lend money, and China needs the U.S. to continue buying its low-priced exports.[60] A China bubble burst threatens the U.S. economy in three ways: (1) the U.S. financial sector could lose billions in Chinese real estate investments, (2) China could sell off U.S. debt and (3) China could flood U.S. markets with cheaper goods, adversely affecting U.S. manufacturers.[61]

If the China bubble bursts, everyone who invested in Chinese property, including U.S. investors, could lose their investment.[62] In 2007, six of the top ten best performing mutual funds in the U.S.

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[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] *Fitch Warns China Banks Face Big 'Bubble Risk'*, *supra* note.
[59] Peter Cohan, *How a Chinese Real Estate Bust Could Hurt the U.S.*, DAILYFINANCE.COM, Jan. 8, 2010, http://www.dailyfinance.com/story/how-a-chinese-real-estate-bust-could-hurt-the-u-s/19308725/.
[60] *Id*.
[61] *Id.*
[62] *Id*.

have China in their names.[63] Morgan Stanley invested $90 million in a Shanghai apartment complex and Goldman Sachs paid $107.6 million to construct a tower in Shanghai's business district.[64] With low U.S. interest rates and substantially higher yields in the rapidly expanding Chinese economy, investment firms are pouring money into this emerging market at a record pace.[65] If investors borrowed money to purchase these properties, then a bubble burst could result in the inability to repay those loans, adversely affecting U.S. lenders.[66]

A bubble burst could also drain substantial resources from the Chinese government through huge stimulus payments and defaulted loans.[67] To raise funds, the Chinese government might sell some of the $2.2 trillion U.S. debt it currently holds.[68] This would drive up interest rates in the U.S. while simultaneously increasing the supply of U.S. debt on the market; this market, of course would find itself without China to act as one of its largest buyers,.[69] Significantly higher interest rates could induce another economic downturn in the U.S. because a larger percentage of the national GDP would be used to pay the higher interest payments on the debt.[70]

Finally, if the bubble bursts, China could increase its rate of exporting goods in an attempt to keep its economy afloat. China is able to maintain price controls on their exported goods by pegging their currency to the U.S. dollar and preventing the Yuan from appreciating.[71] If China exported even more goods into U.S. markets, the trade imbalance would spiral further out of control,

[63] Daisy Maxey, *Bullish Appetite for China Begins to Wane---Fund Managers Pull Back, Sensing Bubble May Burst Sooner Rather Than Later*, WALL ST. J., Dec. 5, 2007, at C15 (referencing Morningstar).
[64] Veneziani & Weisenthal, *supra* note 16, at 4.
[65] Alex Frangos & Bob Davis, *Fears of a New Bubble as Cash Pours In ---Real-Estate, Stock and Currency Markets, Especially in Asia and Pacific, Are Seen at Risk*, WALL ST. J., Nov. 4, 2009, at C1.
[66] Peter Cohan, *supra* note 59.
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] Posting of Robert Hendin to CBS News Blog, *U.S., China Fuel Each Other's Bad Habits*, Nov. 16, 2009, http://www.cbsnews.com/blogs/2009/11/16/politics/politicalhotsheet/entry5668045.shtml (Nov. 16, 2009, 8:18 EST).

threatening U.S. jobs and economic growth in the process.[72] Many experts believe that the U.S. depends on its manufacturing base for sustained long-term economic recovery, so the increased competition from China would only further cripple the U.S. manufacturing base.[73]

F. Conclusion

Compelling evidence supports the conclusion that China is experiencing a bubble. However, it remains to be seen whether China's unique political and financial characteristics will exacerbate or deflate a potential burst. Even if the burst is less severe than the economic downturn of the U.S., any economic turmoil in China could have reverberating international effects. A sudden burst would likely trigger another full scale U.S. economic downturn, while the more likely deflation would probably only cause some U.S. investors to suffer substantial losses and the U.S. manufacturing industry to face an influx of competition. Despite strong predications, China's economic stability remains a source of speculation.

Kristin Lummus[74]

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[72] *Id*.
[73] *Id*.
[74] Student, Boston University School of Law (J.D. 2011).

VI. Sovereign Default: A Detour on the Road to Recovery

A. Introduction

After enduring what has arguably been the worst of the economic crisis, regulators and analysts are turning their attention to the precarious sovereign debts that threaten to restrict global economic recovery efforts.[1] Profligate spending habits and attempts to fight off recession during the recent financial crisis resulted in massive sovereign debt accumulations in many countries.[2] Paying off this debt will take years and the sovereign debt crisis may be only phase two of a long-term economic crisis.[3] The possibility of sovereign defaults will remain a very real threat for years to come.[4] Unlike previous sovereign defaults, these potential defaults originate in the developed world.[5] This article examines the recent rise of sovereign debt in the European Union ("EU")—specifically Spain, Portugal, Ireland and Greece—the possibility of sovereign default in these countries, the effects of sovereign default and possible responses to what many are calling the next international economic crisis.

B. The Rise of Sovereign Debt and Economic Stimuli

Sovereign default is not a rare occurrence. In the past fifteen years many nations defaulted on their debt obligations; the most notorious of these defaults occurred in Russia in 1998 and Argentina in 2002.[6] Argentina's approximately $82 billion default is the largest

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[1] Wanfeng Zhou, *Sovereign Debt Seen as Biggest Threat*, REUTERS.COM, Dec. 11, 2009, http://www.reuters.com/article/idUSTRE5BA3JW20091211.
[2] *Id.*
[3] *See id.*
[4] *See* Aki Ito & Jason Clenfield, *Harvard's Rogoff Sees Sovereign Defaults, 'Painful' Austerity*, BLOOMBERG.COM, Feb. 24, 2010, http://www.bloomberg.com/apps/news?pid=20601087&sid=aAd.sSfnhpTA "Following banking crises, 'we usually see a bunch of sovereign defaults, say in a few years . . . I predict we will again.'").
[5] Zhou, *supra* note 1.
[6] Andrea Zazzarelli, *Sovereign Default and Recovery Rates, 1983-2006*, Moody's Investors Service, June 2007, at 10.

sovereign default in history.[7] Argentina's debt was restructured through a distressed exchange offering where bondholders took value reductions of approximately 70%.[8] The necessary restructuring of Argentina's debt likely will result in an unprecedented loss for bondholders.[9] One similarity between Argentina's 2002 debt crisis and the current situation in Greece is how quickly the crisis is spreading to neighboring countries.[10]

The current sovereign debt crisis is fundamentally different from those discussed above because it "started at the heart of the financial markets of the West."[11] A lack of oversight and enforcement within the EU allowed countries such as Greece to accumulate excessive public debt due to irresponsible fiscal policy.[12] Other countries, like Spain, operated more responsible budgets, but allowed their private sectors to accumulate heavy debt.[13] Years of these types of budgeting decisions combined with debt-driven expansions have taken their toll and the recent financial crisis is exacerbating repayment difficulties.[14]

During the recent financial crisis most countries took a whatever-it-takes approach to keeping their economies afloat.[15] The typical government response was to promulgate a large stimulus package and underwrite private debt obligations.[16] Of course, colossal spending to prevent domestic economies from collapsing

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[7] *See* J.F. Hornbeck, *Argentina's Sovereign Debt Restructuring*, CRS Report for Congress, Oct. 19, 2004.

[8] Zazzarelli, *supra* note 6.

[9] *See* Hornbeck, *supra* note 7.

[10] Anthony Faiola, *Debt Crisis Unsettles European Economy*, WASH. POST, Feb. 6, 2010, at A1.

[11] Brian Blackstone, *Debt Load Hobbles Euro Zone's Prospects*, WALL ST. J., Feb. 12, 2010, at A10.

[12] *See* Charles Forelle, *European Statistics Agency Seeks More Power*, WALL ST. J., Feb. 26, 2010, at A10.

[13] Stephen Fidler, *The Euro's Next Battleground: Spain*, WALL ST. J., Feb. 25, 2010, at A1 ("Madrid ran budget surpluses for years – but Spain's private sector went on a debt-fueled spending binge.").

[14] *See* Javier Hernandez & Jack Ewing, *Investors Fear Europe's Woes May Extend Global Slump*, N.Y. Times, Feb. 5, 2010, at A1.

[15] Nouriel Roubini & Arpitha Bykere, *The Coming Sovereign Debt Crisis*, FORBES.COM, Jan. 14, 2010, http://www.forbes.com/2010/01/13/sovereign-debt-crisis-opinions-colummnists-nouriel-roubini-arpitha-bykere.html.

[16] Zhou, *supra* note 1.

meant issuing the debt necessary to pay for it.[17] The trillions of dollars of sovereign debt issued in the last two years are now drawing even more attention to the sovereign debt dilemma as analysts begin to worry that many countries will not be able to pay off debts accumulated from the unrestrained borrowing of the past decade.[18] Naturally, rating firms are downgrading ratings,[19] and investors are fleeing to safer investments—sometimes even liquidating at a loss.[20]

C. Sovereign Debt in the EU

There is legitimate worry that a collection of European countries including Spain, Portugal, Ireland and Greece, are at high risk for sovereign default.[21] A default of any one of these nations could set off a chain reaction of defaults throughout the EU and beyond, prolonging the current economic downturn.[22] U.S. banks, for example, have $176 billion in exposure to Spain, Portugal, Ireland and Greece.[23] A recent European Commission report shows that the EU was on notice of budget deficits in Spain, Greece and Ireland as recently as March 2009.[24] In fact the EU has been aware of Greece's mismanagement ever since Greece joined the euro area, or

[17] *See* Daniel Fisher, *The Global Debt Bomb*, FORBES, Feb. 8, 2010, at 63 ("The world has issued so much debt in the past two years fighting the Great Recession that paying it all back is going to be hell – for Americans, along with everybody else.").
[18] *See* Hernandez & Ewing, *supra* note 14.
[19] *See* Fisher, *supra* note 17, at 65.
[20] *See* Faiola, *supra* note 10.
[21] *Id.*
[22] *See* Hernandez & Ewing, *supra* note 14 (stating that if Spain, Portugal, Ireland or Greece default on their debts, it could prolong the economic downturn and create a ripple effect).
[23] Karen Brettell, *US Banks Have $176 Bln. Exposure to Greece, Others*, REUTERS.COM, Feb. 9, 2010, http://www.reuters.com/article/idUSN0911899120100209.
[24] EU Urges Action to Curb Budget Deficits, EUROPA.EU, http://ec.europa.eu/news/economy/090324_1_en.htm (last visited Mar. 27, 2010) ("With the economic crisis eating away at public finances, budget deficits in five countries are expected to exceed the 3% of gross domestic product allowed by the EU.").

"eurozone"—the sixteen EU member states that use the euro as their currency—in 2001.[25]

Large budget deficits often cause a "crisis of confidence" among investors, who worry that a country will be unable to pay its debts.[26] Accordingly, rating agencies downgrade the credit rating of a country facing large deficits, further deteriorating investor confidence.[27] Sovereign bonds thus lose value and consumers demand higher yields.[28] What little investment an at-risk country can attract is expensive to maintain,[29] and costly interest payments further the spiral towards sovereign default.

While the Greek crisis stems from reckless fiscal policy, the Spanish crisis is more the result of a private and public "debt-fueled spending binge."[30] Spain's total debt—public and private—rose approximately 14.5% per year between 2000 and 2008.[31] Spain's total debt at the end of 2008 was "$4.9 trillion, or 342% of GDP, a higher percentage than the level in the U.S. and most major economies except Britain and Japan."[32] Public debt is expected to hit 66% of GDP sometime this year,[33] and as of 2009, Spain's budget deficit was 11.4% of GDP.[34] On the whole, investor confidence in Spanish bonds is declining, as evidenced by the increasing cost to insure against Spanish default and increased borrowing costs for Spain.[35] Spain is the eurozone's fourth largest economy. In the event of a possible default, a bailout for Spain would be much more costly than a Greek bailout: a successful aid package to Spain would cost

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[25] *Greece's Sovereign-Debt Crunch*: *A Very European Crisis*, THE ECONOMIST, Feb. 4, 2010, at 75 ("When [Greece] became the 12th country to join the euro in 2001, its public debt was more than 100% of GDP.").

[26] *See* Faiola, *supra* note 10 ("[I]nvestor doubts over the will of Greece, Portugal and other nations to right their accounts have sparked a crisis of confidence . . . .").

[27] *See* Fisher, *supra* note 17, at 66.

[28] *See* Hernandez & Ewing, *supra* note 14; Roubini & Bykere, *supra* note 15.

[29] Roubini & Bykere, *supra* note 15.

[30] Fidler, *supra* note 13.

[31] *Id.*

[32] *Id.*

[33] Blackstone, *supra* note 11.

[34] Fidler, *supra* note 13.

[35] *Id.*

nearly $270 billion, approximately four times the $68 billion economists estimate is necessary for Greece.[36]

Portugal is dealing with its own budget dilemma. After Greece and Spain, Portugal is the third EU country to recently have its debt rating downgraded,[37] and credit default swaps on Portuguese debt recently reached record levels.[38] The demand for Portuguese Treasury Bills at recent auctions has been weaker than expected, mainly because investors require that these risky bills offer higher yields.[39] Portugal expects its budget deficit to be approximately 9.3%, which is higher than the 8% level predicted by the European Commission.[40] Portugal's public debt was expected to be approximately 75% of GDP in 2009,[41] and is predicted to hit 85% this year.[42]

Ireland faces the same difficulties that Spain, Portugal and Greece are encountering: high levels of debt coupled with a larger than expected budget deficit.[43] Analysts note, however, that whereas every EU country facing economic crisis and potential default promises to rein in spending and reduce reliance on debt, Ireland is the only EU country that has "pushed through the serious cuts that have demonstrated its willingness to deal with its huge deficit."[44] Ireland's

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[36] *Id.*

[37] EUBusiness.com, *Portugal Debt Downgrade Spotlights Rising Eurozone Bond Dilemma*, Jan. 22, 2009, http://www.eubusiness.com/news-eu/1232630222.21.

[38] Abigail Moses, *Portugal, Spain Lead Rise in Sovereign Debt Risk on Budget Woes*, BLOOMBERG.COM, Feb. 8, 2010, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a2MYv_jkejCs ("Credit-default swaps on Spain increased 4.5 basis points to a record 171, while swaps on Portugal climbed 15 basis points to an all-time high of 242, CMA DataVision prices show.").

[39] Emese Bartha, *Portuguese Bonds Weaken After T-Bills Sale Lowered*, WSJ.COM, Feb. 3, 2010, http://online.wsj.com/article/BT-CO-20100203-710500.html.

[40] *Id.*

[41] Central Intelligence Agency, The World Factbook: Portugal, https://www.cia.gov/library/publications/the-world-factbook/geos/po.html (last visited Mar. 28, 2010).

[42] Victor Mallet & Peter Wise, *Spain and Portugal Fight to Calm Investors*, FT.COM, Feb. 5, 2010, http://www.ft.com/cms/s/0/f3a7fc9a-1270-11df-a611-00144feab49a.html?ftcamp=rss ("Public debt is expected to hit a 20-year high of 85.4 per cent this year.").

[43] *See* Faiola, *supra* note 10.

[44] *Id.*

willingness to make drastic sacrifices is an example of the hard decisions other debt-laden countries will soon have to make.

Greece is the most dramatic and urgent example of a developed nation currently struggling with sovereign debt. Authorities and investors are monitoring the situation in Greece closely because a Greek default could set off a string of defaults in other EU countries.[45] Additionally, the effects of a Greek default would be felt worldwide as approximately "70% of Greek bonds are held by foreigners."[46]

Greece's economic situation began to unravel in October 2009, when the newly elected Greek government announced that Greece's true budget deficit was 12.7% of GDP, not the modest 5% predicted the previous year.[47] On December 8, 2009, Greece's credit rating fell because of rising debt levels and the shifting budget deficit.[48] Greece was dealt another blow when the EU announced that it seriously doubted the validity of the 12.7% figure due to Greece's unreliable economic data.[49] The markets have reacted to Greece's budgetary blunders accordingly, and yields on Greek bonds have jumped.[50] Greece attempted to alleviate investor fear by pledging to cut the budget deficit to 3% of GDP by 2012, and to reduce it to 8.7% by this year.[51]

In what has been called a "mountain of debt," the Greek government has borrowed approximately 110% of its GDP, an amount measuring $402 billion in December 2009.[52] If Greece is unable to pay its debts, the Greek government will have to be bailed

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[45] *See* Mohamed El-Erian, *Greece Part of Unfolding Sovereign Debt Story*, FT.COM, Jan. 29, 2010, http://www.ft.com/cms/s/0/2fa3be90-0caa-11df-b8eb-00144feabdc0.html.

[46] Faiola, *supra* note 10 ("[R]oughly 70 percent of Greek bonds are held by foreigners, from pension funds to global commercial banks.").

[47] *Greece's Sovereign-Debt Crunch: A Very European Crisis*, *supra* note 25.

[48] Maria Petrakis & Andrew Davis, *Greek Markets Rattled as EU Says Deficit Forecasts 'Unreliable'*, BLOOMBERG.COM, Jan. 12, 2010, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=azBb13sgHPi4#.

[49] *Id.*

[50] *Greece's Sovereign-Debt Crunch: A Very European Crisis*, *supra* note 25, at 76.

[51] *Id.* at 75.

[52] Wolfgang Reuter, *Greek Debt Threatens the Euro*, BUSINESSWEEK.COM, Dec. 8, 2009, http://www.businessweek.com/globalbiz/content/dec2009/gb2009128_445076.htm.

out by stronger eurozone members such as France and Germany, the International Monetary Fund ("IMF") or both to avoid default.[53]

D. Effects of the Sovereign Debt Crisis on Economic Recovery

A wave of sovereign defaults in the EU would slow economic recovery in both the EU and the global economy. High debt levels adversely affect economic recovery because when a nation issues debt, the interest payments necessary to service that debt must be siphoned off from more productive areas of spending and investment.[54] There is a government debt to GDP ratio "tipping point" where a country's rate of growth begins to see diminishing returns.[55] When a nation's government debt is more than 90% of its annual economic output, economic growth rates for that country are usually reduced.[56]

A high debt ratio comes with a higher risk of default, and risk of default comes with a myriad of problems. Investor panic increases the cost of borrowing and destabilizes global currency markets.[57] Governments experience higher credit default swap spreads and have to offer higher yields to attract investors.[58] Consequently, borrowing becomes more and more expensive as investors begin to lose faith in an at-risk country's ability to repay its obligations.[59]

Sovereign default makes it extremely expensive for a government to borrow in the future due to long-term issues with reputation and low credit ratings.[60] When sovereign default occurs there is a drastic decline in output growth because residents are

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[53] *Greece's Sovereign-Debt Crunch: A Very European Crisis*, *supra* note 25, at 76; Faiola, *supra* note 10.
[54] *See* Roubini & Bykere, *supra* note 15.
[55] Fisher, *supra* note 17, at 64.
[56] *Id.* ("Reinhart has found that a 90% ratio of government debt to GDP is a tipping point in economic growth. Beyond that, developed economies have growth rates two percentage points lower, on average, than economies who have not yet crossed the line.").
[57] *See* Faiola, *supra* note 10.
[58] Roubini & Bykere, *supra* note 15.
[59] *See id.*
[60] Bianca De Paoli et al., *Costs of Sovereign Default*, BANK OF ENGLAND, FINANCIAL STABILITY PAPER NO. 1, 2006, *available at* http://www.bankofengland.co.uk/publications/fsr/fs_paper01.pdf.

unable to borrow from domestic or foreign creditors.[61] Additionally, GDP is further reduced because banks stop providing liquidity and credit to the economy in default.[62] Finally, amid such drastic declines, investors inevitably question whether the defaulting government has sufficient foreign currency to defend the exchange rate, which could result in sharp currency depreciation.[63] This is the current concern of the EU—that a Greek default would systemically spread to other eurozone economies and wreak havoc on the value of the euro.[64] Additionally, if Greece goes bankrupt, the cost of borrowing would go up not only for Greece, but for other eurozone members as well.[65] Maintaining the integrity of the euro and managing the cost of borrowing are two main reasons why many believe the EU will not allow a Greek default to occur.[66]

E. Responses to Sovereign Debt in the EU

Inevitably, some type of assistance will be necessary to prevent Greece from defaulting[67] because allowing Greece to default would be far too costly to the eurozone.[68] One issue regarding assistance has been particularly contentious: who should provide the bailout, the EU or the IMF? The Maastricht Treaty currently contains a "no bailout" clause that prevents any EU nation from assuming the

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[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *See* Faiola, *supra* note 10 ("Analysts said the healthy, large economies of the 'eurozone' . . . are likely to step in to prevent a default in a weaker neighbor, if only to head off the turmoil it might cause in the value of the euro.").
[65] *Greece's Sovereign-Debt Crunch: A Very European Crisis*, *supra* note 25, at 76 ("What makes default unpalatable is the fear of contagion – that if Greece were allowed to go under, the cost of borrowing for other troubled euro members would shoot up.").
[66] *See* Faiola, *supra* note 10; *see Greece's Sovereign-Debt Crunch: A Very European Crisis*, *supra* note 25, at 76.
[67] *See* Landon Thomas Jr. & Stephen Castle, *European Union Moves Toward a Bailout of Greece*, N.Y. TIMES, Mar. 1, 2010, at B1 ("[O]ther members of the European Union – much as they would prefer not to – are discussing ways to show that they will stand behind Greece.").
[68] *See* Faiola, *supra* note 10.

debts of another EU nation.[69] However, a stronger nation, such as Germany, could possibly arrange a bridging loan to Greece.[70] A possible solution could come from both France and Germany, who are both encouraging their banks to buy Greek debt[71] that would be backed by government guarantees.[72] Another alternative would be a bailout from the IMF, which would offer cheaper funds with stricter conditions and could possibly be more effective.[73] Many analysts predicted that the EU would opt to assist Greece on its own rather than allow the IMF to rescue Greece, mainly because the latter option is too embarrassing and would damage the reputation of the euro.[74] Kenneth Rogoff, a former chief economist at the IMF, predicted that Greece would eventually have to be bailed out by the IMF.[75] On March 25, 2010, eurozone leaders agreed to draft a rescue plan for Greece.[76] The predominant proposal was a "mix of International Monetary Fund and bilateral loans at market interest rates," even though eurozone leaders expressed confidence that Greece would not "need outside help."[77] EU President Herman Van Rompuy called it a "mixed mechanism but with Europe playing the dominant role. It will be triggered as a last resort."[78] Despite reaching a consensus on a workable proposal, some authorities, including European Central Bank President Jean-Claude Trichet, were initially critical of IMF

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[69] *Greece's Sovereign-Debt Crunch: A Very European Crisis*, *supra* note 25, at 76.
[70] *Id.*
[71] Thomas & Castle, *supra* note 67.
[72] *See id.* ("European officials say the purchase of Greek bonds by government-owned lenders like Germany's KfW Bankengruppe – backed by German government guarantees – will probably be part of any solution . . . .").
[73] *See Greece's Sovereign-Debt Crunch: A Very European Crisis*, *supra* note 25, at 76 ("In any case, a bail-out by Greece's partners is unlikely to be as effective in sorting out the country's finances as an IMF programme.").
[74] *See id.* ("European officials are privately horrified at the thought of calling in the IMF to bail Greece out. Pride is at stake. To turn to the fund for aid would be a humiliation for Europe, never mind the Greeks.").
[75] Ito & Clenfield, *supra* note 4.
[76] Paul Dobson, *Bunds Fall, Greek Bonds Rise After EU Leaders Agree Aid Plan*, BUSINESSWEEK.COM, Mar. 27, 2010, http://www.businessweek.com/news/2010-03-27/bunds-fall-greek-bonds-rise-after-eu-leaders-agree-aid-plan.html.
[77] *Id.*
[78] *Id.*

involvement.[79] Regardless, the final rescue plan will likely withstand any legal challenge.[80] Although a final rescue plan was not fully agreed upon at the time of this writing, it appears certain that the solution will involve a joint effort between the EU and the IMF.

Going forward, there are at least two possibilities the EU can consider to prepare for future financial crises. The first is to increase oversight of the economies of member nations.[81] This could be accomplished through a new agency or by strengthening the EU's statistical authority "Eurostat."[82] Eurostat is already seeking more power, arguing that the current situation in Greece is prima facie evidence of the need for more oversight.[83] Currently, Eurostat is not a true regulator and does not have the power to correct profligate countries.[84] The European Commission proposes giving Eurostat broader auditing powers including "access to the accounts of government entities at central, state, local and social security levels."[85] Eurostat should also have the authority to review the data on which countries base their debt and deficit calculations.[86]

The other option is to develop a type of insurance system whereby member nations would pay premiums based on each country's debt and deficit.[87] The money paid into the system could be used as loan money "to euro members shut out of bond markets."[88] Obviously these two proposals are not mutually exclusive, nor is the

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[79] Bradley Davis, *Trichet's IMF Warning Hits Euro*, WALL ST. J., Mar. 26, 2010, at C2.

[80] *See* Karin Matussek, *Greek Aid to Survive German Court Bid, Lawyers Say*, BUSINESSWEEK.COM, Mar. 26, 2010, http://www.businessweek.com/news/2010-03-26/greek-aid-to-survive-german-court-bid-lawyers-say-update1-.html ("While experts are split over whether the rescue complies with EU law, they say that Germany's Federal Constitutional Court, known for its critical stance over European integration issues, may in the end reject any lawsuits over the bailout.").

[81] *See* Forelle, *supra* note 12.

[82] *See id.*

[83] *Id.*

[84] *Id.*

[85] *Id.*

[86] *Id.* (observing that currently Eurostat "has no authority to look through the figures on which debt and deficit calculations are based.").

[87] *Greece's Sovereign-Debt Crunch: A Very European Crisis*, *supra* note 25, at 77 (citing a forthcoming paper by the Centre for European Policy Studies which proposes such an insurance system).

[88] *Id.*

solution limited to these two proposals. A combination of regulatory reform and insurance that incorporates other preventative measures seems likely.

F. Conclusion

The potential for sovereign default threatens global economic recovery and will be closely monitored for the next several years. The heart of the sovereign debt problem is profligate spending. Going forward, nations such as Greece and Spain must practice fiscal responsibility and the EU must implement preventative measures and maintain sound budgets in the eurozone. For now, the only way to reign in debt is a combination of spending cuts and higher taxes. One critical risk that must be monitored in the deleveraging process is the potential for a double-dip recession, which can often occur during fiscal tightening.[89] Even though deleveraging will likely slow both job growth and short-term economic recovery, it is a necessary step towards long-term recovery. Ireland has already demonstrated the willingness to confront its deficit, and Greece is currently following suit.[90]

Michael Quirk[91]

[89] Simon Nixon, *Four Reasons to Remain Cautious*, WALL ST. J., Jan. 2, 2010, at B10 (stating that a combination of "fiscal tightening and monetary-policy exit strategies leads to a 'double-dip' recession.").
[90] *See* Maria Petrakis & Natalie Weeks, *Greece Said to Announce $6.5 Billion in Deficit Cuts*, BLOOMBERG.COM, Mar. 2, 2010, http://www.bloomberg.com/apps/news?pid=20601087&sid=alGEO8bQP4fg&pos=1 ("The Greek government will announce as much as 4.8 billion euros ($6.5 billion) of additional deficit cuts tomorrow, bowing to pressure from the European Union and investors to do more to tame the region's biggest shortfall . . . .").
[91] Student, Boston University School of Law (J.D. 2011).

VII. The California Budget Crisis

A. Introduction

The current "Great Recession" impacted the tax revenues of every state. Generally, personal income tax, corporate profit tax and a variety of sales taxes account for nearly 55% of state tax revenues.[1] While these three taxes generate significant income during prosperous economic times, each normally experience a decline during a recession. As a demonstration of this fact, the combined budget deficit of all the states for the fiscal year 2010 is around $145.9 billion.[2]

While a decline in tax revenue is not unusual during a recession, California's current budget shortfall resulted from far more than a simple recessionary downturn in revenues. California's unique political atmosphere, combined with unusual constitutional provisions, makes California far more susceptible to recessionary budget issues than other states. Currently, California is in the midst of trying to resolve a $19.9 billion budget deficit for 2010-11,[3] including: (1) $6.6 billion in current budget year shortfall, or carryover from 2009-10 budget shortfall; (2) $12.3 billion projected shortfall for 2010-11; and (3) $1 billion in modest reserve.[4]

A simple comparison of California and other states with similar budget deficits demonstrates California's increased susceptibility to recessions. For fiscal year 2010, state governments project mid-year budget shortfalls in forty-one states.[5] California's $6.6 billion shortfall is greater than any of the other forty-one states, with the next closest being Illinois at $5 billion.[6] The total anticipated budget deficit for all of the states is $37.7 billion, meaning California's $6.6 billion shortfall alone accounts for 17.5% of the

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[1] Liam Denning, *Slump in Tax Revenue Creates State of Siege*, WALL ST. J., Feb. 19, 2010, at C10.
[2] *Id*.
[3] OFFICE OF THE GOVERNOR, 2010-2011 BUDGET PROPOSAL: SOLVING CALIFORNIA'S $20 BILLION DEFICIT (2010).
[4] *Id*.
[5] ELIZABETH MCNICHOL & NICHOLAS JOHNSON, RECESSION CONTINUES TO BATTER STATE BUDGETS; STATE RESPONSES COULD SLOW RECOVERY, 2 (2010).
[6] *Id.*

aggregate state mid-year deficits.[7] To combat the substantial deficit, California Governor Arnold Schwarzenegger has proposed massive program cuts within his 2010-11 budget.[8] This article discusses these cuts, why they are necessary and explores several alternatives.

B. The Path That Led To Fiscal Unsoundness

It started with a simple proposition in 1978: cut property taxes to allow those on fixed incomes to meet their escalating property tax assessments.[9] With the passage of this proposition, known as Prop. 13, California's property tax dynamics changed by capping the total amount of tax collected from each property.[10] Specifically, Prop. 13 limits the annual real estate tax to 1% of the assessed value of the property.[11] This assessed value cannot rise more than 2% annually, unless a change of ownership occurs.[12] When a change of ownership occurs, the purchase price then becomes the new assessed value.[13] For example, a house sold in 2005 for $700,000, would have annual property taxes of $7,000 (or 1%).[14] If in 2006 the house increases in value by 5% to $735,000, the tax base could only increase by 2%, to $714,000. The property owner benefits from not having the additional $21,000 difference between the tax basis and market value included in the property tax calculation.

Passage of Prop. 13 stemmed from a tax revolt against dramatic escalation in property taxes due to correlated increases in homes values.[15] While the passage of this proposition represented a victory for homeowners, its application cut property taxes by 57%,

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[7] *Id.*
[8] CALIFORNIA BUDGET PROJECT, SEARCHING FOR BALANCE: THE SOCIAL AND ECONOMIC CONTEXT OF THE GOVERNOR'S PROPOSED 2010-11 BUDGET (2010).
[9] Kevin O' Leary, *How California's Fiscal Woes Began: A Crisis 30 Years in the Making*, TIME, June 01, 2009, http://www.time.com/time/magazine/article/0,8816,1907504,00.html.
[10] Carolyn Said, *Revenue falls with home prices*, SAN FRANCISCO CHRONICLE, Jan. 25, 2009, at 1.
[11] O'Leary, s*upra* note 9, at 1.
[12] *Id*.
[13] Pete Carey, *Prop. 13 Critics Point To Landmark Property Tax law As A Source Of California's Fiscal Problems*, SAN JOSE MERCURY NEWS, July 26, 2009, at 1.
[14] Said, *supra* note 10, at 1.
[15] O' Leary, *supra* note 9, at 1.

forcing California to rely more heavily on income taxes for revenue.[16] California's current tax structure relies on personal income tax for 52.5% of its revenues.[17] With such heavy reliance on income tax, any fluctuation in income or workers available to tax significantly impacts expected revenues.[18] To that end, California is in one of its worst job markets in decades. In fact, California has lost nearly one million jobs since the recession began.[19] The job market has fallen so dramatically that California has as many jobs as it did ten years ago, with over 3.3 million more working age individuals.[20] There are also nearly six job seekers for every open position and the unemployment rate hit a record high of 11.9 % in July 2009.[21]

Although critics blame Prop. 13 for a major portion of the current financial distress, for many years this tax scheme operated effectively. From 1980-92, California saw an average annual revenue growth rate of 9.8%.[22] Prop. 13 also provided predictability for taxpayers, as well as stability in revenue flows.[23] When the housing market began slumping in 2007,[24] however, property values became depressed. Property tax revenues decreased when homes became foreclosed and the banks were selling the houses at discount prices.[25] In 2008 alone there were 250,000 homes repossessed and sold at an average of 35% less then pre-recession prices.[26] Because the Proposition 13 tax basis changes with sales, the government

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[16] *Id*.
[17] CALIFORNIA BUDGET PROJECT, SEARCHING FOR BALANCE: THE SOCIAL AND ECONOMIC CONTEXT OF THE GOVERNOR'S PROPOSED 2010-11 BUDGET 9 (2010).
[18] Michael B. Farrell, *California budget crisis spurs reform efforts*, CHRISTIAN SCIENCE MONITOR, Nov. 15, 2009, at 1.
[19] CALIFORNIA BUDGET PROJECT, IN THE MIDST OF THE GREAT RECESSION: THE STATE OF WORKING CALIFORNIA 9 (2009).
[20] *Id*. at 5.
[21] *Id*. at 3.
[22] CAL-TAX RESEARCH, PROPOSITION 13: LOVE IT OR HATE IT, ITS ROOTS GO DEEP 5 (1993), *available at* http://www.caltx.org/research/prop13/prop13.htm.
[23] *Id*.
[24] Michael J. Mauboussin, *Anatomy Of A Market Crash*, FORBES, Oct. 25, 2007, *available at* http://www.forbes.com/2007/10/25/michael-mauboussin-crash-markets-marketsp07-ex_mm_1025mauboussin.html.
[25] Said, *supra* note 10, at 1.
[26] *Id*. at 1-2.

collected the 1% tax on the depressed values, resulting in a loss of $37.7 billion in tax revenues.[27]

Prop. 13 not only changed how property taxes were assessed, but it also dramatically handicapped the Legislature's ability to change the tax assessment. One provision of Prop. 13 requires a two-thirds majority to pass any tax increase at the state or local level.[28] Additionally, California has a Constitutional provision that requires a two-thirds majority to pass a budget.[29] A minority of only 34% could now stop either a budget or tax increase from occurring.[30]

While Prop. 13 is heavily to blame for the current fiscal distress of California, the recession also has contributed to diminished returns in other areas that the General Fund relies on. For instance, California's tax revenues rely heavily on both corporate taxes and sales and use taxes, with these taxes contributing about 40.2% of the General Fund Revenues.[31] Since the recession, however, both of these taxes are generating fewer funds. The sales tax has decreased because of people purchasing more through electronic means, most of which escape taxation.[32] Corporate tax revenues decreased for many reasons, including decreased sales and income and from the Government lowering the tax rate on these entities over time.[33] Without a rebound in these areas, California will not see a return to its normal tax revenue.

C. Governor Schwarzenegger's 2010 – 2011 Budget

The 2010-11 proposed General Fund expenditures are expected to total $82.9 billion.[34] While revenues are expected to total $89.3 billion, there will still be a shortfall that requires reconciling.[35] Governor Schwarzenegger has proposed two separate budgets for 2010-11, and will determine which one to implement depending on whether California receives a requested $6.9 billion in federal

[27] *Id*. at 2.
[28] O' Leary, *supra* note 9, at 2.
[29] CAL. CONST. art. IV, §12.
[30] *Id*.
[31] CALIFORNIA BUDGET PROJECT, *supra* note 17, at 9.
[32] *Id*. at 35.
[33] *Id*.
[34] *Id*. at 7.
[35] *Id*. at 9.

funds.[36] In general, though, the following list demonstrates what the Governor's proposed budget reconciliation measures are, as well as each solution's corresponding weight in making up the almost $20 billion in budget shortfall:

1. 34.8% in federal funds
2. 12.2% from reducing Proposition 98 spending, which was a ballot initiative passed in 1988 requiring 40% of General Funds be spent on schools[37]
3. 9.9% from "alternate funding," fund shifts, and other revenues
4. 8.2% from reduction in state employee compensation
5. 5.9% is funding reductions for Medi-Cal and Healthy Families Reductions
6. 5.9% in Correction Facility savings
7. 5.0% in diversion of Prop. 10 and Prop. 63 funds
8. 5.0% in transportation funding swap
9. 4.8% from reductions of the In Home Supportive Services program
10. 4.0% from other health and human services reductions
11. 2.5% by increasing each county's chare of costs for children's programs
12. 1.8% from other spending reductions[38]

More specifically, the 2010-11 budget also includes precise monetary reductions in certain programs. If California does receive the additional federal assistance, the first budget with the following features will be employed:

1. $6.9 billion in federal funds
2. $2.4 billion in cuts to schools and community colleges
3. $1.6 billion in reductions to state employee compensation
4. $1.2 billion in reductions in corrections spending
5. $1.2 billion in reductions to health coverage programs

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[36] *Id*. at 20.
[37] Richard Ross, *Prop. 98's been good for California*, LA TIMES, Feb. 19, 2009, http://www.latimes.com/2009/feb/19/opinion/oe-ross19.
[38] CALIFORNIA BUDGET PROJECT, *supra* note 17, at 19.

6. $1.0 billion in reductions to the In Home Supportive Services (IHSS) program for the elderly, which would eliminate services to 87% of current recipients
7. $792 million in reductions to other health and human services programs
8. $4.8 billion in "alternative funding" and other reductions[39]

If by July 15, 2010 the Governor has not received the full amount of requested federal funds, he will implement the secondary budget with the following additional cuts and revenue generating measures:

1. $1.044 billion by eliminating the CalWORKS program
2. $532 million by reducing Medi-Cal eligibility to the minimum allowed under current federal law and eliminating most remaining optional benefits
3. $495 million by eliminating the IHSS Program completely
4. $126 million by eliminating the Healthy Families Program
5. $2.4 billion in revenues through several onetime measures, including delaying implementation of corporate tax cuts and extending some of the recent temporary tax increases[40]

As of February 2010, California only received $1.5 billion in additional funding,[41] allotted to California in President Obama's budget plan for 2010-11, and the prospects of receiving more seem minimal.[42] Although more funding may arrive before the July 15, 2010 deadline, it seems likely that Governor Schwarzenegger will have to proceed with his secondary budget, at least to make up the difference between the $6.9 billion requested and the $1.5 billion received.

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[39] *Id*. at 20
[40] *Id*. at 21
[41] Richard Simon, *What Obama's budget plan may mean for California*, LA TIMES, Feb. 1, 2010, at http://www.latimes.com/news/nation-and-world/la-na-budget-california2-2010feb02,0,5340760.story
[42] *Id*.

D. The Social and Economic Impact of the Proposed 2010-11 Budget

The recession has not only lowered the amount of income coming in as revenues, but it has also increased the reliance of Californians on government programs.[43] For instance, the number of individuals relying on food stamps increased by more than 905,218, or 43%, between October 2007 and October 2009.[44] Enrollment in Medi-Cal, one of the programs that will suffer significant funding cuts under the proposed budget, experienced an increase in covered individuals of 470,965, or 7.2%, between May 2007 and May 2009.[45] The Healthy Family Program also saw the number of children enrolled in its program rise by 97,172, or 11.8%, between July 2007 and July 2009.[46]

This increased demand, combined with the lack of funding, creates a downward spiral for California's social and health programs. In order to combat these rising costs, the Governor elected to make heavy cuts in health and human services programs and public education. These two areas contribute to more than 67.8% of the current General Fund expenditures, with education composing 42.8% of that total.[47] With education demanding such a large percentage of scarce funds, it seems logical to reduce spending in this area. To accomplish this, the Governor proposed drastic cuts to the public education system

With reduced spending, it seems likely that California public schools will continue to fall in adequacy ranks among the rest of the nation. Currently California's school system ranks among the worst in the nation in per pupil spending, has the highest ratio of children to teachers in grades k-12 with an average of 21.3 students per instructor with a U.S. average of 14.4 per instructor, and 36th in the nation in percentage of high school students who graduate with a diploma.[48]

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[43] CALIFORNIA BUDGET PROJECT, PROPOSED BUDGET CUTS COME AT A TIME OF GROWING NEED 1 (2010).
[44] *Id*. at 6.
[45] *Id*. at 9.
[46] *Id*. at 8.
[47] CALIFORNIA BUDGET PROJECT, *supra* note 17, at 7.
[48] *Id*. at 40 (stating that California ranks 45th in per pupil spending (spending $8,825 per student as compared to the U.S. average of $11,052) and that

As the statistics demonstrate, California ranks in the bottom of states in most important categories of spending. Even though California spends about 42.8% of its General Fund (about $35 billion in 2010–2011 budget)[49] on education, the taxable revenues have not been able to meet the demands of a growing population.

While cutting costs of health and social programs and education may seem draconian, the sheer amount of funds required to provide these services necessitates a reduction. Although the idea of limiting social programs may seem disastrous to the citizens of California, the experience may very well provide information on the possible detrimental effects of providing these services. By eliminating some programs, California could provide insight into the positive and negative consequences of limiting government aid.

E. The Future Outlook and Possible Solutions

Although the Governor had success closing the gap for the 2009-10 budget and appears to have reconciled the 2010-11 budget, the majority of forecasters believe California will be in trouble for years to come.[50] One report forecasts more deficits in the upcoming years in the amounts of $21.3 billion in 2011-12, $23 billion in 2012-13, and $18.4 billion in 2014-15.[51]

The outlook for the budget deficits follows closely with the negative expectations of the California job market. Even if jobs grow at a level of 268,700 annually, consistent with growth experienced in other years such as in 2005, it would still take California more than three years to regain the almost one million jobs it lost since the recession.[52] This time frame does not even account for the job growth necessary to match the working age population growth.[53] Forecasts, however, directly contradict that growth will match 2005 levels. In

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fewer than 68% of California public high school students graduate with a diploma).

49 *Id*. at 7.

50 *Id*. at 27.

51 LEGISLATIVE ANALYST'S OFFICE, CALIFORNIA'S FISCAL OUTLOOK: THE 2010 –11 BUDGET 3 (2010), *available at* http://www.lao.ca.gov/2009/bud/fiscal_outlook/fiscal_outlook_111809.aspx

52 CALIFORNIA BUDGET PROJECT, *supra* note 19, at 9.

53 *Id.*

fact, some forecasters are projecting that California's annual unemployment rate will remain above 10% through 2012.[54]

So what are the possible solutions to the California Budget crisis? First, California should change procedural requirements of the Legislature. Without revamping the tax system and budget process to allow for a simple majority approval, California will remain subject to a minority imposing undue influence on financial decisions.[55] While the minority lawmakers may not find change desirable, popular vote could amend Prop. 13 and the California Constitution. However, it seems clear that the majority of Californians do not want to change the legislative restrictions, as a recent poll showed that 52% of voters oppose lowering the vote needed to pass a budget to a simple majority.[56]

Second, California needs to revamp its tax system. Changing Prop. 13, however, will have negative effects on both low income and elderly homeowners.[57] For instance, if Prop.13 is repealed, 92% of elderly property owners will experience an increase in taxes, some as high as 160%.[58] It also seems that most Californians do not want Prop. 13 changed, with a recent poll showing that 69% percent oppose any reconstruction of the property tax.[59]

If a change does occur, however, California should develop a new property tax scheme that does not require the government to rely so heavily on personal income tax, corporate taxes, and sales and uses taxes. By diversifying revenue sources, California will become less susceptible to decreases in revenues during a recession. One solution is to return to a property tax system that assesses tax liability off market value. This scheme has the positive consequence of basing tax payment off wealth, but has the negative effect of allowing for large increases of tax liabilities if property values increase.

California could also maintain the tax cap for residential homeowners but allow for increases to market value of corporate entities, known as a "split-roll."[60] Under the split-roll concept,

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[54] CALIFORNIA BUDGET PROJECT, *supra* note 16, at 27.
[55] O' Leary, *supra* note 9, at 2.
[56] Editorial, *Ambivalence over state government reforms*, SANTA CRUZ SENTINEL, Nov. 1, 2009, at 1.
[57] Cal-Tax, *supra* note 21, at 1
[58] *Id*.
[59] *Ambivalence over state government reforms*, *supra* note 56, at 1.
[60] Op-Ed, *Split roll is bad news for small business*, ALAMEDA TIMES-STAR, Sept. 5, 2009, at 1.

commercial property loses the protections of Prop. 13, and pays a higher rate that is assessed more often.[61] While this solution would protect the low income and elderly homeowners from increased tax liability, it would almost certainly have a negative impact on California's economy. "Business properties already account for 60% of local property taxes" and increasing business property taxes even by 1% may result in a loss of 43,000 jobs.[62]

Another option is to close the loophole that exists for businesses under the current Proposition 13 structure. Right now, "whenever a partnership buys a property and no one individual holds a majority stake, the transaction is not considered a change of ownership and the property does not get reassessed."[63] Basically, the ownership change provision is not triggered "unless 50 percent changes hands in one transaction."[64] Practically, this exclusion means that some commercial properties are paying taxes on land under "decades-old valuations."[65] Closing the loophole is a good option because it does not create a new tax, but simply reforms an existing one.[66] Despite its appeal, increasing taxes on business and the correlated job losses seen with the split-roll still exists.[67]

Finally, California may simply have to increase taxes and cut spending until the American economy as a whole recovers from the "Great Recession." Every state experiences some decrease in tax revenues during a recession, and California is no exception. If California makes changes, the State can once again experience fiscal soundness.

Joseph Scott McVicker[68]

[61] *Id.*
[62] Carl Lambert, *Property tax hike would cost Californians*, LOS ANGELES BUS. J., Nov. 23, 2009, at 1.
[63] Thomas D. Elias, *Legislators are still ignoring a huge tax loophole*, LONG BEACH PRESS-TELEGRAM, July 30, 2009, at 1.
[64] Dan Walters, *Fixing state woes may include prop. 13 adjustment*, THE SACRAMENTO BEE, Apr. 29, 2009, at 2.
[65] Elias, *supra* note 63, at 2.
[66] *Id.*
[67] Lambert, *supra* note 62, at 1.
[68] Student, Boston University School of Law (J.D. 2011).

VIII. The AIG Bailout and AIG's Prospects for Repaying Government Loans

A. Introduction

American International Group (AIG) is an international insurance corporation that handles a wide range of insurance and insurance-related activities.[1] AIG's activities include general insurance, life insurance and retirement services, financial services and asset management.[2] AIG also lends mortgages, issues commercial paper and participates in the derivatives market.[3] In addition, AIG maintains an extensive securities lending program in which insurance companies lend securities for cash capital, which is then invested in residential mortgage-backed securities.[4] AIG, the "largest domestic life insurer" in the United States, was on the brink of collapse in September 2008.[5] The government subsequently bailed out AIG; AIG is currently attempting to repay its debt. This article discusses the AIG bailout, focusing on AIG's current financial situation and the prospects of AIG repaying the taxpayer money it borrowed through the government.

B. Events Leading to AIG's Collapse

During the end of 2007 and beginning of 2008, AIG suffered major losses on credit default swaps and in its securities lending program.[6] The company faced mounting liquidity pressures as a result.[7] In September 2008, AIG's debt rating was downgraded by rating agencies.[8] As a result of the downgrade, AIG was required to

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[1] The Emergency Economic Stabilization Act of 2008 created the Troubled Asset Relief Program (TARP) and requires GAO to oversee actions taken under TARP. U.S. GOVT. ACCOUNTABILITY OFFICE, TROUBLED ASSET RELIEF PROGRAM: STATUS OF GOVERNMENT ASSISTANCE PROVIDED TO AIG 4, GAO-09-075 (2009) [hereinafter GAO REPORT]
[2] *Id.*
[3] *Id.* at 8.
[4] *Id.*
[5] *Id.* at 5.
[6] *Id.* at 14.
[7] GAO REPORT, *supra* note 1, at 14.
[8] Moody's lowered AIG's rating two notches from Aa3 to A2. Standard & Poor's Rating Services lowered its rating by three notches from AA- down

provide $20 billion to meet collateral demands; it was unable to do so without assistance.[9]

Multiple events led to AIG's inability to meet its collateral demands. Many blame this deficiency on an AIG London subsidiary, AIG Financial Products Corporation, which engaged in various risky financial transactions, and sustained losses of $25 billion.[10] Another contributor to AIG's financial crisis was one of AIG's largest insurance units in Delaware that dealt in volatile credit default swaps.[11] Ultimately, a number of factors including AIG's London and Delaware branches, as well as the overall effect of the housing and credit crisis led to AIG's downfall.[12] In order to avoid a complete meltdown, AIG needed immediate and immense financial support.

C. Government Rescue

On September 16, 2008, the Federal Reserve Board (Board) announced that it would authorize the Federal Reserve Bank of New York (FRBNY) to lend up to $85 billion to AIG under Section 13(3) of the Federal Reserve Act.[13] Because of AIG's size, the Board determined that a complete collapse of AIG would be extremely harmful to already fragile financial markets and economic performance in general.[14] To ensure that government and taxpayer interests were protected, the Board collateralized its loan with AIG's assets, the assets of AIG's subsidiaries, and the majority of AIG subsidiary stock.[15] The loan carried a twenty-four-month term with interest accruing on the outstanding balance at a rate of three-month Libor plus 850 basis points.[16] In exchange for extending this $85 billion loan, the government received a 79.9% equity interest in AIG and the power to veto dividend payments to both common and preferred

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to A-. Fitch Ratings reduced its rating two notches from AA- to A. GAO REPORT, *supra* note 1 at 12.

[9] *Id.* at 12.

[10] Mary Williams Walsh, *Risky Trading Wasn't Just on the Fringe at A.I.G.*, N.Y. TIMES, Jan. 31, 2010, at B1; GAO REPORT, *supra* note 1 at 4.

[11] Walsh, *supra* note 10.

[12] *Id.*

[13] Press Release, Federal Reserve Board of Governors, (Sept. 16, 2008), http://www.federalreserve.gov/newsevents/press/other/20080916a.htm.

[14] *Id.*

[15] *Id.*

[16] *Id.*

shareholders.[17] The Board stated that it expected AIG to repay the loan with profits made from the sale of AIG's assets.[18] Yet the Board's loan was insufficient and extremely expensive, with a projected cost to AIG in the first twelve months of nearly as much as AIG's 2006 profits, its highest grossing year.[19]

On October 9, 2008, AIG borrowed an additional $37.8 billion through the FRBNY.[20] On November 25, 2008, the U.S. Treasury purchased $40 billion in AIG senior preferred stock, with authority of the Systemically Significant Failing Institutions program, under the Troubled Asset Relief Program and the Emergency Economic Stabilization Act.[21] The government assumed AIG's mortgage-backed securities as well as some if its most toxic credit derivatives in a rescue package that totaled over $153 billion in loans and capital.[22] In the fourth quarter of 2008, AIG reported a $61.7 billion loss, the largest quarterly loss in financial history.[23] Despite this, government provided an additional $30 billion in loans to AIG in March 2009 and relaxed the terms of its loan to AIG.[24] With government loans now totaling $182 billion,[25] AIG had become the largest recipient of government aid in the bailout,[26] and became the target of unbridled public hostility.

D. Public Response to the Government's Bailout

Public outrage over the Government's bailout of AIG reached a boiling point in March of 2008, when AIG announced that it would pay $175 million in bonuses to its employees, many of whom helped lead AIG to near collapse and the resulting massive

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[17] *Id*.
[18] *Id.*
[19] *Cheque Mate*, ECONOMIST, Nov. 15, 2008, Vol. 389, Issue 8606.
[20] Press Release, Federal Reserve Board of Governors, *supra* note 13.
[21] Press Release, U.S. Department of the Treasury, Treasury to Invest in AIG Restructuring Under the Emergency Economic Stabilization Act (Nov. 10, 2008) *available at* http://www.ustreas.gov/press/releases/hp1261.htm.
[22] *Cheque Mate*, *supra* note 19.
[23] Andrew Ross Sorkin & Mary Williams Walsh, *A.I.G. Reports Loss of $61.7 Billion as U.S. Gives More Aid*, NY TIMES.COM, Mar. 2, 2009, http://www.nytimes.com/2009/03/03/business/03aig.html.
[24] *Id.*
[25] Jeffrey McCracken, et. al, *AIG Nears Deal To Sell Asia Unit*, WALL ST. J., Mar. 1, 2010, at A1.
[26] *Id.*

government bailout. AIG defended the payout, stating that the bonuses were guaranteed to employees through a retention program created in early 2008.[27] Despite the justification, outrage erupted in Congress as well. On March 18, 2009, during heated discussions concerning AIG's recent announcement of bonuses, many members of Congress expressed disgust and resistance towards the bonuses, including Congressmen Earl Blumenauer:

> Mr. Speaker, not quite so fast on the AIG bonuses. The weasels who drove that company into the ground may not even be entitled to the bonuses in their contract based on their performance. And a failed company rescued from bankruptcy by the United States Government may not be obligated to pay them anyway.[28]

On March 19, 2008, spurred on by a "tidal wave of public anger," the House of Representatives voted 328 to 93 to recoup bonus money by placing a 90% tax on bonuses paid to executives of companies receiving government money.[29] By late August 2008, employees indicated they would return $45 million of the bonus payments.[30] As of February 2010, the government has collected $19 million.[31]

Cognizant of ongoing public and Congressional hostility towards 2009 bonuses, AIG cut its 2010 bonuses, by over $20 million, to $100 million.[32] To placate employees angered by these pay cuts, AIG paid their bonuses earlier than scheduled.[33] Furthermore, in order to mollify the public and keep employees accountable, AIG

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[27] Brady Dennis, *AIG Asks Employees To Decide on Cuts in Bonuses*, WASHINGTON POST, Jan. 26, 2010, at A11.

[28] 155 CONG. REC. H3530 (daily ed. Mar. 18, 2009) (statement of Rep. Blumenauer).

[29] *House Passes 90% Tax on Bonuses at Rescued Firms*, Deal Book, NYTIMES.COM, Mar. 19, 2009, http://dealbook.blogs.nytimes.com/2009/03/19/in-house-anger-over-aig-bonuses-turns-partisan.

[30] Serena Ng, *Despite Critics, AIG Sets Bonuses - Lawmakers Oppose Pay for Unit That Racked Up Losses; General Counsel Named*, WALL ST. J., Feb. 3, 2010, at C13.

[31] *Id.*

[32] Mary Williams Walsh & Sewell Chan, *$100 Million Bonus Plan at A.I.G. Draws Fire*, N.Y. TIMES, Feb. 10, 2010, at B1.

[33] Dennis, *supra* note 27.

also plans to introduce a compensation system that ranks employee performance numerically in order to determine the size of their bonuses.[34] AIG expects this ranking system to satisfy Kenneth Feinberg, the Treasury Department official overseeing compensation levels at a number of big firms, including AIG, which received government support.[35] This proposed system has drawn both anger and fear from executives at AIG, who lost many valuable employees after the bailout, and AIG insiders worry the new system will create additional anxiety among employees at a time when morale at the company is already low.[36]

E. The Future of AIG and its Ability to Repay

AIG accepted approximately $130 billion of the $182 billion offered by the U.S. government bailout loan,[37] and is currently attempting to repay $97 billion under the guidance of Chief Executive Robert Benmosche.[38] Although AIG is still struggling, there are some signs of improvement for the insurance giant. After a $61.7 billion loss from the fourth quarter of 2008, AIG reported a much lower $8.9 billion loss for its fourth quarter in 2009.[39] AIG's total 2009 loss totaled $11 billion, down from nearly $100 billion in 2008.[40] AIG's insurance companies began to show some signs of improvement in the second quarter of 2009, but it is too early to determine whether this constitutes a trend.[41] A number of factors, including AIG's liquidity, sales and asset holdings reflect AIG's current and future ability to generate profit and cash proceeds with which AIG can repay its loan.

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[34] Michael J. de la Merced, *A.I.G. Will Use a Grading System for Bonuses*, N.Y. TIMES, Feb. 10, 2010, at B6.
[35] *Id.*
[36] Serena Ng &Joann S. Lublin, *AIG Pay Plan: Rank and Rile—Insurer to Rate Workers on Scale, Compensate Accordingly; Are You a 1 or a 4?*, WALL ST. J., Feb. 11, 2010, at C1.
[37] McCracken, *supra* note 25.
[38] *Id.*
[39] *A.I.G. Posts $8.9 Billion 4th-Quarter Loss*, Deal Book, NYTIMES.COM, Feb. 26, 2010,http://dealbook.blogs.nytimes.com/2010/02/26/a-i-g-posts-8-9-billion-fourth-quarter-loss/?scp=3&sq=AIG&st=cse.
[40] *Id.*
[41] G.A.O. REPORT, *supra* note 1 at 51 (2009).

AIG continues to rely on the U.S. government for its source of both liquidity and capital,[42] in particular the FRBNY Revolving Credit Facility and the Treasury's equity facility.[43] AIG is still unable to acquire liquidity from private sources.[44] However, AIG's shareholder equity—an indicator of solvency —has risen from the efforts of AIG, FRBNY and the Treasury through restructuring the makeup of government assistance and from paid-in capital from federal assistance and investment.[45] It is therefore clear that from a liquidity standpoint, AIG's progress has been minimal.

In contrast to its liquidity difficulties, AIG's sales in both services and subsidiaries appear promising. In December 2009, AIG once again became the top seller of fixed annuities to bank customers, a sign that AIG is making progress.[46] As of May 1, 2009, AIG had paid back $1.4 billion to FRBNY from the proceeds of sales, and projected an available $4.6 billion to pay to FRBNY from the proceeds of recently closed sales.[47] Total sales in 2009 greatly exceeded sales in 2008,[48] a promising sign for the insurance giant.

In addition to annuity sales, AIG has also concentrated on selling some of its assets, namely some of its subsidiary companies, as part of its restructuring plan to meet its loan obligations. AIG plans to use the profits from these asset sales to repay its loans and also to provide loans to its subsidiary companies.[49] In AIG's largest attempt to repay its loan, on February 28, 2010, AIG entered the final stages of the sale of its Asian life insurance business, American International Assurance Ltd. (AIA), to Prudential PLC for approximately $35.5 billion.[50] The Board and Treasury Department officials agreed to this deal.[51] The Prudential deal is favorable to the government and taxpayers because its expected profit of $25 billion cash greatly exceeds the $15 billion that was initially projected from an IPO of AIA.[52]

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[42] *Id.*
[43] *Id.* 43-44.
[44] *Id.*
[45] *Id.*
[46] Mary Williams Walsh, *A.I.G. Units Omit Name and Excel*, N.Y. TIMES, Dec. 9, 2009, at B1.
[47] *Id.* at 50-51.
[48] *Id.*
[49] *Id.* at 50.
[50] McCracken, *supra* note 25.
[51] *Id.*
[52] *Id.*

AIG is also currently in discussions to sell their subsidiary company, American Life Insurance Co., (Alico) to MetLife for up to $15 billion, enabling AIG to repay the FRBNY's $9 billion preferred stake.[53] AIG has already arranged to give the FRBNY the first $9 billion it receives from any sale of the subsidiary.[54] Any additional proceeds from the sale of Alico would go towards paying the FRBNY's $35 billion credit facility still remaining from the government's original loan to AIG from September of 2008. [55] However, AIG may receive MetLife stock rather than cash in the potential deal.[56] Receiving stock rather than cash would increase uncertainty and could potentially delay AIG's bailout repayment effort.[57] Also, acquiring MetLife stock rather than cash means that the FRBNY would be prohibited from selling the stock for months, resulting in the replacement of "one illiquid equity stake only with another."[58] Therefore although AIG's asset sales have great potential in generating the most profit with which to repay loans, numerous uncertainties still remain including whether AIG will be able to close on current deals as well as the value of what AIG will receive in return.

The value of AIG's holdings has steadily risen since September 2008. The proceeds from the Federal Reserve's Maiden Lane portfolio assets have been used to repay $6.8 billion on the loan owed to the FRBNY as of September 2, 2009.[59] Although the portfolio value of the Maiden Lane assets has slightly declined, the Federal Reserve believes that Maiden Lane portfolio assets will appreciate in the future, and note that the portfolios will continue to generate principal and interest payments before maturity or sale."[60] AIG's mortgage-backed securities and collateralized debt obligations have risen in value: the FRBNY's January 21, 2010 report valued the

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[53] Lauren Silva Laughlin & James Pethokoukis, *Another Wrinkle in the A.I.G. Bailout*, NYTIMES.COM, Feb. 11, 2010, http://www.nytimes.com/2010/02/11/business/11views.html?dbk.
[54] Mary Williams Walsh & Michael J. de la Merced, *A.I.G. Unit May Be Sold to MetLife*, N.Y. TIMES, Jan. 20, 2010, at B1.
[55] *Id*.
[56] Silva, *supra* note 53.
[57] *Id.*
[58] *Id.*
[59] G.A.O. REPORT, *supra* note 1, at 50.
[60] *Id.*

combined portfolio holdings at $38 billion in September 2009, and since then, markets have continued to strengthen.[61]

Considering the government's 79.9% equity ownership, AIG's market capitalization is approximately $18 billion.[62] Furthermore, AIG's book value was $73 billion at the end of September 2009.[63] However, although these valuations seem promising, there is also a 60% chance that AIG's common equity will be valueless, thus taxpayers' bailout money may not be repaid in full.[64] Turning these valuations into cash is difficult, and if the government were to sell its large holdings over a short period of time, market prices could dramatically fall.[65] In February 2010, AIG announced its plan to keep $500 billion in derivatives in an attempt to avoid selling parts of the company at "bargain basement prices" by holding onto derivatives that have gained value since the crisis.[66] Overall, as the economy slowly improves, so do the overall value of AIG holdings and with it, the ability for these holdings to generate profit to repay government loans.

F. Cost of Government Rescue

The Congressional Budget Office projects that the AIG bailout will cost the Treasury Department $9 billion, "a fraction of what was initially expected."[67] It remains uncertain whether the Board will lose money on their loan to AIG, but major losses are not expected.[68] In January 2010, President Obama announced that he intends to get back "every penny" of bailout money through a new bank tax that would collect approximately $90 billion over ten years from the fifty

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[61] Lauren Silva Laughlin & Richard Beales, *A.I.G.'s Big Debt to U.S. Taxpayers*, N.Y. TIMES, Jan.
26, 2010, at B2.
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *A.I.G. Said to Plan to Keep $500 Billion in Derivatives*, NYTIMES.COM, Feb. 18, 2010, http://dealbook.blogs.nytimes.com/2010/02/18/a-i-g-said-to-plan-to-keep-500-billion-in-derivatives/?scp=2&sq=aig&st=cse.
[67] David Cho & Brady Dennis, *Treasury's AIG Bailout Cost Estimate is Reduced*, The Washington Post, Jan. 30, 2010, at A11.
[68] *Id.*

large financial firms that borrowed money.[69] This proposal is awaiting congressional approval.[70]

G. Conclusion

Despite AIG's notorious near collapse in September 2008, the subsequent largest government bailout to a single company that ensued[71] and the widespread public and Congressional outrage that followed in the wake of the government bailout, AIG's future ability to repay its debts, although uncertain, currently appears promising. The government's ability to recoup loan money depends on a number of factors, including the general health of the economy, AIG's long-term health, AIG's future ability to acquire liquidity from private sources, fixed annuity sales, sales of certain businesses such as Alico and AIA, AIG's common equity valuation and the maturation sales of Maiden Lane assets.[72]

With the Treasury Department and FRB keeping a close watch, along with pressure from the public, President Obama and Congress, AIG's every move has careful oversight and added guidance to aid in the implementation of effective strategies to meet its loan obligations. Furthermore, the forthcoming sales of Alico and AIA alone could bring in profits over $50 billion.[73] If AIG continues its plan of divesting some of its companies, the profit from these future sales would allow AIG to repay more of its debts. However, because the sales of these assets may result in stock rather than cash proceeds, the reduced cash value of these sales must also be taken into account. Therefore, although a number of uncertain factors will affect AIG's ability to repay its debts, AIG is on its way to repaying a large portion of its government bailout loan.

Pam Selvarajah[74]

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[69] *Id.*
[70] *Id.*
[71] McCracken, *supra* note 25.
[72] G.A.O. REPORT, *supra* note 1, at 51.
[73] McCracken, *supra* note 25.
[74] Student, Boston University School of Law (J.D. 2011).

IX. Evaluating TARP

A. Introduction

On October 3, 2008, the U.S. government enacted the Emergency Economic Stabilization Act in response to the crippling financial crisis. As part of this legislation, the government implemented the Troubled Asset Relief Program ("TARP"), to restore liquidity to suffering financial institutions.[1] Given the complexity and enormity of the recession, TARP has taken on several different forms in an attempt to bring confidence and stability back to the financial industry and the economy as a whole.[2] Initially, the government implemented TARP as a means of removing toxic assets from bank balance sheets.[3] The government then quickly utilized TARP funds as a way to provide much needed liquidity to struggling banks.[4] Recently, the evolution of TARP culminated in the use of funds to stabilize the securitization markets and even the automobile industry.[5] This paper provides an overview of the relative strengths and weaknesses of TARP.

B. The Repayment of TARP Funds

The Capital Purchase Program ("CPP") represents the largest funding initiative under TARP.[6] The government injected capital into struggling banks through the CPP by purchasing senior preferred stock.[7] This program supplied capital injections to 707 financial institutions at a cost of $205 billion.[8] Of the 707 financial institutions that received additional liquidity, at least 300 of these institutions

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[1] Erik D. Klingenberg, *Summary and Analysis of the Troubled Asset Relief Program*, 62 CONSUMER FIN. L.Q. 26, 26 (2008).
[2] CONG. OVERSIGHT PANEL, 111TH CONG., TAKING STOCK: WHAT HAS THE TROUBLED ASSET RELIEF PROGRAM ACHIEVED? 6 (Dec. 9, 2009) [hereinafter TAKING STOCK].
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] *Id.* at 18.
[7] *Id.*
[8] CONG. OVERSIGHT PANEL, 111TH CONG., EXITING TARP AND UNWINDING ITS IMPACT ON THE FINANCIAL MARKETS 35 (Jan. 13, 2010) [hereinafter EXITING TARP].

represented smaller community banks.[9] The CPP program expired on December 29, 2009.[10]

As for repayment, financial institutions participating in the CPP may only repurchase their preferred shares after receiving approval from the appropriate banking regulator.[11] The inability of banking regulators to articulate precise standards for determining when banks are healthy enough to repurchase their preferred shares has caused concern for many banks.[12] Despite this problem, the Treasury received $122 billion from institutions participating in the CPP.[13] In September, the Treasury issued a report announcing that it expected to receive additional repayments totaling $50 billion over the next eighteen months.[14] Currently, there remains an outstanding balance of $58 billion that must be repaid under the program.[15]

In terms of profits, the Treasury so far has earned a 17% rate of return on its investments.[16] This figure includes repayments that have taken the form of dividends, warrants and preferred shares.[17] However, probably the most important statistic of TARP involves its total cost to the American taxpayers. According to Mark Zandi, Chief Economist and Cofounder of Moody's Economy.com, TARP may cost taxpayers somewhere between $100 and $150 billion.[18] Although costly, this figure is significantly smaller than the original $700 billion amount allocated by Congress.[19]

C. Phasing Out TARP

The U.S. Treasury expects to close TARP in a variety of stages. First, the ability of the Treasury to commit funds to troubled

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[9] *Id.* at 19.
[10] *Id.* at 35.
[11] *Id.* at 43.
[12] *Id.* at 43-44.
[13] *Id.* at 40.
[14] *Id.*
[15] *Id.*
[16] *Id.* at 82.
[17] *Id.*
[18] *Taking Stock: Independent Views on TARP's Effectiveness: Before the Cong. Oversight Panel*, 98th Cong. 1 (2009) (statement of Mark Zandi, Chief Economist and Cofounder of Moody's Economy.com) [hereinafter Zandi].
[19] *Id.*

financial institutions will expire on October 3, 2010.[20] Second, once the Treasury completes purchasing distressed assets from bank balance sheets, it must then decide how best to sell those assets in order to maximize returns for the American taxpayer.[21] In deciding upon an appropriate time to sell such assets, the Treasury will consider: (1) the stability of the individual financial institution, (2) the potential return on the taxpayers' investment and (3) the overall health of the financial industry.[22] Third, exiting TARP requires eliminating the belief in the marketplace that the federal government will once again bail out banks if another recession occurs.[23]

The phasing out of TARP in 2010 will be limited to three distinct areas including: (1) providing community banks with capital to promote small business lending, (2) re-energizing the securitization markets through the Term Asset-Backed Securities Loan Facility ("TALF") and (3) curbing home foreclosures.[24] In terms of supporting small businesses, the Treasury first plans to purchase $15 billion in guaranteed securities from the Small Business Administration ("SBA").[25] Second, as mentioned previously, the Treasury plans to provide capital assistance to community banks in return for the promise that these banks will increase lending to small businesses.[26] Smaller banks that receive capital assistance will be required to submit quarterly reports explaining how the funds have been used to support small businesses.[27] Third, and finally, the Treasury plans to loan up to $20 billion to its TALF initiative.[28]

The Home Affordable Modification Program ("HAMP") represents one initiative under TARP utilized to prevent home foreclosures.[29] The Treasury initially allocated $50 billion to HAMP.[30] Under this program, mortgage servicers are eligible for a one-time $500 incentive payment if a distressed borrower who is in imminent danger of default successfully modifies his mortgage.[31]

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[20] EXITING TARP, *supra* note 8, at 4.
[21] *Id.*
[22] *Id.*.
[23] *Id.* at 5.
[24] *Id.* at 8.
[25] *Id.* at 109.
[26] *Id.*
[27] *Id.* at 111.
[28] EXITING TARP, *supra* note 8, at 109.
[29] *Id.*at 113.
[30] *Id.*
[31] *Id.*

Also, under HAMP, homeowners are eligible to receive an additional $1,000 towards principal reduction if they remain current on their mortgage payments for five years.[32] Finally, as part of the Treasury's effort to reduce home foreclosures, mortgage servicers are entitled to receive $500 for the modification or extinguishment of second lien mortgages.[33]

D. Measuring the Success of TARP

Measuring the relative effectiveness of TARP has proven quite difficult, most likely because any success or failure experienced is in part attributable to the other rescue efforts enacted by the Federal Reserve Board and the Federal Deposit Insurance Corporation.[34] The majority of analysts agree that the government needed to take action in order to bring stability back to the financial services industry.[35] To this end, most agree that TARP successfully eased the panic surrounding the failing economy and brought strength back to the financial markets.[36]

The TED spread represents one measure utilized by analysts to evaluate the relative effectiveness of TARP.[37] In essence, the TED spread evaluates the cost at which large banks borrow from one another on a short-term, unsecured basis.[38] It does so by measuring the interest rate spread on short-term U.S. government debt and interbank loans.[39] A rising TED spread indicates an increasing potential for defaults on interbank loans.[40] At the height of the

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32 *Id.* at 114.
33 *Id.*
34 *Taking Stock: Independent Views on TARP's Effectiveness, Before the Cong. Oversight Panel*, 109th Cong. 1 (2009) (statement of Dean Baker, Co-director of the Center for Economic and Policy Research (CEPR)) [hereinafter Baker].
35 TAKING STOCK, *supra* note 2, at 93-94.
36 Baker, *supra* note 34, at 1.
37 COMM. FOR A RESPONSIBLE FED. BUDGET, TROUBLED ASSET RELIEF PROGRAM: YEAR-END REVIEW 5 (2009) [hereinafter RESPONSIBLE FEDERAL BUDGET].
38 Allen Ferral and Atanu Saha, *Securities Litigation and the Housing Market*, 35 J. Corp. 97, 115-116 (2009).
39 RESPONSIBLE FED. BUDGET, *supra* note 37, at 5.
40 Frank A. Hirsch & Joseph S. Dowdy, *Whither Wachovia? Wells Fargo Wins the Battle for the Storied North Carolina Banking Institution*, 13 N.C. Banking Inst. 167, 193 (2009).

financial crisis, the TED spread equaled 4.65%.[41] However, as of December 2009, the TED spread leveled off to more normal levels at 0.21%.[42]

Bank lending has improved since the inception of TARP with $2.2 trillion in new loans originated by the twenty one largest banks who participated in the CPP.[43] Of this $2.2 trillion, Bank of America has provided $579 billion in new loans.[44] This figure demonstrates the relative healthy position Bank of America enjoys, despite severe economic distress.[45] Aside from bank lending, government repayments also represent a way to measure the overall effectiveness of TARP. As of December 9, 2009, at least fifty banks repurchased $71 billion of their own stock from the Treasury.[46]

Although several indicators point to TARP as being successful, many more factors demonstrate the relative weakness of the program. As Congressional Oversight Panel chairwoman Elizabeth Warren stated, "Congress set goals for the TARP that went well beyond short-term financial stability, and by that measure problems remain."[47] Most notably, TARP failed to achieve its main goal of removing toxic assets from bank balance sheets.[48] Until this is resolved, bank lending will continue to suffer.[49]

Criticisms of TARP fall into three general categories. First, commentators criticize TARP for failing to adequately address the substantive problems of the banking crisis including: (1) the incentive of bank management to take risk and (2) the inadequate reserve capital requirements of banks.[50] Second, commentators criticize TARP for failing to address the issue of moral hazard and Too Big To Fail ("TBTF").[51] TBTF refers to the idea that some financial institutions are "systemically important," meaning their

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[41] RESPONSIBLE FED. BUDGED, *supra* note 37, at 5.
[42] *Id.*
[43] *Id.* at 6.
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *Has TARP Been Effective?*, COLUMBIA STATE, Dec. 10, 2009.
[48] Ronald D. Orol, *Panel: TARP Averted Crisis But It Hasn't Achieved Other Goals: Congressional Oversight Panel Says Problems Remain In The Financial Markets*, Dec. 9, 2009.
[49] *Id.*
[50] TAKING STOCK, *supra* note 2, at 95.
[51] *Id.*

failure could threaten the entire financial system.[52] Third, commentators criticize TARP to the extent it was created and implemented in an ad-hoc, opaque fashion.[53]

The failure of TARP to adequately address the substantive problems of the banking industry is evident in the number of bank failures that occurred since the beginning of the financial crisis. Generally, in a normal economic year, only a handful of banks fail.[54] However, in 2009 alone, 130 bank failures occurred.[55] Overall, since the inception of the financial crisis, a total of 160 banks have failed.[56] These figures demonstrate the relative weakness of the banking industry, despite the fact that over 700 banks received funding through various TARP initiatives.[57]

Going forward, bank failures may be concentrated among smaller banks. Though many of these smaller institutions received TARP aid, failure remains likely because smaller banks are heavily exposed to commercial real estate loans.[58] Such loans are expected to suffer high rates of default in the near future.[59] Consequently, TARP's failure to resolve the exposure of small banks to commercial real estate loans will hinder broad economic recovery in the future.[60]

Finally, TARP's failure to make lasting changes in executive compensation represents another substantive weakness of the program. The financial services industry has exploded in recent years, accounting for nearly 30% of all corporate profits in the U.S.[61] As a result of this success, bank executives received lucrative salaries.[62] Although many financial firms received support from American taxpayers, it remains unclear whether any bank executive received a reduction in pay as a result of TARP.[63] For example, despite receiving enormous funding from TARP, AIG paid $168

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[52] Huberto M. Ennis and H.S. Malek, *Bank Risk of Failure and the Too-Big-To-Fail Policy*, FED. RESERVE BANK OF RICHMOND ECON. Q., Spring 2005, at 21.
[53] TAKING STOCK, *supra* note 2, at 95.
[54] RESPONSIBLE FED. BUDGET, *supra* note 37, at 6.
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] TAKING STOCK, *supra* note 2, at 97-98.
[59] *Id.* at 98.
[60] *Id.*
[61] Baker, *supra* note 34, at 3.
[62] *Id.*
[63] *Id.*

million in retention bonuses to its employees in March of 2010.[64] Kenneth Feinberg, Special Master for TARP Executive Compensation, recently approved a $10.5 million salary and stock package for AIG's President and CEO Robert Benmosche.[65] Executives at AIG received bonuses totaling $12.1 million.[66]

1. Case Study: AIG

AIG represents one of the largest TARP recipients in terms of funds received, along with Bank of America and Citigroup.[67] In early March 2009, AIG announced the single largest quarterly loss in American history at $61.7 billion.[68] Consequently, the Treasury and the Federal Reserve have since committed over $182.3 billion to the financial conglomerate.[69] Specifically, the Treasury originally committed a total of $69.8 billion to AIG in preferred shares, $46.9 billion of which was still outstanding as of December 31, 2009.[70] On November 25, 2008, the Treasury provided a further capital infusion to AIG by purchasing $40 billion in preferred shares.[71] Finally, on April 17, 2009, the Treasury once again committed to lend an additional $29.8 billion to AIG.[72] The stated purpose of the Treasury in providing AIG with these capital infusions is to make the company stable enough to obtain private funding on its own initiative.[73]

Government assistance remains critical for AIG. Without support from the Treasury and Federal Reserve, AIG's credit ratings would likely suffer an immediate downgrade.[74] Consequently, the Treasury must be careful not to remove assistance too quickly before AIG is stable enough to maintain its own credit rating.[75] As stated in January's Congressional Oversight Report, "[c]redit rating agencies

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64 Mark A. Hofmann & Judy Greenwald, *Treasury Ignored AIG Pay, Watchdog Says*, BUS. INS., Oct. 19, 2009, at 25.
65 Judy Greenwald & Mark A. Hofmann, *Government Limits Executive Pay at AIG*, BUS. INS., Oct. 26, 2009, at 28.
66 *Id.*
67 EXITING TARP, *supra* note 8, at 64.
68 *Id.* at 78.
69 *Id.* at 64.
70 *Id.* at 64-65.
71 *Id.* at 66.
72 *Id.* at 67.
73 *Id.* at 70.
74 *Id.* at 71.
75 *Id.*

such as Moody's have indicated that AIG's current credit ratings are maintained only because of the extraordinary government assistance, making the government extra cautious about any premature exit that might trigger a ratings downgrade and thereby destabilize AIG and the financial system."[76]

As for an exit strategy regarding AIG, the Treasury announced recently that institutional and systemic stability are currently more important factors to consider than returning money to the American taxpayers.[77] According to the Treasury, AIG still represents a systemic threat to the national economy and probably would receive a non-investment grade credit ratings if the government ceased providing aid to the financial institution.[78] The Treasury most likely will take a "buy and hold" approach to the assets of AIG, especially assets that take the form of collateralized debt obligations ("CDOs") and residential mortgage-backed securities ("RMBS").[79] This "buy and hold" strategy probably represents the most feasible option for the Treasury because reasonable prices cannot currently be obtained in the market for CDOs and RMBSs.[80]

Despite the gloom surrounding AIG, the company has posted two consecutive quarterly profits.[81] AIG's recent success can in attributed in part to the company's retention of customers through the financial crisis and the success of its annuity products.[82] Going forward, the rate at which AIG is able to repay the Treasury and the Federal Reserve will depend in large part upon the success it has in selling its derivative products that are connected to the mortgage-backed securities industry.[83]

2. Case Study: GM and Chrysler

The evolution of TARP culminated in the Automobile Industry Financing Program ("AFIP"), whereby the Treasury initially lent $19.4 billion to GM and $4 billion to Chrysler.[84] Despite this

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[76] *Id.*
[77] *Id.* at 77.
[78] *Id.*
[79] *Id.* at 78.
[80] *Id.*
[81] *Id.* at 81.
[82] *Id.* at 81-82.
[83] *Id.* at 82.
[84] *Id.* at 84-85.

assistance, GM and Chrysler entered bankruptcy, ultimately costing American taxpayers $62.7 billion.[85] Further statistical analysis reveals that the U.S. federal government currently owns $7.1 billion in debt securities of Chrysler and 10% of its common equity, $5.7 billion in debt securities of GM and 60.8% of the common equity of GM.[86] As of September 30, 2009, the federal government expects TARP losses equaling $30.4 billion to accrue from both GM and Chrysler.[87] In the end, American taxpayers likely will not receive the entirety of their investments in GM and Chrysler.[88]

E. Conclusion

TARP may, in the end, cost taxpayers between $100 and $150 billion.[89] It is difficult to calculate whether the Treasury has put taxpayer dollars to their most efficient use, especially since the Treasury's rescue efforts must be considered in conjunction with the other rescue efforts of the Federal Reserve Board and the Federal Deposit Insurance Corporation.[90] Despite this difficulty, most analysts agree that TARP accomplished its primary goal of easing the panic surrounding the financial crisis.[91] However, it is difficult to portray TARP as a complete success. Congress implemented TARP in 2008, and by the end of 2009, 130 banks had failed.[92] Even more bank failures are expected to occur in the coming months as commercial real estate loans enter default.[93] The relative success of TARP will also be measured by how soon companies such as AIG begin to operate successfully without government assistance.

Callan Skinner[94]

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[85] *Id.* at 85.
[86] *Id.* at 86.
[87] *Id.* at 88.
[88] *Id.*
[89] Zandi, *supra* note 18, at 1.
[90] Baker, *supra* note 34, at 1.
[91] *Id.*
[92] RESPONSIBLE FED. BUDGET, *supra* note 37, at 6.
[93] TAKING STOCK, *supra* note 2, at 98.
[94] Student, Boston University School of Law (L.L.M. 2010).

X. Government Investment in Clean Technology

A. Introduction

Clean technology, or cleantech, generally refers to a range of ideas, products and services aimed at minimizing the environmental impact of human energy use.[1] It also encompasses the financial industries that invest in the technologies, assets and business sectors concerned with clean energy and sustainability.[2] The primary research arcs in this field concern new energy sources, energy efficiency and reducing the environmental impact of non-renewable, natural resources.[3] Typical cleantech technologies include fossil-fuel alternatives like wind and solar power, as well as renewable hydrocarbon energies like ethanol.[4]

Although fossil fuel industries dwarf the nascent cleantech movement, investment in cleantech has grown dramatically in recent years. However, the major obstacle that nearly all cleantech projects share is cost; even relatively inexpensive technologies like wind and solar power require substantial investment. The recent economic downturn exacerbated this problem, as private investment money has all but dried up, and many cleantech programs are struggling to find sufficient funding. Cleantech today, therefore, relies heavily on government support in the form of grants, tax credits, subsidies and loan guarantees. As such, the primary focus of this article is the cleantech provisions of the American Recovery and Reinvestment Act of 2009 (Recovery Act) and the future of government investment in cleantech.

B. The Recovery Act

During his campaign and upon taking office in January 2009, President Barack Obama repeatedly indicated his intention to invest in new energy sources, while also working to make nuclear power and coal technology cleaner.[5] President Obama confirmed this

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[1] Neal Dikeman, *What is clean tech?*, GREEN TECH, Aug. 10, 2008, http://news.cnet.com/8301-11128_3-10012950-54.html.
[2] *Id.*
[3] *See id.*
[4] *See id.*
[5] *See, e.g.*, Martin LaMonica, *What Obama presidency means for clean tech*, GREEN TECH, Nov. 5, 2008, http://news.cnet.com/8301-11128_3-1008

commitment in signing the Recovery Act into law on February 17, 2009.[6] In responding to the pressing economic crisis facing this country, the Recovery Act contains significant support for the cleantech industry. To emphasize this fact, President Obama held the signing ceremony at the Denver Museum of Nature and Science.[7] As Vice-President Joe Biden said in a progress report concerning the Recovery Act, "[t]he energy components of the Recovery Act represent the largest single investment in clean energy in American history."[8]

Few of the Recovery Act's numerous energy-related provisions do not, in some way, relate to cleantech.[9] Additionally, many of the non-energy related provisions will nonetheless benefit cleantech development and production.[10] The Recovery Act's provisions can be broken down into two categories: the first includes provisions concerning renewable energy sources, while the second encompasses other provisions that directly or indirectly relate to cleantech.

1. Renewable Energy Provisions

The Recovery Act contains unprecedented spending and tax incentives for renewable energy sources including geothermal and solar energy, wind energy and energy from biofuels.[11] The Act allocated over $465 million toward geothermal energy and solar power.[12] While geothermal technology received an extraordinary

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2064-54.html (outlining President Obama's ambitious campaign cleantech goals, which included nuclear energy).

[6] Sheryl Gay Stolberg, *Obama signs huge stimulus bill*, N.Y.TIMES.COM, Feb. 17, 2009, http://www.nytimes.com/2009/02/17/world/americas/17iht-18webstim.20260581.html.

[7] *Id.*

[8] *US Recovery Act will create 900,000 new jobs in renewable energies*, RENEWABLEENERGYFOCUS.COM, Dec. 18, 2009, http://www.renewableenergyfocus.com/view/6050/us-recovery-act-will-create-900000-new-jobs-in-renewable-energies [hereinafter *9,000 new jobs*].

[9] *See Getting to $787 Billion*, WALL ST. J., Feb. 17, 2009, http://online.wsj.com/public/resources/documents/STIMULUS_FINAL_0217.html (classifying Recovery Act spending and tax cuts).

[10] *See id*.

[11] *900,000 new jobs*, *supra* note 8.

[12] U.S. DEP'T OF ENERGY, *Over $467 Million in Funding Announced for Geothermal and Solar*, May 27, 2009, http://apps1.eere.energy.gov/news/daily.cfm/hp_news_id=167.

$350 million investment for demonstration projects and research and development, the quickly expanding solar industry received $115 million, including $51 million for photovoltaic cell development and $40 million for addressing non-technical barriers to implementing solar technology.[13] The Recovery Act's funding for geothermal energy surpasses any previous government commitment to this technology.[14] This is likely due, in part, to the novelty in the U.S. of geothermal technology. Solar power, on the other hand, was one of the first renewable energy sources this country explored, most notably during the oil crises of the 1970s. The Department of Energy reports that the Recovery Act's funding of solar power will primarily be used to scale up the solar industry to make it cost competitive with conventional energy sources.[15]

Wind energy is a significant part of the renewable energy sector, and government incentives and financing have expanded the industry over the last four years.[16] However, the economic crisis disproportionately affected wind energy.[17] A relatively young industry, wind energy requires government investment to support growth, and would have almost certainly collapsed without the Recovery Act.[18] Curiously, direct spending was only $93 million, which included $45 million for turbine research and development.[19] This relatively small allocation seems puzzling in light of the industry's reliance on government support, and its position as one of the most productive new energy sources in the U.S.[20] The U.S. currently generates more wind energy than any other country, and has been the global leader in new wind installations for the past four

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[13] *Id.* Examples of non-technical barriers include "grid connection, market barriers to solar energy adoption in cities, and the shortage of trained solar energy installers." *Id.*

[14] *Id.*

[15] *Id.*

[16] Jeffry S. Hinman, *The Green Economic Recovery: Wind Energy Tax Policy After Financial Crisis and the American Recovery and Reinvestment Tax Act of 2009*, 24 J. ENVTL. L. & LITIG. 35, 36 (2009).

[17] *Id.* at 37.

[18] *Id.*

[19] U.S. DEP'T OF ENERGY, *Secretary Chu Announces $93 Million from Recovery Act to Support Wind Energy Projects*, Apr. 29, 2009, http://apps1.eere.energy.gov/news/daily.cfm/hp_news_id=163.

[20] *Id.*

years.[21] However, the government primarily subsidizes wind energy through tax incentives.[22]

One of the most important and dramatic tax incentives is the 30% investment credit provided for small wind turbines.[23] Small wind turbines generally have a 100 kilowatt capacity or less[24] and are primarily used as auxiliary power in homes and small businesses.[25] Despite the current recession, this 30% tax credit is expected to produce dramatic growth for the "small-wind" market.[26] Although wind energy, generally, faces some significant financial and practical problems, the Recovery Act's tax incentives are considerable; at minimum, the incentives will likely maintain new wind installations at pre-recession levels.[27]

During his presidency, George W. Bush strongly pushed for the expansion of the corn ethanol industry, despite sharp criticism about corn ethanol's sustainability.[28] In 2009, California officially declared that corn biofuel has too large a carbon footprint to be considered a source of clean technology.[29] However, California's assessment was based on *current* ethanol emissions.[30] President Obama appears a bit more optimistic. The White House predicts that ethanol production will become much more efficient in the near future, and the President is looking to triple annual production over

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[21] *Id.*

[22] *See* Hinman *supra* note 16, at 37 (detailing the tax incentive history of the wind energy industry from 1978 to the present).

[23] William Armsby, *Stimulus may get small wind turbines spinning*, CNN, Mar. 09, 2009, http://www.cnn.com/2009/TECH/03/09/small.wind.turbines/index.html.

[24] By comparison, the capacity of utility-scale turbines generally ranges between 700 kilowatts and 2.5 megawatts. American Wind Energy Ass'n., http://www.awea.org/faq/wwt_basics.html#How many turbines does it take to make one megawatt (MW).

[25] Armsby, *supra* note 23.

[26] *Id.* (quoting American Wind Energy Association advocate Ron Stimmel as saying the tax credit "is going to blow the top off the [small turbine] market").

[27] Hinman *supra* note 16 at 68.

[28] James Gerstenzang, *Bush defends ethanol emphasis*, L.A. TIMES, May 03, 2008, at A11.

[29] Douglas Fisher & The Daily Climate, *Is Ethanol From Corn Bad for the Climate?*, SCIENTIFIC AMERICAN, Feb. 12, 2010, http://www.scientificamerican.com/article.cfm?id=ethanol-corn-climate.

[30] *Id.*

the next twelve years.[31] That would bring U.S. ethanol production up to thirty-six billion gallons a year by 2022.[32] In a press conference held in May 2009, Environmental Protection Agency Administrator Lisa Jackson explained that while fifteen billion of the thirty-six billion gallons projected for 2022 are expected to come from corn, "corn ethanol is just a bridge to advanced biofuels."[33] More advanced biofuels include cellulosic, municipal waste product and algae technologies.[34] The Recovery Act's spending mirrors this priority for funding advanced biofuels, allocating only $20 million of the $786 million biofuels budget for ethanol research.[35]

2. Other Cleantech Provisions of the Recovery Act

The Recovery Act also contains many provisions unrelated to "green" renewable energy, but which will nonetheless affect the future of cleantech in the U.S. Among these are the promotion of energy efficiency, battery and electric vehicles and the electric grid.

Energy efficiency is a mainstay of cleantech because it is often the simplest and cheapest means of reducing energy consumption.[36] Reduced consumption in turn decreases the environmental impact of human energy use, regardless of the energy source. The U.S. primarily promotes energy efficiency through building codes, appliance standards[37] and vehicle fuel-economy standards.[38] However, the U.S. has many plans for future efficiency initiatives. Accordingly, the Recovery Act contains substantial spending and tax

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[31] *Id.*
[32] *Id.*
[33] Adam Shake, *President Allocates 786M in Recovery Act Funds to BioFuel Infrastructure*, SIMPLE EARTH MEDIA, May 05, 2009, http://twilightearth.com/news/president-allocates-786m-in-recovery-act-funds-to-biofuel-infrastructure.
[34] *Id.*
[35] *DOE Announces Nearly $800 Million from Recovery Act for Biofuels*, May 05, 2009, http://apps1.eere.energy.gov/news/daily.cfm/hp_news_id=164 (March 21, 2010).
[36] Ehud Zion Waldoks, *Energy efficiency – silent gun in clean technology arsenal*, THE JERUSALEM POST, Feb. 14, 2010, http://www.jpost.com/HealthAndSci-Tech/ScienceAndEnvironment/Article.aspx?id=168704.
[37] Appliance standards prohibit the sale of inefficient appliances and determine which kinds of appliances are sold in the U.S. *Id.*
[38] *Id.*

incentives for energy efficiency, including $5 billion to supplement the weatherization assistance program; $4.5 billion for the conversion of federal buildings into more efficient, "high-performance green buildings;"[39] and $2.7 billion in energy efficiency and conservation grants to states and local governments.[40]

The Recovery Act created forty-eight new advanced battery and electric drive programs, which are intended to accelerate the domestic development of battery and electric vehicle technologies.[41] The Recovery Act also allotted $2.4 billion in grant money to these areas, including $1.5 billion for domestic battery manufacturers, $500 million for electric drives and $400 million for the government to purchase thousands of electric and hybrid vehicles.[42] The Recovery Act's investment in battery and electric vehicles furthers President Obama's goal of getting "one million plug-in hybrid vehicles on the road by 2015."[43]

Cleantech in the U.S. is hamstringed by this country's electric infrastructure.[44] After clean energy is converted into electricity, it is shipped through the U.S.'s "third world" electric grid, which is spread out over a large and diverse geographical area.[45] Further, the most promising areas for harnessing clean energy are often rural, and that energy must travel large distances to reach areas of demand.[46] For example, solar radiation is strongest in the Southwest, while wind power is most abundant in the plains region of the Midwest.[47] Getting power from these areas to an urban hub like New York City means shipping the electricity through thousands

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[39] Michael Grabell & Christopher Weaver, *The Stimulus Plan: A Detailed List of Spending*, Feb. 13, 2009, http://www.propublica.org/special/the-stimulus-plan-a-detailed-list-of-spending.

[40] U.S. Department of Energy, *Breakdown of Funding*, http://www.energy.gov/recovery/breakdown.htm.

[41] U.S. DEP'T OF ENERGY, *DOE Announces $2.4 Billion for U.S. Batteries and Electric Vehicles*, Aug. 05, 2009, http://apps1.eere.energy.gov/news/daily.cfm/hp_news_id=192.

[42] *Id.*

[43] *Id.*

[44] Andrew Schatz, *A Tale of Three Signatories: Learning From the European Union, Japanese, and Canadian Kyoto Experiences in Crafting a Superior United States Climate Change Regime*, 70 U. PITT. L. REV. 593, 638 (2009).

[45] *Id.*

[46] *Id.*

[47] *Id.*

of miles of electric infrastructure ill-equipped to handle that power efficiently.[48] In an attempt to rectify this problem, the Recovery Act funded the installation of an extra 3,000 miles of electrical transmission lines.[49] However, energy experts estimate that the U.S. may need "an additional 12,000 miles of new lines to more fully support renewable energy expansion."[50]

C. The Future of Cleantech

1. The Proposed Budget

With nearly $2.4 billion earmarked for the cleantech sector, President Obama's recently proposed budget is a substantial increase over the previous budget of $113 million for cleantech.[51] The President's proposal includes $500 million in subsidization for renewable energy and energy efficiency projects, and $300 million for solar power development.[52] Additionally, the President's proposal would increase the Department of Energy's budget by almost 5%, to $28.4 billion,[53] despite the President's pledge to freeze future non-military discretionary spending at 2010 levels.[54]

2. A Private-Public Option

Despite welcoming ongoing government assistance, some groups fear that the private sector may have permanently ceded control of investment opportunities to the government.[55] Most

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48 *Id.*
49 *Id.*
50 *Id.* at 639.
51 Poornima Gupta & Laura Isensee, *Clean tech sector seeks long term support from Obama*, REUTERS, Feb. 2, 2010, http://www.reuters.com/article/idUSTRE61065O20100202.
52 *Id.*
53 Katie Howell et al., *Obama Budget Increases Funding for Energy Research and Nuclear Power*, SCIENTIFIC AMERICAN, Feb. 2, 2010, http://www.scientificamerican.com/article.cfm?id=obama-energy-research-nuclear-power.
54 *Id.*
55 Nathan Gronewold, *Clean tech frets as power of government's purse grows*, N.Y. TIMES, June 25, 2009, http://www.nytimes.com/gwire/2009/06/25/25greenwire-clean-tech-frets-as-power-of-governments-purse-g-661.html.

financiers report that they are happy with the government's involvement, as long as it is not permanent.[56] One promising solution may be a hybrid private-public option. A trade group called the American Council on Renewable Energy has proposed a joint private-public venture, similar to the Small Business Investment Company (SBIC) program.[57] SBICs are small, privately owned investment firms that receive substantial government support, and are currently an important link between the government and the private sector.[58] Such a venture in the cleantech industry would allow private organizations to administer cleantech investments with the government's assistance. Although an SBIC-like program might be more difficult to develop in the cleantech industry, where investments are generally long-term and startup costs are high, long-term government loans at favorable rates could make small investment companies with a specific focus on cleantech an attractive and feasible funding option.[59]

3. China

President Obama stated in his 2010 State of the Union Address, "the nation that leads the clean energy economy will be the nation that leads the global economy."[60] Many foreign powers, especially China and Europe, are aggressively pursuing renewable energy sources. China, which recently implemented its own stimulus package, included in it "substantial investment in energy-efficient transportation and upgrades to improve the efficiency of the electricity transmission network."[61] Over the next three years, the Chinese government plans to spend $142 billion of its $570 billion

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[56] *Id.*
[57] *Id.*
[58] Small Business Notes, *Small Business Investment Companies (SBICs)*, http://www.smallbusinessnotes.com/financing/sbic.html (Mar. 21, 2010).
[59] *See* Gronewold, *supra* note 55.
[60] Remarks by the President in State of the Union Address, Jan. 27, 2010, http://www.whitehouse.gov/the-press-office/remarks-president-state-union-address.
[61] *Energy Efficiency Faces Obstacles in China*, FORBES, Apr. 30, 2009, http://www.forbes.com/2009/04/29/china-energy-efficiency-business-oxford-analytica.html.

stimulus package on "environmental improvements."[62] This significant spending, coupled with China's favorable economic position during the current crisis, suggest that China may be poised to attract U.S. and other foreign investments in cleantech.[63]

4. Potential Cleantech Legislation

In his 2010 State of the Union Address, President Obama urged Congress to create "incentives that will finally make clean energy the profitable kind of energy in America."[64] Such legislation, whether stand-alone or as part of a larger bill, would likely include subsidies and credits for green companies, eliminate existing oil industry subsidies, expand nuclear loans, and support "green job" training.[65] Importantly, in his speech, President Obama also called for climate change legislation that would limit greenhouse gas emissions.[66] A bill providing for a cap-and-trade program passed the House of Representatives in June 2009, but support is much weaker in the Senate, where it did not pass. A cap-and-trade program would have an enormous effect on the cleantech industry by forcing companies to reduce their greenhouse gas emissions and seek to store up surplus emissions credits for profitable trade. However, as President Obama recently acknowledged, an energy bill this year is unlikely to pass the Senate with a cap-and-trade program in tow.[67] Instead, the President is looking to continue to support the cleantech market with strong subsidization and tax incentives.[68]

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[62] Mei Gechlik, Making Transfer of Clean Technology Work: Lessons of the Clean Development Mechanism, 11 SAN DIEGO INT'L L.J. 227, 242 (2009).

[63] *See id.*

[64] State of the Union Address, *supra* note 60.

[65] Derek Thompson, What Will Obama's Energy Bill Look Like Without Cap-and-Trade?, THE ATLANTIC, Feb. 3, 2010, http://business.theatlantic.com/2010/02/what_will_obamas_energy_bill_look_like_without_cap-and-trade.php.

[66] Joel Kirkland, *Carbon Traders and Clean-Tech Companies Heartened by State of the Union*, N.Y. TIMES, Jan. 28, 2010, http://www.nytimes.com/cwire/2010/01/28/28climatewire-carbon-traders-and-clean-tech-companies-heart-2348.html.

[67] Thompson, *supra* note 65.

[68] *Id.*

5. Greenhouse Gasses

Another development that may mirror the effect of a cap-and-trade program is the new classification of greenhouse gasses by the Environment Protection Agency (EPA). The EPA formally declared in April 2009 that it will classify the greenhouse gas CO_2, and five other gasses, as pollutants under the Clean Air Act.[69] This move paves the way for EPA regulation that will affect the cleantech industry and the U.S. energy sector. Just as subsidization incentivizes companies to invest in cleantech, economic sanctions for polluting will likely cause companies to move away from greenhouse-emitting fossil fuels. Coupled with an emerging social consciousness of greenhouse gasses and global warming, the EPA's regulation will likely increase demand for cleantech.

D. Conclusion

Cleantech aims to minimize the environmental impact of human energy use by developing renewable sources of energy and reducing the use and impact of non-renewable resources. Despite the substantial cost of cleantech development, government subsidization makes cleantech viable in many industrial, commercial and residential applications. The Recovery Act dramatically increased the size and scope of government spending on cleantech, although this spending may be insufficient in some areas to meet the enormous costs of structural change to the energy sector.[70] Nevertheless, the Recovery Act represents an unprecedented level of government support for cleantech.

Looking forward, cleantech is poised to play a significant role in the U.S. energy sector. As other countries race to invest heavily in cleantech, President Obama has committed the U.S. to lead cleantech research, and to develop the energy source(s) of the future. To this end, the President's recently proposed budget will substantially increase cleantech spending compared to previous years. The President also strongly urged Congress to pass new legislation that would make cleantech more profitable and to create a cap-and-trade emissions program. Although cap-and-trade may realistically be several years away, the EPA's new treatment of

[69] John M. Broder, *E.P.A. Clears Way for Greenhouse Gas Rules*, N.Y. TIMES, Apr. 18, 2009, at A15.
[70] Gupta & Isnee, *supra* note 51.

greenhouses gasses may similarly spur new demand for cleantech. Although the effect of the Recovery Act's cleantech provisions is still uncertain, the government will continue to influence the development of cleantech substantially as the industry grows domestically and internationally.

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[71] Student, Boston University School of Law (J.D. 2011).

XI. Proprietary Trading: Market Threat or Political Scapegoat?

A. Introduction

On January 21, 2010 President Obama introduced a proposed addition to the financial markets reform bill being drafted in the Senate. The proposal, dubbed the "Volcker Rule" after former chairman of the Federal Reserve and current White House economic adviser Paul Volcker, would prohibit commercial banks that enjoy the protection of federal guarantees from conducting proprietary trading. The proposal comes amid a frenzy to revamp the nation's financial regulatory structure in an effort to avoid future financial crises like the one that began in 2007. While in pursuit of a sound goal, the Volcker Rule has been heavily criticized as being "transparently political,"[1] rushed and lacking necessary details regarding its implementation. This article examines the proposed Volcker Rule and some of the reactions and commentary that has emerged in response to the President's announcement, outlines the main arguments for and against the proposal and discusses several alternatives.

B. What And Who Would Be Affected?

The depression era Glass-Stegall Act divided financial intermediaries in the U.S. into two groups, separating deposit taking institutions (commercial banks) from investment banks and other firms engaged in securities trading.[2] In 1999 the Gramm Leach Bliley Act (GLBA) repealed Glass-Steagall and moved the country towards a system of "universal banking."[3] GLBA permits the formation of bank holding companies and has drastically increased the types of activities in which banks may engage. As a result, banks and their affiliates provide a wide range of financial services and

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[1] Damian Paletta, *Dodd Vents Over Handling of Bank Proposal*, WALL ST. J., Feb. 3, 2010, http://online.wsj.com/article/SB10001424052748704022804575041320302301844.html?KEYWORDS=dodd+vents

[2] William Armstrong, *Meeting at the Halfway House on Banking Reform*, SEEKING ALPHA, Feb. 21, 2010, http://seekingalpha.com/article/189686-meeting-at-the-halfway-house-on-banking-reform.

[3] *Id.*

products, "ranging from simple deposit facilities for savers to making markets in esoteric derivatives and insurance products." [4]

Proprietary trading refers to the process by which banks trade stocks, bonds, commodities, currencies, derivatives or any other financial instruments for their own account rather than for clients. Proprietary trading desks focus on similar strategies as hedge funds, but they tend to use much more leverage in taking their positions, thereby increasing risk.[5] The act of banks taking positions with their own funds, however, is heavily intertwined with market making and other services they provide for clients, making a ban difficult to implement.[6]

A bank is said to make a market in a security if it holds itself out as willing to buy and sell that security at quoted prices.[7] This activity is a crucial component of a liquid market as it ensures that buyers and sellers have the necessary counter parties to effect their desired trades.[8] The risk in making markets is that banks may end up holding positions that they normally would not take.[9] Thus, proprietary trading relates to market making in at least two ways: (1) it enables banks to hold investments needed as inventory to facilitate

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[4] *Id.*

[5] *What Are the Real Risks of Proprietary Trading?*, WALL ST. J., Jan. 21, 2010, http://blogs.wsj.com/deals/2010/01/21/what-are-the-real-risks-of-proprietary-trading/tab/article/.

[6] *Statement of Barry Zubrow Before the Comm. on Banking, Housing, and Urban Affairs of the United States Senate*, 111th Cong. 2 (2010) (statement of Barry Zubrow, Chief Risk Officer and Executive Vice President of JPMorgan Chase & Co.); *see also* Sewell Chan, *Bernanke Defends Fed's Ability to Supervise Banks*, N.Y. TIMES, Feb. 26, 2010, at B3.

[7] RICHARD S. CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 528 (4th ed. 2009).

[8] Kate Kelly, *Banks Gear Up For A Battle*, WALL ST. J., Feb. 2, 2010, http://online.wsj.com/article/SB10001424052748703422904575039502973649716.html#articleTabs%3Darticle; *see also Statement of E. Gerald Corrigan Before the Comm. on Banking, Housing, and Urban Affairs of the United States Senate*, 111th Cong. 9 (2010) (statement of E. Gerald Corrigan, Managing Director, Goldman, Sachs & Co.) ("[T]he capital that is provided in the market-making process is the primary source of the liquidity that is essential to the efficiency and price discovery traits of financial markets.").

[9] Kelly, *supra* note 8.

customer trades,[10] and (2) it enables banks to hedge against risky positions.[11]

Under the new proposal, banks and bank holding companies would be forced to choose between giving up their banking charter and engaging in proprietary trading.[12] The names of the firms most affected by the proposed rule are no surprise: Goldman Sachs, Morgan Stanley, JPMorgan Chase, Citigroup and Bank of America. What is surprising, however, are the small percentages of these firms' revenues that are derived from proprietary trading: Goldman estimates this percentage at less than 7%, Morgan Stanley at 2-3%, Citigroup at less than 2% and JPMorgan and Bank of America estimate that less than 1% of their revenues arise from proprietary trading.[13] While the impact on revenues might be minimal, banks oppose the proposal because it would "reduce [their] size . . . , their profits and their impact on the wider economy."[14] Additionally, it could place American banks at a disadvantage relative to foreign banks in the international market.[15]

Goldman Sachs and Morgan Stanley, the biggest players in proprietary trading, would likely avoid the prohibition by giving up their bank holding company charters and going back to being broker dealers.[16] Both have small deposit-taking arms.[17] JPMorgan, Bank of

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[10] Ryan Avent and Kevin Drum, *Putting Stronger Limits Into the Dodd Bill*, SEEKING ALPHA, Mar. 24, 2010 http://seekingalpha.com/article/ 195419-putting-stronger-limits-into-the-dodd-bill.

[11] *Id.; see also Statement of Barry Zubrow*, *supra* note 6 at 2.

[12] Bill McConnell, *Obama Calls for Size Limits, Banning Proprietary Trades*, THEDEAL.COM, Jan. 21, 2010 (noting that the Volcker Rule would extend to bank parents as well).

[13] Kelly, *supra* note 8.

[14] Satyajit Das, *Paul Volcker's Trojan Horse*, BUSINESSSTANDARD.COM, Feb. 26, 2010, http://www.business-standard.com/india/news/satyajit-das-paul-volcker%5Cs-trojan-horse/386855/.

[15] Charles Calomiris, *A Boon to Foreign Banks*, NATIONALJOURNAL.COM, Mar. 14, 2010, http://economy.nationaljournal.com/2010/03/do-we-need-a-volcker-rule.php?rss=1 ("Prohibiting proprietary trading would force banks to rely on relatively uninformed people to advise and execute for clients. Clients would switch to banks located in countries that permit bankers to be smart.").

[16] Daniel Gross, *Obama's Get Goldman Plan*, SLATE MAGAZINE, Feb. 22, 2010, http://www.slate.com/id/2242205/.

America and Citigroup would face a tougher choice, however, as all three have large deposit taking as well as securities operations.[18]

C. Reactions to the Volcker Rule

While most agree that new regulation in the financial sector is desirable to protect the U.S. economy from future credit crises, the Volcker Rule has been met with mixed reactions by lawmakers and bankers. Supporters point to the importance of eliminating the ability of traders to make bets with taxpayer guaranteed money.[19] Opponents, on the other hand, criticize the proposal as politically driven and unfeasible.[20] They also point to the regulation's effect of increasing the cost of capital[21] and leaving U.S. banks without the economies of scale necessary to compete in the international arena.[22]

1. Perceived Benefits of the Volcker Rule

The major concern with federally insured banks engaging in proprietary trading is that traders are able to gamble with federally insured funds, keeping most of the gains while potentially passing losses on to shareholders and taxpayers,[23] what some call a "recipe

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17 Peter Eavis, *Obama Takes the Fight to Wall Street*, WALL ST. J., Jan. 22, 2010,http://online.wsj.com/article/SB10001424052748703699204575017420357009544.html.

18 *Id.*

19 Armstrong, *supra* note 2.

20 Chan, *supra* note 6.

21 Sewell Chan, *Dodd Denounces Pace of Banking Overhaul*, N.Y. TIMES, Feb. 5, 2010, at B4; *see also* Andrew Ross Sorkin, *JPMorgan Shows Its Concern About New Bank Rules*, N.Y. TIMES, Feb. 25, 2010, http://dealbook.blogs.nytimes.com/2010/02/25/jpmorgan-shows-its-concern-about-new-bank-rules/ ("Mr. Staley noted . . . that the bank would respond to stricter regulation by passing any extra expenses on to its customers and increasing the cost of credit, which could reduce the amount of cash it lent out to businesses.").

22 *Id.* (quoting Mr. Zubrow, "Capping the scale and scope of healthy financial firms cedes competitive ground to foreign firms and to less regulated, nonbank financial firms – which will make it more difficult for regulators to monitor systemic risk.").

23 Armstrong, *supra* note 2.

for moral hazard on a massive scale."[24] In addition, several proponents of the proposal, including Paul Volker himself, point to the inherent conflicts of interest that exist if a bank simultaneously trades for customers' and its own accounts. The most obvious concern is what is known as "front-running," whereby a bank is able to take advantage of advance knowledge of customer trades. By trading on its own account ahead of executing the customers' orders, a bank is able to exploit anticipated changes in price.[25] The idea is that separating proprietary trading from client services will eliminate this possibility of trading against client positions.

Banks that have proprietary trading desks attempt to reduce such conflicts of interest by separating the trading business from its commercial banking. However, critics contend that these separations, called "Chinese Walls," are not as impermeable as they claim to be.[26] As former chairman Volcker noted during his testimony on February 2, 2010, "even with the best efforts of boards and management, so-called Chinese Walls can[not] remain impermeable against the pressures to seek maximum profit and personal remuneration."[27]

A further argument espoused by former chairman Volcker in his testimony is that, proprietary trading aside, commercial banks have at their disposal a wide array of potentially profitable activities which are more than sufficient to "provide the base for strong, competitive – and profitable – commercial banking organizations, able to stand on their own feet domestically and internationally in fair times and foul."[28] What is more, or so the argument goes, the core functions of commercial banking already contain substantial risk. We should not permit activities that are not central to these

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[24] Shah Gilani, *How the Demise of Glass-Steagall Helped Spawn the Credit Crisis*, MONEY MORNING, Feb. 17, 2010, http://moneymorning.com/2010/02/17/credit-crisis-7/.

[25] John Carney, *Former Goldman Trading Strategist: Of Course Goldman Traders Use Knowledge Of Client Trades To Make Money*, BUSINESS INSIDER, Feb. 11, 2010, http://www.businessinsider.com/former-goldman-trading-stratgist-of-course-goldman-traders-use-knowledge-of-client-trades-to-make-money-2010-2.

[26] *Statement of Paul A. Volcker Before the Comm. on Banking, Housing, and Urban Affairs of the United States Senate*, 111th Cong. 4 (2010) (statement of Paul A. Volcker).

[27] *Id.*; s*ee also Statement of E. Gerald Corrigan*, *supra* note 8 at 13.

[28] *Statement of Paul A. Volcker*, *supra* note 26 at 5.

functions to increase that risk.[29] Even further, Volcker and others have pointed out that, besides increasing risk, allowing proprietary trading by commercial banks in fact tilts towards such banks an otherwise level playing field in the area of private equity and hedge funds.[30]

2. The Rule's Major Shortcomings

Though successful in catering to Main Street's current distrust of Wall Street, the Volcker Rule may not be the answer, as it fails to reach the causes of the most recent financial meltdown.[31] The major problem with the Rule, recently raised by Federal Reserve chairman Ben Bernanke, is the difficulty in drawing a bright line between purely proprietary trading and market-making activities.[32] Chairman Bernanke's concerns are echoed by JPMorgan Chase's chief risk officer Barry Zubrow. As Zubrow states "[a]ny individual trade, taken in isolation, might appear to be 'proprietary trading', but in fact is part of the mosaic of serving clients and properly managing the firm's risks."[33] Drawing the wrong line between banned proprietary trading and facilitation trades, these critics argue, could have disastrous consequences for banks and markets, either in terms of liquidity management or in terms of unhedged risk exposure.[34]

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[29] Warren S. Hersch, *Volcker: Thaw Congress*, LIFE AND HEALTH INSURANCE NEWS, Feb. 23, 2010, http://www.lifeandhealthinsurancenews.com/News/2010/2/Pages/Volcker-Thaw-Congress.aspx (quoting Volcker, "There is already plenty of risk in commercial banking. Do we really want to add more risk that is not central to the functions of the banks?").

[30] Andrew Ross Sorkin, *Bankers in Davos Seek a United Message on Volcker Rule*, N.Y. TIMES, Feb. 1, 2010, at B1, (claiming that some private equity executives like the proposed rule because it eliminates competition from commercial banks); *see also Statement of Paul A. Volcker*, *supra* note 26 (noting that "curbing proprietary interests by commercial banks is in the interest of fair and open competition.").

[31] *Statement of Barry Zubrow*, *supra* note 6 at 2 (stating that the proposed restricted activities were not what led to the financial crisis).

[32] Chan, *Bernanke Defends Fed's Ability to Supervise Banks, supra* note 6.

[33] *Statement of Barry Zubrow*, *supra* note 6 at 3.

[34] *Glass-Steagall Lite*, THE ECONOMIST, Jan. 22, 2010, http://www.economist.com/displaystory.cfm?story_id=15374543 ("Getting it wrong would be counter-productive: preventing banks from hedging their risks would make them less stable.").

While proponents of the Volcker Rule partially blame risky trading by banks for the financial crisis, opponents are quick to point out that trading losses did not play a significant role in bringing about the financial turmoil of the past two years. The largest firms that failed (or that had to be bailed out) in fact had minimal trading losses. For example, Lehman Brothers' proprietary trading losses in its second and third quarters of 2008 totaled less than $1 billion.[35] While Morgan Stanley and Merrill Lynch did have substantial trading losses, these losses were independent from their commercial banking operations and arguably would not have been prevented by a Volcker Rule.[36] As John Dugan, the Comptroller of the Currency, and others argue, the majority of trading losses at banks were not proprietary losses, but losses related to trading for customers.[37] What brought down the largest banks were complex and highly leveraged instruments.[38] These instruments, however, were securitized forms of what was created by banks in their traditional lending functions.[39]

Even supporters of the Volcker Rule admit that proprietary trading is a positive activity. President Obama's National Economic Council Lawrence Summers described proprietary trading as a "good" and "valuable" activity.[40] He notes that "[i]t's just not one the president believes should take place in a bank,"[41] some economists argue that it in fact should take place in banks. According to them, it is not good public policy to prohibit banks from engaging in an

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[35] Mark Gimein, *What Makes Banks Fail?* THE BIG MONEY FROM SLATE, Jan. 24, 2010, http://www.thebigmoney.com/print/5078.

[36] *Id.*

[37] Dan Freed, *Citigroup Regulator: Don't Blame Prop Trading*, THESTREET.COM, Mar. 26, 2010, http://www.thestreet.com/story/10711810/1/citigroup-regulator-dont-blame-prop-trading.html.

[38] *Statement of E. Gerald Corrigan*, *supra* note 8 at 11 (claiming that the largest losses resulted from traditional lending magnified by very complex and highly leveraged instruments, not trading activities); *see also* Gimein, *supra* note 35 (reporting that Lehman's losses resulted largely from packaging bad bank loans into bad bonds).

[39] *Statement of E. Gerald Corrigan*, *supra* note 8 at 11; *see also* Gimein, *supra* note 35.

[40] Joshua Zumbrum, *Summers Says Regulators Will Define Proprietary Trading*, BUSINESSWEEK.COM, Mar. 1, 2010, http://www.businessweek.com/news/2010-03-01/summers-says-regulators-will-define-proprietary-trading.html.

[41] *Id.*

activity for which they are so well suited.[42] First, banks already have the necessary infrastructure in place due to the trading they do for customers. Thus, the marginal costs of running proprietary desks are extremely low. Second, banks have access to tremendous amounts of market information that gives them an inherent advantage. [43]Given this advantage, on average, banks' trading activities should be unusually profitable and should therefore make them stronger and more competitive internationally.[44]

D. Alternatives

In the midst of the reactions to the President's January 21, 2010 announcement, several commentators have made suggestions for financial reform. Philip Augar, a former investment banker and the author of *Chasing Alpha: How Reckless Growth and Unchecked Ambition Ruined the City's Golden Decade*, proposes one fairly straight forward alternative: prohibit banks that trade for customers or for themselves from giving advice to clients. This would create two types of firms: (1) specialist trading firms that make markets for customers and that would be free to trade on their own accounts; and (2) advisory firms that would not be able to trade for themselves and would have to deal with clients on an agency basis through the trading firms.[45]

Augar sees three major advantages to this rule. First, he argues it would be a transparent system that is easier to implement and police than the Volcker Rule. There would be minimal risk of "one component contaminating another" and the rule would be straightforward: any firm trading in markets may not also speak to clients.[46] Second, by making banks choose one way or another, this system would produce "smaller, less connected institutions," thereby minimizing systemic risk.[47] Third, it would reduce moral hazard and the inherent conflicts of interest that exist in a system where firms are

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[42] Douglas J. Elliott, *Restricting Bank Activities*, http://www.brookings.edu/experts/elliottd.aspx (last visited Feb. 4, 2010).
[43] *Id.*
[44] *Id.*
[45] Philip Augar, *A Better Way to Break Up the Banks*, HARVARD BUSINESS REVIEW, Feb. 4, 2010, http://blogs.hbr.org/cs/2010/02/a_better_way_to_break_up_the_b.html.
[46] *Id.*
[47] *Id.*

allowed to "work for both sides of a transaction and to take a principal turn out of the middle."[48] Augar acknowledges that as a consequence of his alternative, the cost of capital may rise and markets may become less liquid. He is quick to note, however, that these consequences would likely help to prevent a future credit crisis.[49]

A similar solution is proposed by William Armstrong, a former banker. His solution would continue to allow the existence of large bank holding companies, but it would require that the different financial intermediation activities are performed by different legal entities under the bank holding company umbrella.[50] The holding company's activities would be limited to "activities related to the general administration of its financial intermediation businesses," and strict limits would be placed on the extent to which the commercial banks within the group could finance other group entities.[51] Armstrong contends that his system would be easier to implement than a Volcker Rule and would preserve banks' economies of scale while at the same time protecting the taxpayer from bearing the cost of trading losses.[52]

E. The Proposed Draft Legislation

On March 15, 2010, Senator Dodd unveiled a draft of the financial markets reform bill being drafted by the Senate Finance and Banking Committee.[53] The bill finally offers a definition of what proprietary trading is, defining it as:

> purchasing or selling, or otherwise acquiring and disposing of, stocks, bonds, options, commodities, derivatives, or other financial instruments by an insured depository institution, a company that

[48] *Id.*
[49] *Id.*
[50] Armstrong, *supra* note 2.
[51] *Id.*
[52] *Id.*
[53] Covington & Burling, LLP, *Senate Financial Reform Addresses Proprietary Trading*, Mar. 19, 2010, http://www.cov.com/files/Publication/beaeb4175dbc44ebb57b086955632929/Presentation/PublicationAttachment/b04b4e2d9a33457587ee2bdc29a86227/Senate%20Financial%20Reform%20Legislation%20Addresses%20Proprietary%20Trading.pdf#page=1.

> controls an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 . . . and any subsidiary of such institution or company, for the trading book of such institution, company, or subsidiary.[54]

Acknowledging the importance of market making and hedging by banks, the bill exempts from this definition:

> purchasing or selling, or otherwise acquiring and disposing of, stocks, bonds, options, commodities, derivates, or other financial instruments on behalf of a customer, as part of market making activities, or otherwise in connection with or in facilitation of customer relationships, including hedging activities related to such a purchase, sale, acquisition, or disposal.[55]

Further, "obligations of the United States or any agency of the United Sates" and any obligations fully guaranteed by the government are exempt from the trading ban.[56]

While the bill provides a definition of proprietary trading, questions as to this definition's workability remain. Some critics argue that since facilitation trades and hedging positions would be exempted, there is no objective test for what constitutes banned proprietary trading: "[t]he same asset could be held for liquidity management outside of a trading book, yet be bought and sold in exactly the same manner as if it were in a trading book."[57] In effect, the bill injects into the determination of proprietary trading a subjective intent element.[58]

Additionally, the proposed legislation neither enacts the Volcker Rule (or something similar), nor does it force lawmakers to

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[54] S.__, 111th, Cong. § 619 (2010), *available at* http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf.
[55] *Id.*
[56] *Id.*
[57] Avent and Drum, *supra* note 10.
[58] *Id.*

vote on its adoption.[59] Instead, under section 619(g), the draft legislation states that the Financial Stability Oversight Council ("FSOC") shall within 6 months of enactment of the new bill,

> complete a study of the definitions . . . and other provisions . . . to assess the extent to which [these would] (i) promote and enhance the safety and soundness of depository institutions . . .; (ii) protect taxpayers and enhance financial stability . . .; (iii) limit the inappropriate transfer of Federal subsidies . . . to unregulated entities; (iv) reduce inappropriate conflicts of interest . . . ; (v) raise the cost of credit or other financial services . . . ; and (v) limit activities that have caused undue risk or loss in depository institutions . . . .[60]

Within nine months of completion, the FSOC "shall jointly issue final regulations" regarding the implementation of the proprietary trading ban.[61] Under section 989, the bill also mandates a Government Accountability Office Study on Proprietary Trading. This would require the Comptroller General (who, as noted above, opposes the Volcker Rule) to conduct a study of the risks of proprietary trading and present his findings in a report to the Congress within fifteen months of enactment of the bill.[62] As commentators have pointed out, these provisions effectively get the Volcker Rule adopted as law or dropped from the debate "without lawmakers having to vote for it."[63]

F. Conclusions

As lawmakers and lobbyists begin to tackle the draft legislation, the Volcker Rule and its fate remain as vague as at the time of the President's initial proposal. Apparently unfazed by the proposal, Citigroup is rebuilding its proprietary trading unit after almost half of

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[59] *Id*.
[60] S.__, 111th Cong. (2010).
[61] *Id.*
[62] *Id.*
[63] Avent and Drum, *supra* note 10.

its employees left earlier this year.[64] JPMorgan is buying the European and Asian arms of RBS Sempra Commodities, a trading joint venture between San Diego-based Sempra and the Royal Bank of Scotland Group. [65] While this move will increase its trading abilities, JPMorgan did acknowledge that the President's proposed Volcker Rule influenced its decision: the bank was initially in talks to buy all of RBS Sempra, before limiting its acquisition to RBS Sempra's overseas operations.[66]

The ultimate decision on the Volcker Rule has not only been postponed for at least another fifteen months, but also removed from the Congress, confirming perhaps the notions that the proposal was rushed and too political. As the draft legislation stands now, the future of proprietary trading by insured depository institutions seems to come down to how well proprietary trading units behave during their fifteen month probation. Additionally, one cannot help but think that the pace of economic recovery and the banks' ability to return to profitability will play a crucial factor.

Alexander L. Mackinger[67]

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[64] Bradley Keoun, *Citigroup Bolsters Trading Unit as Volcker Rule Spurs Defectors*, BLOOMBERG, Mar. 16, 2010, http://www.bloomberg.com/apps/news?pid=20601103&sid=aUxmSVOobU1Y.

[65] Liam Denning, *J.P. Morgan Hedges on Volcker Rule*, WALL ST. J., Feb. 17, 2010, http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748704804204575069831284117798.html.

[66] Andrew Ross Sorkin, *JPMorgan Shows Its Concern About New Bank Rules*, N.Y. TIMES, Feb. 25, 2010, http://dealbook.blogs.nytimes.com/2010/02/25/jpmorgan-shows-its-concern-about-new-bank-rules/.

[67] Student, Boston University School of Law (J.D. 2011).