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The Legal Origins Theory in Crisis

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The Legal Origins Theory in Crisis

Lisa M. Fairfax[*]

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I. INTRODUCTION

Economists describe the current global financial crisis as the worst financial crisis since the Great Depression.[1] Moreover, the U.S.

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government's response has been almost as unprecedented as the crisis it is aimed to forestall and correct. Scholars have debated at length not only the cause of the crisis,[2] but also about whether the crisis and its severity could have been predicted.[3] By contrast, relatively little attention has been paid to whether we could have predicted America's response to the crisis. Because the legal origins theory purports to predict how countries respond to economic and social problems, it has the potential to fill this void.[4] In that regard, this Article seeks to test that theory's predictive value with respect to America's crisis response, and thereby shed some light on the strength of, and limits to, the theory.

Beginning in 1997, four authors published a series of articles based on a theory that the historical origins of a country's laws shape its legal rules and regulations, as well as its fundamental approach to problem-solving.[5] This theory, known as the legal origins theory or LLSV,[6] predicts that a country's legal origin influences its laws and regulations. As a result, the theory asserts that common law countries and civil law countries will differ with respect to their laws and regulations because of their legal origins. Moreover, the theory suggests that a country's legal origins will dictate how a country responds to social and economic problems. That is, a country's legal

1. *E.g.*, *Three Top Economists Agree 2009 Worst Financial Crisis Since Great Depression; Risks Increase if Right Steps Are Not Taken*, REUTERS, Feb. 27, 2009, http://www.reuters.com/article/pressRelease/idUS193520+27-Feb-2009+BW20090227.

2. *See, e.g.*, *infra* Part III.A.

3. *See, e.g.*, Peter Coy et al., *What Good Are Economists Anyway?*, BUS. WK., Apr. 16, 2009, at 26 (explaining why economists mostly failed to predict the crisis); Stephen Mihm, *Dr. Doom*, N.Y. TIMES, Aug. 17, 2008, at MM26 (describing audience's skepticism to predictions by NYU economist Nouriel Roubini that a crisis was brewing).

4. *See* Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285, 306–09 (2008).

5. The four authors are Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. *E.g.*, Nicholas Thompson, *Common Denominator*, LEGAL AFFAIRS, Jan./Feb. 2005, *available at* http://www.legalaffairs.org/issues/January-February-2005/feature_thompson_janfeb05.msp. For examples of these articles, see Rafael La Porta et al., *The Quality of Government*, 15 J.L. ECON. & ORG. 222 (1999) [hereinafter La Porta, *Quality of Government*] (investigating through empirical data and comparisons what determines the quality of governments across several countries); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (examining the origin and enforcement of laws regarding the protection of corporate shareholders and creditors across forty-nine diverse civil law and common law countries); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) (examining the connection between legal protections for investors and development of capital markets in various countries).

6. An acronym of the four original theorists' last names.

origins shape the manner in which it confronts new economic and political challenges.[7] As a result, countries in the civil law tradition will not only respond to problems differently than countries in a common law tradition, but will also respond to such problems in a particular way that is unique and consistent with their legal tradition. In this respect, the theory not only explains the differences in the development of institutions, but also reflects a "mode of thought" or attitude about how best to deal with problems.[8] Moreover, the theory contends that a country's legal tradition tends to better predict its institutions and rules than other cultural, political, social or economic factors.[9]

Important for purposes of this Article, the theory purports to have at least some predictive value during times of upheaval.[10] During such times, when legal rules change in response to a crisis, the legal origins theory predicts that they will change in ways that are consistent with a country's legal tradition.[11] This is because, at its core, the theory reflects a fundamental approach to problem solving.[12] The legal origins theory stems from the premise that legal origins "represent fundamentally different strategies of social control of economic life, which express themselves in how countries confront new economic or political challenges."[13] In other words, America's legal origins should strongly influence the manner in which the United States approaches economic problems, and that approach should be fundamentally distinct from the manner in which countries from a civil law tradition respond to such problems. In this regard, the legal origins theory should be particularly relevant in times of crisis because it should be able to predict the manner in which countries respond to crisis. If this theory is accurate, America's

7. La Porta et al., *supra* note 4, at 307.

8. *See id.* at 287, 307. La Porta and his co-authors, in an earlier draft of this paper, suggested that the legal origins families represent "expressions of fundamental approaches to solving social problems." La Porta et al., *The Economic Consequences of Legal Origins*, Second Draft, June 4, 2007, at 4, http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/2007fall-Speakers_9-25_Shleifer.pdf [hereinafter La Porta, *Economic Consequences*, Second Draft].

9. *See* La Porta et al., *supra* note 4, at 310–15.

10. The Legal Origins Theory purports to have some predictive value that helps to explain a country's actions. Hence, this Article refers to both the predictive and explanatory value of the Legal Origins Theory.

11. La Porta et al., *supra* note 4, at 308.

12. *Id.* at 307.

13. La Porta, *Economic Consequences*, Second Draft, *supra* note 8, at 7.

legal tradition should have a profound impact on its current crisis response. That being said, it is important to note that legal origin theorists themselves suggest that the theory may not operate during times of particularly severe financial turmoil.[14] With this limitation in mind, this Article seeks to test the boundaries of the legal origins theory by assessing whether it could have predicted the manner in which the U.S. has responded to the current economic crisis or if the turmoil was so significant that the theory loses its predictive value.

Legal origins theory would predict that the United States response would be steeped in a common law tradition and therefore be at odds with a response expected from civil law entities. After examining America's response to date, this Article notes that, at least on the surface, its current response seems to run counter to its legal origins in some fundamental ways. This inconsistency suggests that political, social, and economic forces do more to explain the United States response to significant financial and economic turmoil than its legal origins. From this perspective, this Article maintains that the current crisis is so severe that it overwhelms any explanatory or predictive value that may have been derived from the legal origins theory. To be sure, a more nuanced examination of the United States response does illuminate some strands of its legal tradition that have emerged in the context of its crisis response, suggesting that the theory may be operative, put perhaps in a more muted and nuanced manner.

Part I of this Article gives some background on the legal origins theory. Part II briefly highlights the current economic crisis and pinpoints some of America's principal responses. Part III then explores whether those responses are consistent with the legal origins theory. This Part demonstrates the manner in which those responses run counter to America's origins, thus undermining the predictive value and hence strength of that theory, at least in the context of a major crisis. However, Part III also reveals some ways in which the United States response may be deemed consistent with the legal origins tradition, and thus may validate the theory's predictive value even during severe upheaval. Part IV offers some concluding thoughts about the relevance of the theory in crisis.

14. *See* La Porta et al., *supra* note 4, at 327.

II. THE LEGAL ORIGINS THEORY

The legal origins theory contends that the historical origins of a country's laws determine its legal rules as well as the nature of its political, economic, and legal institutions. Thus, legal origins explain why countries have developed distinct legal rules and regulations across a broad range of disciplines as well as distinct modes of resource allocation and interactions between the government and its citizens.[15] Moreover, legal origins can often better explain a country's legal and economic institutions than political and cultural variables.[16]

The legal origins theory rests on at least two premises. First, most countries received their legal system through colonization or some other involuntary means, making their legal origins largely exogenous.[17] In other words, conquering countries export their legal system to other nations.[18] As a result, the theory may lose its explanatory or predictive force if a country voluntarily chooses its legal origin—as is the case with Japan.[19] Second, countries' legal traditions essentially fall into one of two categories: civil or common law.[20] From this perspective, differences in legal origins mainly

15. *See generally* Juan Botero et al., *The Regulation of Labor*, 119 Q.J. ECON. 1339 (2004) (investigating labor market regulation through applicable laws in eighty-five countries including French civil law, Scandinavian civil law, socialist, and common law countries); La Porta, *Quality of Government*, *supra* note 5, at 261–62 (comparing and contrasting the influence of socialist, French civil law, German civil law, Scandinavian civil law, and common law legal origins on government performance).

16. *See, e.g.*, David M. Foster, *Politics, Legal Origins, and the Roots of Modern Economic Institutions* (Mar. 25, 2005) (seminar paper for Advanced Issues in Corporate Governance, Professor Mark J. Roe), at 3–4.

17. La Porta et al., *supra* note 4, at 286.

18. *Id.* at 288 ("[A] key feature of legal traditions is that they have been transplanted typically though not always through conquest or colonization, from relatively few mother countries to most of the rest of the world." (internal citation omitted)).

19. Though Japan's legal system was influenced by German civil law tradition, Japan chose to incorporate that influence voluntarily rather than have it enforced through colonization. *See id.* at 290.

20. *Id.* at 288. To be sure, within the civil law tradition, the legal origins theory recognizes the distinctions between French, German, and Scandinavian civil law, while noting that the distinctions are relatively subtle. La Porta, *Quality of Government*, *supra* note 5, at 231; *see also* La Porta et al., *supra* note 4, at 390. The theory also recognizes the socialist legal tradition, which originates in the Soviet Union, noting that such tradition falls within the civil law family, but with pronounced differences when compared with other civil law systems. La Porta et al., *supra* note 4, at 288; La Porta, *Quality of Government*, *supra* note 5, at 231. Nevertheless, the theory rests primarily on the notion that France and England established two dominant forms of legal systems that were then exported to countries that they conquered.

originate from either the English common law system or the French civil law system, both of which form the foundations of modern common and civil law systems.[21] Countries with common law origins include the United States, Canada, Australia, India, and South Africa.[22] Although the civil law tradition originates in Roman law, it is generally identified with France and the countries influenced by French conquest including Portugal, Spain, Northern and Sub-Sahara Africa, and French Caribbean Islands.[23] Legal origin theorists also have referred to groups of countries that share the same legal tradition as legal families,[24] and in this vein, England represents "mother-country" of the common law family while France is matriarch of the civil law countries.[25]

Legal origin theorists contend that a country's legal origin impacts the nature of its institutions, and leads to the development of distinct features. Thus, common law systems embrace limited state intervention and restraints on government power, resulting from its emphasis on protecting individual rights and their private property rights.[26] By contrast, the civil law tradition is associated with enhanced government ownership and control.[27] Hence, growth of administrative power represents a hallmark of civil law.[28] Another critical hallmark of a civil law system is the central control of banks. Civil law systems also feature policies aimed at nationalization and direct state control of industry.[29]

In addition to these features associated with government intervention, legal origins determine the nature and role of the judiciary within a country. For the common law system, judicial rule-making and judicial independence are absolutely essential.[30] Moreover, the power of judicial review represents a hallmark of the

21. La Porta et al., *supra* note 4, at 288–89.

22. *Id.* at 288.

23. *Id.* at 289 ("[T]he civil law tradition is the oldest, the most influential, and the most widely distributed around the world . . . .").

24. *E.g.*, KONRAD ZWEIGERT & HEIN KÖTZ, INTRODUCTION TO COMPARATIVE LAW 68 (1998); La Porta et al., *supra* note 4, at 286.

25. *See* La Porta et al., *supra* note 4, at 288, 318.

26. La Porta, *Quality of Government*, *supra* note 5, at 232.

27. *See generally id.* at 231–33 (asserting that the civil legal tradition demonstrates and results in the creation of institutions to increase state power).

28. *See* La Porta et al., *supra* note 4, at 304.

29. *Id.* at 308.

30. *See id.* at 305.

common law tradition. In this regard, judicial lawmaking is a central feature of the common law ideology.

The legal origins theory also maintains that legal traditions are robustly linked to financial development. Thus, common law countries tend to be more economically developed with more sophisticated financial markets and development.[31] This results in part from the strong emphasis on investor protection as well as the higher quality of contract enforcement that emanates from the common law tradition.[32] It also results from a more independent judiciary that helps secure property rights.[33] Importantly, legal origin theorists do not maintain that common law always produces the most economically efficient outcome.[34]

In addition to being highly correlated to particular institutions and modes of governmental regulation, the theory predicts that countries will adopt particular attitudes or ideologies based on their legal origins. Thus, because legal origins represent distinct strategies regarding control of economic life, legal origins represent fundamentally different strategies regarding how to confront economic or political challenges.[35] In this respect, legal origins influence governmental approaches to problem solving, predicting the strategies a country will employ to grapple with social and economic concerns.[36] The theory predicts that civil law governments' responses will focus on expanding government control, while common law governments will favor market solutions and reliance on the judiciary.[37] The theory further predicts that common law governments will steer clear not only from administrative solutions when crafting solutions to new problems, but also from the nationalization of banks and companies.[38]

Finally, legal origins theorists posit that the theory may better predict a country's institutions and attitudes than other factors. To be sure, the theory does not dismiss the importance of political, cultural, or social influences. However, legal origin theorists note

31. *See id.* at 294–98.
32. *Id.* at 298.
33. *Id.*
34. *Id.* at 309.
35. *Id.* at 307.
36. *See id.*
37. *See id.*
38. *Id.* at 308.

that legal origins often have greater predictive power than such influences.[39] Theorists do caution that the saliency of the legal origins hypothesis may be tested depending on the nature and extent of certain crisis, suggesting that the theory may have important limitations.

These observations regarding the predictive power of the legal origins theory appear to have relevance in predicting the government's response to the current crisis. Indeed, the legal origins theory certainly includes predictions about the content of that response as well as the ideologies that would shape that response. The next parts of this Article focus on the government's response and the extent to which the legal origins theory comports with that response.

III. FINANCIAL CRISIS AND THE GOVERNMENT'S RESPONSE

Many theories exist regarding what caused the current financial crisis and why the crisis has had such a devastating impact on the economy in the United States and abroad.[40] However, most scholars

39. *See id.* (noting that the distinct strategies with respect to social control of business and institutions among countries within different legal traditions have persisted despite political and other changes within such countries); *see also* Foster, *supra* note 16.

40. *See generally* Steven Davidoff & David Zaring, *Big Deal: The Government's Response to the Financial Crisis*, at 2, *available at* http://ssrn.com/abstract=1306342 (noting that regulatory failures played a role in the financial crisis); Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis* (Dec. 5, 2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020396; Hershey Friedman & Linda Friedman, *The Global Financial Crisis: What Went Wrong?*, Mar. 9, 2009, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1356193 (noting that the lack of appropriate regulation of the market in general and derivatives in particular, single-minded pursuit of self-interest, and the failure of rating agencies played a role in the financial crisis); Gary Gorton, Yale School of Management & NBER, Federal Reserve Bank of Kansas City, Jackson Hole Conference: The Panic of 2007 (Aug. 4, 2008), http://www.kc.frb.org/publicat/sympos/2008/Gorton.08.04.08.pdf.; Austin Murphy, *The Financial Crisis of 2008: Causes and Solutions* (Nov. 4, 2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1295344&rec=1&srcabs=1306342 (noting that the crisis had such a broad impact because of theoretical modeling based on unrealistic assumptions which led to fundamental mispricing of credit default swaps); Faten Sabry & Thomas Schopflocher, *The Subprime Meltdown: A Primer* (June 21, 2007) at 9, http://www.nera.com/image/PUB_SubPrimer_1108.pdf (pinpointing, among other things, the relaxation of underwriting standards and the increase in short-term interests as factors contributing to the financial crisis); John B. Taylor, *The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong* (Nov. 2008), at 2-3, http://www.stanford.edu/~johntayl/FCPR.pdf (noting that monetary excesses, or relatively loose monetary policy reflected in unusually low interest rates, was the main cause of the financial crisis).

agree that many factors played a role in causing the crisis and its ripple effect through the financial sector and broader economy. As Federal Reserve Chairman Ben Bernanke noted, those factors included "widespread declines in underwriting standards, breakdowns in lending oversight by investors and rating agencies, increased reliance on complex and opaque credit instruments that proved fragile under stress, and unusually low compensation for risk-taking."[41] This section does not seek to analyze these factors or otherwise examine the various theories regarding the cause of the crisis, but rather provides a brief account of the financial crisis and the government's response in order to examine if that response comports with the legal origins theory's apparent predictions regarding how the United States would respond to crisis.[42]

A. *A Financial Crisis and Recession*

Most experts pinpoint the immediate cause of the current global financial crisis as the bursting of the U.S. housing bubble and the related collapse of the subprime mortgage market.[43] The boom and

41. Ben S. Bernanke, Chairman, Federal Reserve, Speech at the Stamp Lecture, London School of Economics: The Crisis and the Policy Response (Jan. 13, 2009), http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm.

42. For a more detailed thought assessment of the crisis and its causes, see Demyanyk & Van Hemert, *supra* note 40; Gorton, *supra* note 40; Murphy, *supra* note 40.

43. In January 2009, Federal Reserve Chairman Ben Bernanke described the crisis as follows:

> For almost a year and a half the global financial system has been under extraordinary stress—stress that has now decisively spilled over to the global economy more broadly. The proximate cause of the crisis was the turn of the housing cycle in the United States and the associated rise in delinquencies on subprime mortgages, which imposed substantial losses on many financial institutions and shook investor confidence in credit markets. However, although the subprime debacle triggered the crisis, the developments in the U.S. mortgage market were only one aspect of a much larger and more encompassing credit boom whose impact transcended the mortgage market to affect many other forms of credit. Aspects of this broader credit boom included widespread declines in underwriting standards, breakdowns in lending oversight by investors and rating agencies, increased reliance on complex and opaque credit instruments that proved fragile under stress, and unusually low compensation for risk-taking.
>
> The abrupt end of the credit boom has had widespread financial and economic ramifications. Financial institutions have seen their capital depleted by losses and writedowns and their balance sheets clogged by complex credit products and other illiquid assets of uncertain value. Rising credit risks and intense risk aversion have pushed credit spreads to unprecedented levels, and markets for securitized assets, except for mortgage securities with government guarantees, have shut down. Heightened systemic risks, falling asset values, and tightening credit have in turn

bust of the housing market led to financial and credit crises that spread around the globe and triggered a recession.

Between 1997 and 2006, the United States experienced a significant housing bubble, increasing the average price of an American home by 124%.[44] This housing bubble was encouraged by a combination of factors, including low interest rates and governmental policy encouraging homeownership.[45] For existing homeowners, the increased value of their homes meant that they could extract equity from their home by refinancing at lower interest rates. For new homeowners, low interest rates coupled with policies encouraging home ownership translated into lower monthly payments that made homes more affordable to more people.

Notably, home price appreciation outpaced increases in median income levels in record numbers. For example, from 2000 to 2005 such appreciation outpaced income growth by more than six-fold.[46] Consequently, while houses were more expensive, income levels did not rise to meet that expense. Instead, borrowers were able to purchase these more expensive houses by relying on mortgage products that lowered their monthly payments, such as interest-only and balloon payment loans.[47] The most popular and prevalent of such products were adjustable rate mortgages, or ARMs, which were mortgages with relatively easy initial terms and rates that would reset periodically at higher, market-based interest rates.[48] By providing for

> taken a heavy toll on business and consumer confidence and precipitated a sharp slowing in global economic activity. The damage, in terms of lost output, lost jobs, and lost wealth, is already substantial.

Bernanke, *supra* note 41.

44. *CSI: Credit Crunch*, ECONOMIST, Oct. 18, 2007.

45. Economist John Taylor notes that the U.S. monetary policy was too easy, or "loose fitting," because of unusually low interest rates, and this monetary excess was the primary cause of the boom and bust. At the very least, Taylor suggests, the unusually low interest rate policy accelerated the housing boom and bust. John B. Taylor, *The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong* (Nov. 2008), http://www.stanford.edu/~johntayl/FCPR.pdf. Taylor also indicates that other countries deviated from more appropriate interest rates, and that the housing boom was largest when these deviations were the largest. *Id.* at 5. Taylor concludes that these global policies were likely influenced by the Fed's interest rate decisions. *Id.* at 6.

46. JOINT CENTER FOR HOUSING STUDIES OF HARVARD UNIVERSITY, THE STATE OF THE NATION'S HOUSING: 2008, at 7 (2008), http://www.jchs.harvard.edu/publications/markets/son2008/son2008.pdf [hereinafter *State of Nation's Housing*].

47. *Id.* at 1–2. Interest-only loans refer to loans that defer the payment of principal for a set number of years.

48. *Id.*; *see also* Sabry & Schopflocher, *supra* note 40, at 3.

lower payments prior to the reset, ARMs and similar mortgage products enabled people to secure larger mortgages and purchase more expensive homes than they could otherwise afford. So long as home prices increased and interest rates remained low, these mortgage products appeared to benefit homeowners despite the possibility of resetting at less favorable terms. This is because if borrowers found themselves unable to make payments once the rate reset, they had sufficient equity in their homes to refinance at a lower rate or sell their home at a profit. During this period, people took on additional debt to refinance or purchase homes, which caused home mortgage debt to increase dramatically, reaching record highs in 2006 and 2007.[49]

Coupled with the housing bubble was the proliferation of subprime mortgages—mortgages issued to borrowers with imperfect credit scores because of impaired or little credit history, high debt-to-income ratios, or some other characteristic that made the borrower more prone to default.[50] Such loans are distinct from prime loans offered to borrowers with relatively good credit history. Although the interest rates on subprime loans were higher than those on prime loans, the vast majority of subprime loans were ARMs with low introductory teaser rates, thereby ensuring low monthly payments for borrowers.[51] When such teaser rates reset, most subprime borrowers simply refinanced into another subprime loan.[52] Subprime loan originations exploded during the early 2000s, rising from $120 billion in 2001 to $625 billion in 2005.[53] By 2005, subprime loans comprised some twenty percent of the nation's mortgage lending.[54]

49. Colin Barr, *The $4 Trillion Housing Headache*, FORTUNE, May 27, 2009 (noting that home mortgage debt was at its highest levels ever in 2006 and 2007, with 2008 being the third-highest on record, and that Americans' mortgage debt was $10.4 trillion at the end of 2008).

50. Sabry & Schopflocher, *supra* note 40, at 2. Subprime loans are generally associated with borrowers with a credit score below 620. *Id.* However, predatory and other unsavory lending practices sometimes resulted in borrowers obtaining subprime loans even when their credit scores would have qualified them for prime loans. Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boom, Industry Pushed Loans to Broader Market*, WALL ST. J., Dec. 3, 2007, at A1.

51. Sabry & Schopflocher, *supra* note 40, at 3–4.

52. *Id.* at 3.

53. *Id.*

54. *Id.* at 1.

The sharp rise in subprime mortgages was spurred by financial innovation that reduced the risk associated with providing loans to default-prone borrowers, government policies that encouraged homeownership, policies that increased institutions' ability to take on additional debt, and relaxed underwriting standards for loans. First, financial innovations based on the mortgage industry served to redistribute and shift the risk associated with subprime mortgages, spurring the demand for such mortgages. Financial innovation took several forms. As an initial matter, the process of securitization enabled banks to pool various mortgages and sell them to investors in the form of mortgage-backed securities, shifting the risk of such mortgages to investors.[55] Similarly, collateralized debt obligations, or CDOs, enabled entities to pool mortgage assets and sell them in different classes or tranches as securities, again passing the risk related to such assets to investors.[56] Even when the tranches consisted of subprime mortgages, many of them received high credit ratings, making them attractive to investors.[57] Another important innovation was credit default swaps and other financial derivative products that enabled companies to purchase contracts to hedge the risk associated with subprime mortgages.[58] Such swaps essentially allowed companies to purchase insurance against the risk of default.[59] Insurance entities, particularly American International Group, Inc. ("AIG"), recorded record profits as a result of their involvement with credit default swaps insuring mortgage-backed securities.[60] More importantly, the use of these swaps and other financial innovations increased dramatically in the last decade, accelerating

55. *Id.* at 4–7.

56. DOUGLAS LUCAS ET AL., COLLATERALIZED DEBT OBLIGATIONS: STRUCTURES AND ANALYSIS (2006); JANET TAVAKOLI, COLLATERALIZED DEBT OBLIGATIONS AND STRUCTURED FINANCE, 14–29 (2003).

57. Frank Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis*, June 29, 2009, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1427167; Elliot Blair Smith, 'Race to Bottom' at Moody's, S&P Secured Subprime's Boom, Bust, Bloomberg.com, Sept. 25, 2008, http://www.bloomberg.com/apps/news?pid=20601109&sid=ax3vfya_Vtdo.

58. Partnoy, *supra* note 57, at 219–21; *see also* Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME, Mar. 17, 2008.

59. LUCAS, *supra* note 56, at 219–21.

60. Robert O'Harrow & Brady Dennis, *Downgrades and Downfall*, WASH. POST, Dec. 31, 2008, at A01, *available at* http://w3.lexis.com/research2/delivery/download/retrieve.do?filename=downgrades__downfalls.pdf&jobId=1823%3A177117329&ssb=0_512012564.

companies' appetite for risky loans upon which they could use such innovations.[61]

Second, government policies encouraging home ownership, particularly for middle and low income families, prompted the creation of new loan products, in lieu of the conventional thirty-year fixed mortgage, aimed at making mortgages more affordable. Indeed, in order to encourage affordable housing and more flexible loan products, government sponsored entities Fannie Mae and Freddie Mac significantly increased their purchases of mortgage-backed securities backed by subprime loans, further fueling the market for such securities and loans.[62]

Third, policies that increased the ability of financial institutions to bear significant amounts of debt enabled such institutions to heavily invest in mortgage backed securities and other products, accelerating demand for subprime products. In 2004, the Securities and Exchange Commission (the "SEC") altered its net capital rule in a manner that enabled certain entities to leverage themselves an unlimited number of times.[63] Consequently, by 2007 financial institutions routinely used thirty times leverage when making investments.[64] The new rule therefore not only enabled such institutions to increase their investments in debt, but also ensured that such institutions had very little equity to offset their high debt levels.

Finally, the increased demand for mortgages not only encouraged banks to lower their underwriting standards, but also prompted some entities to engage in predatory lending practices.

61. In 1994, JP Morgan introduced the first credit default swap, and over the next decade and a half, credit default swaps became the most widely traded derivative product. *Id.*

62. Carol D. Leoning, *How HUD Mortgage Policy Fed the Crisis*, WASH. POST, June 10, 2008, at A01, *available at* http://w3.lexis.com/research2/delivery/download/retrieve.do?filename=hud_mortgage.pdf&jobId=1822%3A177127766&ssb=0_51208285.

63. Stephen Labaton, *The Reckoning: Agency's '04 Rule Let Banks Pile Up New Debt*, N.Y. TIMES, Oct. 2, 2008, *available at* http://www.nytimes.com/2008/10/03/business/03sec.html. In 2004, the SEC changed its net capital rule, allowing firms with more than $5 million in assets to leverage themselves an unlimited number of times rather than the 12 to 1 ratio that had been in existence since 1975 when the SEC established the net capital rule.

64. John Mauldin, *A Positive Third Quarter?*, THE RESOURCE 2-3 (July 2009), http://reonationwide.com/resource/09%20july.pdf. When the rule was altered, five firms qualified and subsequently enhanced their leverage: Bear Stearns, Lehman Brothers, Merrill Lynch, Goldman Sachs, and Morgan Stanley. *Id.* None of the firms survived the crisis as independent entities, likely in large part due to the fact that their debt-to-equity ratio was too high to absorb the losses they suffered as a result of the crisis. *Id.*

Because they no longer had to absorb the risk of such lending practices, banks were increasingly willing to offer loans to borrowers with little or no down payment or real proof of income. Such practices not only fueled the growth of the subprime industry, but increased the likelihood that borrowers would obtain mortgages that they could ill-afford. Some entities went further, purposefully luring borrowers into inappropriate loans in light of their credit history and income levels.[65] Interestingly, one *Wall Street Journal* report found that sixty-one percent of borrowers with subprime loans had credit scores that qualified them for more attractive prime loans.[66] In the end, an insatiable appetite for subprime mortgages negatively affected many different types of borrowers. Relaxed underwriting standards, along with the aforementioned factors, ensured the rapid growth of the subprime mortgage industry, and thus served to inflate the housing bubble.

In 2006 and 2007, the housing bubble burst, causing a decline in housing prices and a subsequent rise in home delinquencies and foreclosures. In the first quarter of 2006, real estate prices began cooling, and between the fourth quarter of 2005 and the first quarter of 2006, the median U.S. housing price fell more than three percent, beginning a steady decline in the market.[67] The year 2007 saw the largest drop in home prices in twenty years,[68] and the first annual median price decline since the Great Depression.[69] The decline in housing prices made it difficult to refinance or sell homes at a profit. Moreover, in 2004 interest rates began to climb, ensuring that ARMs reset at higher rates, making it difficult for homeowners to afford their new monthly payments.[70] As a result, the rate of

65. Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039 (2007); David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985 (2006).

66. Brooks & Simon, *supra* note 50, at A01.

67. Les Christie, *Real Estate Cools Down*, May 16, 2006, http://money.cnn.com/2006/05/15/real_estate/NAR_firstQ2005_home_prices/index.htm.

68. *See* Martin H. Bosworth, *Home Prices Drop Sharply: Unsold Homes Increase*, *ConsumerAffairs.com*, Aug. 29, 2007, *available at* http://www.consumeraffairs.com/news04/2007/08/home_sales02.html.

69. Mike Sunnucks, *National Home Price Decline in 2007 Called First Drop Since Great Depression*, PHOENIX BUSINESS JOURNAL, Jan. 24, 2008, http://sanjose.bizjournals.com/phoenix/stories/2008/01/21/daily45.html.

70. Press Release, IRS, Interest Rates Increase for the Second Quarter of 2004, http://www.irs.gov/newsroom/article/0,,id=120820,00.html.

delinquencies and foreclosures began to rise. By August of 2008, more than six percent of all mortgages were delinquent, while more than two percent of loans were in foreclosure, both of which reflect record highs.[71] Most of the defaults and foreclosures were on ARMs, particularly subprime ARMs.[72] In the first quarter of 2007, the delinquency rate for subprime loans increased to more than thirteen percent, more than five times the delinquency rate for prime loans.[73] Prime ARM foreclosures have also started to rise, and experts predict that new foreclosures will likely be dominated by prime ARMs.[74]

These problems in the housing market triggered a collapse of the subprime mortgage industry. More than twenty-five subprime lending firms declared bankruptcy in February and March of 2007. In April 2007, the largest independent U.S. subprime lender, New Century Financial Corporation, filed for bankruptcy.[75] In January 2008, Bank of America purchased Countrywide Financial, the largest U.S. mortgage lender, for $4 billion as a result of its losses in the mortgage market.[76]

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71. Press Release, Delinquencies and Foreclosures Increase in Latest MBA Nat'l Delinquency Survey, http://www.mbaa.org/NewsandMedia/PressCenter/64769.htm (Sept. 5, 2008) (national survey by the Mortgage Bankers Association). The significant rise in state foreclosures in California and Florida enhanced the foreclosures percentages and overwhelmed improvements in other states.

72. *Id.*

73. Press Release, Mortgage Bankers Assoc., Delinquencies Decrease in Latest MBA Nat'l Delinquency Survey, http://www.mbaa.org/NewsandMedia/PressCenter/55132.htm (June 14, 2007) (reporting that delinquency rate for prime loans increased to 2.58% and to 13.77% for subprime loans).

74. *Id.*

75. Julie Creswell, *Mortgage Lender New Century Financial Files for Bankruptcy*, NYTIMES.COM, Apr. 2, 2007, http://www.nytimes.com/2007/04/02/business/worldbusiness/02iht-loans.5.5118838.html. The company's shares plunged from nearly $66 a share in 2004 to $1 in 2007. *Id.* In March 2007, New Century's shares lost 90% of their value, and the NYSE halted trading in their shares. David Cho, *Huge Mortgage Lender Files Bankruptcy*, WASH. POST, Apr. 3, 2007, at A01. When it filed for Chapter 11 bankruptcy protection, New Century also laid off more than half of its workforce. *Id.*

76. The Associated Press, *Bank of America to Acquire Countrywide*, MSNBC.COM, Jan. 11, 2008, http://www.msnbc.msn.com/id/22606833. One of the first signals that the decline and crisis in the housing and subprime market was being mirrored around the globe was on September 13, 2007, when the Bank of England agreed to provide an emergency loan to the Northern Rock, one of the UK's largest mortgage lenders. *Northern Rock Gets Bank Bailout*, BBC NEWS, Sept. 13, 2007, http://news.bbc.co.uk/2/hi/business/6994099.stm. Of course, the article indicates that most believed the problems at Northern Rock and in the mortgage industry were temporary in nature. *Id.* This would prove false as some five months later, on February 17, 2008, Britain nationalized Northern Rock. Gonzalo Vian & Loveday Morris, *Northern Rock Nationalized as U.K. Rejects Virgin Bid*, BLOOMBERG.COM, Feb. 17,

Further evidence of the market's deterioration emerged with the difficulties experienced by Freddie Mac and Fannie Mae. Both entities, heavily invested in the subprime markets, experienced dramatic drops in stock prices and severe liquidity problems. As a result, on September 7, 2008, the government seized control of Fannie Mae and Freddie Mac, placing them into government conservatorship.[77] At that point, such entities owned or guaranteed about half of the mortgage market.[78]

The interlinked nature of the financial innovations that relied on the prime and subprime mortgage industry ensured that declines in that industry would severely impact other sectors. Financial institutions that had invested in the industry began experiencing significant losses and liquidity issues. Indeed, the securitization market ground to a halt and credit markets froze as institutions that held or insured mortgage-backed securities watched their assets drop dramatically in value.

Entities invested in the subprime mortgage market began admitting to significant losses. For example, by the end of July 2007, Bear Stearns announced that two of its hedge funds that had invested in various mortgage-backed securities had lost almost all of their capital and would file for bankruptcy.[79] Then too, the investment banking industry, with its heavy involvement in

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2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aR399_tyWInw. The move represented the first time since 1984 that the government was forced to nationalize a bank, and England's biggest bank nationalization since 1946. *Id.*

77. Statement by Secretary Henry M. Paulson, Jr., on Treasury and Federal Housing Finance Agency Protection to Protect Financial Markets and Taxpayers (Sept. 7, 2008), http://www.ustreas.gov/press/releases/hp1129.htm. In explaining the move, Treasury Secretary Paulson stated:

> And let me make clear what today's actions mean for Americans and their families. Fannie Mae and Freddie Mac are so large and so interwoven in our financial system that a failure of either of them would cause great turmoil in our financial markets here at home and around the globe. This turmoil would directly and negatively impact household wealth: from family budgets, to home values, to savings for college and retirement. A failure would affect the ability of Americans to get home loans, auto loans and other consumer credit and business finance. And a failure would be harmful to economic growth and job creation. That is why we have taken these actions today.

Id.

78. Charles Duhigg, *Loan-Agency Woes Swell from a Trickle to a Torrent*, NYTIMES.COM, Jul. 11, 2008, http://www.nytimes.com/2008/07/11/business/11ripple.html.

79. Gretchen Morgenson, *Bear Stearns Says Battered Hedge Funds Are Worth Little*, N.Y. TIMES, July 18, 2007, at C02.

mortgage-backed securities and derivative products, found itself in significant turmoil. In fact, the major firms were unable to survive without significant financial assistance and intervention. In March 2008, Bear Stearns announced major liquidity problems and was granted a twenty-eight day emergency loan from the Federal Reserve (the "Fed").[80] Two days later, in a transaction facilitated by financing from the Fed, JPMorgan Chase announced that it would purchase Bear Stearns for $2 a share, though the amount was later increased to $10 a share.[81] On September 14, 2008, after suffering liquidity problems similar to Bear Stearns and a forty-five percent decline in share price, Lehman Brothers was unable to obtain the same government financial assistance as Bear Stearns and filed for bankruptcy, making it the largest bankruptcy in history at $639 billion.[82]

On September 15, 2008, Bank of America announced its $50 billion purchase of Merrill Lynch in order rescue the firm from near collapse.[83] On September 21, 2008, Goldman Sachs and Morgan Stanley, the remaining two largest investment banks, announced that they would convert into bank holding companies, which exposed them to additional regulation, but also afforded them access to loans from the Fed.[84]

The collapse of the subprime mortgage industry also negatively impacted the insurance industry. Most notably, AIG, which had some $441 billion in credit default swaps, began suffering significant losses.[85] On September 16, 2008, the Fed loaned AIG $85 million

80. Bear Stearns reported a $12 billion drop in liquid assets, which represented a sixty-seven percent decline. Davidoff & Zaring, *supra* note 40, at 13.

81. *Id.* at 16–20.

82. Some have argued that the government's failure to intervene on Lehman's behalf worsened the financial crisis, but Taylor contends that pinpointing the non-intervention decision as the primary reason for the increased severity of the financial crisis is questionable. Instead, it is likely that Paulson's testimony on the severity of the problem drove the market as well as uncertainty about how the government would respond to the problem. Taylor, *supra* note 40, at 16–17.

83. "Bank of America's chief executive . . . [claimed] that officials in the Bush administration and the Federal Reserve threatened to remove top executives of the bank" if it refused to agree to the merger with Merrill Lynch. Sean Lengell, *Bank Reports Threat by Fed*, WASH. TIMES, June 12, 2009, at A01.

84. *See* Neil Irwin & Binyamin Appelbaum, *Giant Investment Banks Grasp for Government Safety Net*, WASH. POST, Sept. 22, 2008, at A01.

85. *See* Carol D. Leonnig, *Government Again Expands AIG Rescue Plan*, WASH. POST, Nov. 11, 2008, at D01.

amid concerns that AIG would collapse and trigger widespread losses throughout the industry and financial sector.[86] In exchange, the government took a 79.9% stake in AIG.[87] In October 2008, the Fed authorized the borrowing of up to $37.8 billion in securities from AIG.[88] As of August 2009, the total investment in AIG has been almost $120 billion, which includes asset purchases, bridge loans, and government stakes in AIG subsidiaries.[89]

The banking industry similarly was marked by failures and government bailouts. On September 25, 2008, Washington Mutual declared bankruptcy and, in a transaction facilitated by the Federal Deposit Insurance Corporation ("FDIC"), sold its bank operations to JPMorgan Chase.[90] On September 28, as Wachovia appeared to be on the verge of insolvency, Wachovia began negotiating to be purchased by Citigroup, but ultimately closed a deal with Wells Fargo.[91]

These kinds of bank failures prompted the passage of legislation aimed at providing financial assistance to troubled banks, including some of the largest. Two such banks receiving significant aid were Citigroup and Bank of America. In November 2008, Citigroup, which had just received $25 billion in government funds in October 2008, received an added $20 billion in government funds, and the government agreed to guarantee about $306 billion in real estate and other loans and securities.[92] In exchange, the government received $20 billion of preferred stock in Citigroup, and as a fee for the guarantee, Citigroup agreed to issue the government an

86. *See id.*; Press Release, Fed. Reserve Bank of N.Y., Statement by the Fed. Reserve Bank of N.Y. Regarding AIG Transaction (Sept. 29, 2008), http://www.newyorkfed.org/newsevents/news/markets/2008/an080929.html [hereinafter *Statement by the Fed. Reserve Bank of N.Y. Regarding AIG Transaction*].

87. *Statement by the Fed. Reserve Bank of N.Y. Regarding AIG Transaction*, *supra* note 86.

88. *See* Barry Meier & Mary Williams Walsh, *AIG to Get Additional $37.8 Billion*, N.Y. TIMES, Oct. 9, 2008, at B01.

89. *See* David Goldman, *CNNMoney.com's Bailout Tracker*, CNNMONEY.COM, http://money.cnn.com/news/storysupplement/economy/bailouttracker.

90. *See* Davidoff & Zaring, *supra* note 40, at 41.

91. *Id.* at 42–43.

92. Eric Dash, *Citigroup to Halt Dividend and Curb Pay*, NYTIMES.COM, Nov. 24, 2008, http://www.nytimes.com/2008/11/24/business/24citibank.html. For the Fed press release on the Citigroup deal, see http://www.federalreserve.gov/newsevents/press/bcreg/20081123a.htm.

additional $7 billion in preferred shares.[93] The loan not only restricts the payment of bonuses and certain executive compensation, but also requires that Citigroup receive consent before paying dividends over one cent per share.[94] In February 2009, Citigroup received its third government intervention, increasing the government's stake in the company up to thirty-six percent, pursuant to which the government's preferred shares would be converted into common shares.[95] Thus, instead of injecting cash into the company, the government used its position to increase equity in the company.

Bank of America has received some $45 billion in government funds, including an initial $25 billion loan and an additional $20 billion loan in January 2009.[96] In addition, the government has agreed to guarantee some $118 billion of its assets.[97] The government also agreed to absorb certain bank losses in exchange for an additional $4 billion of preferred shares.[98] The Bank of America deal is structured like the Citigroup transaction, with the government acquiring an equity position in the bank while imposing compensation and governance restrictions on it. The combined loans make the government the largest Bank of America shareholder with approximately a six percent stake in the company.[99]

The collapse of the housing market and turmoil in the financial sector has had a devastating impact on the economy, triggering a recession both in the United States and abroad. Thus, 2007 and 2008 have been marked not only by steep drops in the stock market,

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93. *See* Dash, *supra* note 92 (describing term sheet).

94. Amanda Ruggeri, *Citigroup Receives Latest Government Bailout to Protect Troubled Lending Market*, U.S. NEWS, Nov. 24, 2008, http://www.usnews.com/articles/news/national/2008/11/24/citigroup-receives-latest-government-bailout-to-protect-troubled-lending-market.html. The dividend restriction essentially halts dividend payments at Citigroup.

95. *See* David Enrich & Deborah Solomon, *Citi, U.S. Reach Accord on a Third Bailout*, WALL ST. J., Feb. 28, 2009, at B1, *available at* http://online.wsj.com/article/SB123573611480193881.html. At the end of July 2009, Citigroup took steps to effectuate this conversion of the government's stake. *See Citi Takes Big Step to Giving U.S. 34 Percent Stake*, REUTERS, July 23, 2009, http://www.reuters.com/article/GCA-CreditCrisis/idUSTRE56M6DM20090723 (describing exchange offer).

96. *See* Eric Dash et al., *Bank of America to Receive Additional $20 Billion*, NYTIMES.COM, Jan. 16, 2009, http://www.nytimes.com/2009/01/16/business/worldbusiness/16iht-16merrill.19411223.html.

97. *Id.*; *see also* Press Release, FDIC, Treasury, Fed. Reserve and the FDIC Provide Assistance to Bank of Am. (Jan. 16, 2009), http://www.fdic.gov/news/news/press/2009/pr09004.html.

98. Dash, *supra* note 96.

99. *Id.*

but also by heavy job losses. By March 2009, the U.S. unemployment rate reached 8.5%, its highest level in over twenty-five years.[100]

As this section reveals, the boom and bust of the housing bubble set off a chain reaction in the broader financial and economic sector. The next section pinpoints some of the major ways in which the government responded to this collapse.

B. The Government Response

Broadly speaking, the government responded to the economic crisis with a steady drumbeat of legislation aimed at providing financial assistance both to specific industries in turmoil and to the broader economy. Moreover, as the problem worsened, each new piece of legislation and new program appeared to have a broader reach and mandate. This section briefly describes some of the most critical pieces of legislation.

1. Early legislative responses

The first major legislative effort to respond to the crisis was the Economic Stimulus Act of 2008 (the "Stimulus Act"), signed on February 13, 2008, by President George H.W. Bush.[101] The Stimulus Act appropriated some $266 million to provide certain tax rebates for individuals to be paid as quickly as possible.[102] For businesses, the Stimulus Act offered one-time incentives for investment in new equipment and write-off of tax losses.[103] The

100. The Associated Press, *U.S. Jobless Claims Rise more than Expected*, NYTIMES.COM, Apr. 23, 2009, http://www.nytimes.com/2009/04/24/business/economy/24econ.html.

101. *See* Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613 (Feb. 13, 2008).

102. The Economic Stimulus Act of 2008 ("ESA") appropriated $266 million for the Department of Treasury to be available until September 30, 2009. *See id.* § 101(e). The ESA allowed a tax rebate in 2008 of an amount equal to the lesser of an individual's net income tax liability or $600 (or $1200 for a joint return) as well as a $300 tax rebate per child. *Id.* § 101. The ESA also allowed at least $300 in tax rebates (or $600 for a joint return) for taxpayers who had qualified income of at least $3000, with qualified income defined as earned income, social security benefits for seniors and certain veteran's compensation and pensions. *Id.* Although the rebates placed limits on taxpayers who earn more than $75,000 (or $150,000 for joint returns), the rebates applied even to families that earned too little to pay taxes. *See id.* (noting that qualified individuals include taxpayers with income levels of at least $3000).

103. The ESA increased the limit up to which a business could expense property purchased and placed in service during 2008 to $250,000—its highest level ever and double the previous limit of $125,000. *See id.* § 102. The ESA also provided a special tax depreciation

Stimulus Act also increased the maximum mortgage amounts that various government agencies could give to potential homebuyers.[104] The plan deliberately did not include long term policy changes such as permanent tax cuts. Instead, the tax rebates were designed to improve the economy by quickly stimulating consumer and business spending. While one study of the Stimulus Act's impact suggests that it did successfully stimulate spending,[105] another found no significant increase in consumption resulting from the rebates.[106]

On July 30, 2008, President Bush passed legislation aimed at responding more directly to the housing crisis. The Housing and Economic Recovery Act of 2008 (the "Housing Act") provided some $300 billion in housing relief including additional property tax deductions, homebuyer tax credits, and development of a refinance program for homebuyers with subprime loans.[107] The Housing Act authorized the Federal Housing Administration (the "FHA") to guarantee up to $300 billion in new 30-year fixed rate mortgages for subprime borrowers.[108]

2. *TARP and economic reinvestment*

As the economy worsened, and it appeared clear that greater response was warranted, broader legislation surfaced. On September 20, 2008, Treasury Secretary Henry Paulson submitted a plan (the "Paulson Plan") to create a Troubled Assets Relief Program, or "TARP." The Paulson Plan, less than three pages long, proposed to use up to $700 billion to buy mortgage-related assets from any financial firm headquartered in the United States.[109] The purpose of

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allowance for certain property acquired and placed in service during the 2008 calendar year. *See id.*

104. In an effort to provide liquidity to the housing markets and continue to encourage the securitization of mortgages, the ESA temporarily increased loan limits eligible for purchase by Fannie Mae and Freddie Mac. *Id.* § 201.

105. *See* Christina Broda and Jonathan A. Parker, *The Impact of the 2008 Rebate*, VOXEU, Aug. 15, 2008, http://www.voxeu.org/index.php?q=node/1541.

106. Taylor notes that there was no statistically significant increase in consumption as a result of the rebate because most people saved their funds and did not spend their rebate checks. *See* Taylor, *supra* note 45, at 12-13.

107. *See* Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008).

108. *See id.* § 257.

109. *See Text of Draft Proposal for Bailout Plan*, NYTIMES.COM, Sept. 20, 2008, http://www.nytimes.com/2008/09/21/business/21draftcnd.html?ref=business [hereinafter *Draft of Paulson Plan*].

the Paulson Plan was to improve the liquidity and financial condition of entities hampered by mortgage-related assets by removing such assets from their balance sheets. The House generated an expanded version of the Paulson Plan, now 110 pages, and submitted it for vote on September 29.[110] Although supporters of the expanded bill insisted that a significant bailout was necessary to avoid a collapse of the financial and economic system, concerns about government intervention in the financial markets and the overall efficacy of the Paulson Plan ultimately led the House to vote it down.[111] The rejection was followed by a 778 point drop in the Dow Jones Industrial Average, the largest single-day point drop ever.[112]

Ultimately, on October 3, 2008, Congress enacted a revised plan (now 451 pages), called the Emergency Economic Stabilization Act of 2008 (the "Stabilization Act").[113] The Stabilization Act established the $700 billion TARP; however, it included more details and oversight than that proposed under the original Paulson Plan and the rejected House bill. The Stabilization Act granted broad authority to the Treasury Secretary to purchase "troubled assets"—mortgages, securities, or other instruments based on or related to such mortgages—and to develop policies and procedures related to that purchase.[114] TARP funding was approved on a graduated basis, such that $250 billion would be immediately available and an additional $100 billion would be released when the President submitted a request to Congress certifying that such funds were necessary.[115] However, while the President could submit a similar request for the final $350 billion, Congress could deny the request through a joint resolution of disapproval.[116] On January 12, 2009, at

110. *See* Jonathan Weisman, *House Rejects Financial Rescue, Sending Stocks Plummeting*, WASH. POST, Sept. 30, 2008, at A01; Carl Hulse & David M. Herszenhorn, *House Rejects Bailout Package, 228–205; Stocks Plunge*, NYTimes.com, Sept. 29, 2008, http://www.nytimes.com/2008/09/30/business/30bailout.html.

111. *See* Hulse & Herszenhorn, *supra* note 110.

112. Alexandra Twin, *Stocks Crushed: Approximately $1.2 Trillion in Market Value is Gone After House Rejects the $700 Billion Bank Bailout Plan*, CNNMoney.com, Sept. 29, 2008, http://money.cnn.com/2008/09/29/markets/markets_newyork/index.htm?postversion=2008092918.

113. *See* Emergency Economic Stabilization Act, Pub. L. No. 110-343, 122 Stat. 3765 (2008). The Stabilization Act also temporarily raised the FDIC insurance limits to $250,000. *See id.* § 136.

114. *See id.* § 101.

115. *See id.* § 115.

116. *See id.*

the request of President-Elect Barack Obama, President Bush requested the final $350 billion of TARP funds.[117]

Under the Stabilization Act, those who received TARP funds also became subject to certain executive compensation and corporate governance provisions. As an initial matter, a company receiving TARP funding must grant the government a warrant to receive stock or debt in the company—effectively enabling the government to take an equity interest in all of the companies to which it distributes TARP funds.[118] The Stabilization Act also allowed the Treasury Secretary to require companies to meet executive compensation and corporate governance standards for the duration of the period in which loans were outstanding. Thus, companies must impose limits on compensation to exclude incentives for senior executives (the top five most highly compensated executives) to take "unnecessary and excessive risks."[119] Companies also must provide for a "claw-back" or recovery of bonuses or other incentive-based compensation paid to a senior executive officer based on earnings or other criteria later proven to be materially inaccurate.[120] Moreover, companies are required to prohibit golden parachute payments to the senior executive officer, i.e., payments made at the executive's departure from the company for any reason, other than payments for services or benefits already accrued.[121] Notably, the Stabilization Act contained a grandfather clause for compensation payments made pursuant to a valid employment contract executed on or before the Stabilization Act's enactment.[122] When AIG, which had received some $170 billion in financial assistance under TARP and other plans, paid large bonuses to their executives,[123] the grandfather

117. Holly Rosenkrantz, *Obama Asks Bush to Seek TARP Funds From Congress*, BLOOMBERG.COM, Jan. 12, 2009, http://www.bloomberg.com/apps/news?pid=20601110&sid=aik5Wv_K3na8.

118. *See* Emergency Economic Stabilization Act § 113(d), Pub. L. No. 110-343, 122 Stat. 3765 (2008).

119. *Id.* § 111(a).

120. *Id.* § 111. Section 304 of the Sarbanes-Oxley Act of 2002, Pub. Law. No. 107-204, 116 Stat. 745, also has a claw-back provision, but it is more limited, as it only applies to the CEO or CFO of public companies, is based solely on a financial report, and has a limited recovery period.

121. *See* Emergency Economic Stabilization Act § 111(b)(2)(C), Pub. L. No. 110-343, 122 Stat. 3765 (2008).

122. *Id.* § 111(d).

123. David Cho & Brady Dennis, *Bailout King AIG Still to Pay Millions in Bonuses; Geithner Gets Firm to Make Revisions*, WASH. POST, Mar. 15, 2009, at A01; Edmund L.

clause was heavily criticized.[124] Finally, the Stabilization Act prohibited companies that received TARP assistance in excess of $300 million from taking a deduction for federal income tax purposes for compensation above $500,000.[125]

Pursuant to the newly enacted Stabilization Act, on October 28, 2008, the Treasury Department purchased $125 billion in preferred stock from nine banks that had previously agreed to subscribe to the TARP facility.[126] Five of the banks have repaid the Treasury Department, leaving $65 billion unpaid.[127] By July 2009, the Treasury Department had deployed $200 billion in financial assistance to hundreds of banks.[128] Only about $70 billion of these funds have been repaid.[129]

On February 4, 2009, the Treasury Department announced additional restrictions on executive compensation for TARP recipients (the "Treasury Guidelines").[130] The Treasury Guidelines drew a distinction between firms receiving funds through a "generally available capital access program," which refers to programs having the same terms for all recipients, and firms that

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Andrews & Peter Baker, *A.I.G. Planning Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES, Mar. 14, 2009, at A01, *available at* http://www.nytimes.com/2009/03/15/business/15AIG.html. AIG planned to pay some $165 million in bonuses. A few days later, the House approved a 90% tax on the bonuses as well as bonuses paid by any firms receiving significant sums of bailout money. Carl Hulse & David M. Herszenhorn, *House Approves 90% Tax on Bonuses After Bailouts*, N.Y. TIMES, Mar. 19, 2009, at A01, *available at* http://www.nytimes.com/2009/03/20/business/20bailout.html.

124. *See, e.g.*, *Dodd: Administration Pushed for Language Protecting Bonuses*, CNNPolitics.com, Mar. 19, 2009, http://www.cnn.com/2009/POLITICS/03/18/aig.bonuses.congress/.

125. Emergency Economic Stabilization Act, § 302(a)(5)(A)(i), Pub. L. No. 110-343, 122 Stat. 3765 (2008).

126. U.S. Gov't Accounting Office, *Troubled Asset Relief Program: Capital Purchase Program Transactions for October 28, 2008, through May 29, 2009, and Information on Financial Agency Agreements, Contracts, Blanket Purchase Agreements, and Interagency Agreements Awarded as of June 1, 2009 (GAO-09-707SP, June 2009), an E-Supplement to GAO-09-658*, http://www.gao.gov/special.pubs/gao-09-707sp/; *Bailed Out Banks: The Treasury Department Has Invested About $200 Billion in Hundreds of Banks Through Its Capital Purchase Program in an Effort to Prop Up Capital and Support New Lending*, CNNMONEY.COM, http://money.cnn.com/news/specials/storysupplement/bankbailout/ [hereinafter *Bailed Out Banks*].

127. *See Bailed Out Banks*, *supra* note 26.

128. For a list of all banks that have received funds as of July 2009, see *id.*

129. *See id.*

130. Press Release, U.S. Dep't of the Treasury, Treasury Announces New Restrictions on Executive Compensation, (Feb. 4, 2009), http://www.ustreas.gov/press/releases/tg15.htm.

require "exceptional assistance," and hence have specific negotiated agreements with the Treasury.[131] Examples of firms that fall under this exceptional assistance definition include AIG, Bank of America, and Citigroup. For firms receiving exceptional assistance, the new restrictions limited total annual compensation for senior executives to $500,000, other than restricted stock, which stock cannot vest until the government has been repaid with interest.[132] In addition, companies receiving TARP funds must have a "say on pay" vote from their shareholders—a non-binding vote on executive compensation.[133] The restrictions also expanded the number of employees subject to executive compensation limits. Hence, the once modest claw-back provision was expanded to encompass not just the top five senior executives, but the next twenty senior executives if they knowingly engaged in providing inaccurate information.[134] Similarly, the Stabilization Act's golden parachute prohibition was extended to the top ten senior executives, while providing that at least the next twenty-five executives would be prohibited from receiving golden parachutes in excess of one year's compensation.[135]

For firms participating in generally available capital access programs, the Treasury Department announced its intention to propose similar executive compensation rules for public comment.[136] While such rules were similar to those for firms with exceptional assistance, they were either less restrictive or applied to fewer executives.[137] These Treasury Guidelines reflected President Obama's efforts to "promote systemic regulatory reform" by ensuring that

131. *Id.*

132. *Id.* The Treasury Department also proposed that companies not receiving exceptional financial assistance be subject to this limitation unless it was waived by a vote of fully informed shareholders. The ESA already had made compensation in excess of $500,000 less attractive for companies by requiring that certain TARP recipients forgo any deduction for compensation for federal income tax purposes in excess of that amount. Hence, the Treasury Guidelines expand upon this requirement.

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.*

137. For example, with respect to golden parachutes, the ban would apply to the top five senior executives as opposed to ten. Moreover, instead of a complete prohibition on such parachutes, executives in companies receiving general assistance would be restricted to receiving a golden parachute that was no greater than one year's annual compensation. *See id.*

governance and compensation rules better promoted long-term value and growth.[138]

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (the "Reinvestment Act"), a $787 billion economic stimulus plan.[139] Similar to the 2008 Stimulus Act, the Reinvestment Act provided tax relief for individuals and small businesses.[140] However, the Reinvestment Act sweeps more broadly than tax relief by expanding unemployment and social welfare benefits while providing aid for education, health care, infrastructure, and energy.

The Reinvestment Act also amended the Stabilization Act to broaden the limits on executive compensation by providing more comprehensive provisions.[141] Although the Reinvestment Act adopted many of the restrictions articulated in the Treasury Guidelines, there were some differences between the two. Instead of limiting the rules to companies receiving exceptional assistance, the Reinvestment Act generally imposed such restrictions on all TARP recipients.[142] For example, the Reinvestment Act required that all companies receiving TARP funds have a shareholder "say on pay" vote.[143] The Reinvestment Act mirrored the Treasury Guidelines' claw-back provision for the top five senior executives and the next top twenty most highly compensated executives.[144] However, unlike the Treasury Guidelines, the Reinvestment Act's claw-back applied to such executives regardless of their knowledge of material inaccuracies on which their bonuses or other awards was based.[145] With respect to golden parachute payments, the Reinvestment Act tracked the Treasury Guidelines' expansion of the prohibition to a senior executive or any of the next five most highly compensated employees, but made no provision for any other executives.[146] The Reinvestment Act also did not incorporate the $500,000 annual compensation limit, but it did subject all TARP recipients to the

138. *See id.*

139. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115.

140. *See id.* §§ 1001–04, 1211–12.

141. *See id.* § 7001.

142. *See id.*

143. *Id.* § 7001(e)(1).

144. *See id.* § 7001(b)(3)(B).

145. *Id.* § 7001(b)(3)(B).

146. *See id.* § 7001(b)(C).

provision requiring that executive compensation over $500,000 cannot be deducted for federal income tax purposes.[147] The Reinvestment Act also prohibited all bonuses other than long term restricted stock, although the number of employees prohibited from receiving a bonus depended upon the amount of financial assistance.[148]

In addition to the restrictions that tracked, at least to some extent, the Treasury Guidelines, the Reinvestment Act imposed further requirements. TARP recipients must have a company-wide policy on approval for excessive or luxury expenditures.[149] Further, TARP recipients must establish a compensation committee of the board comprised entirely of independent directors who, among other things, generate compensation plans that exclude incentives for unnecessary and excessive risk taking.[150] The Reinvestment Act also requires the CEO and CFO to certify in writing their compliance with these new provisions in its annual SEC filings or to the Treasury Secretary in the case of non-public companies.[151]

Finally, the Reinvestment Act directed the Treasury Secretary to review bonuses, retention awards, and other compensation paid to senior executive officers and the next twenty most highly compensated employees to determine if they were inconsistent with revised compensation provisions, TARP, or the public interest.[152] If such a determination is made, the Reinvestment Act directs the Treasury to negotiate with the TARP recipient and employee for appropriate reimbursements.[153]

In June 2009, the Treasury Department reconciled the discrepancies between the Reinvestment Act and Treasury Guidelines by issuing rules implementing the executive compensation provisions of the Reinvestment Act (the "Executive Compensation Rules").[154] These Executive Compensation Rules consolidated and superseded

147. *Id.* § 7001(b)(1)(B) (incorporating the deduction prohibitions set forth in I.R.C. § 162(m)(5) where applicable).

148. *Id.* § 7001(b)(3)(D)(i).

149. *See id.* § 7001(d).

150. *Id.* § 7001(c)(2).

151. *Id.* § 7001(b)(4).

152. *Id.* § 7001(f)(1).

153. *Id.* § 7001(f)(2).

154. *See* TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394 (Jun. 15, 2009) (to be codified at 31 C.F.R. pt. 30), *available at* http://www.treas.gov/press/releases/reports/ec%20ifr%20fr%20web% 206.9.09tg164.pdf.

all the previous rules and guidance regarding executive compensation.[155] These rules essentially implemented the provisions of the Reinvestment Act, while drawing some distinctions with respect to the manner in which the provisions would be applied based on the amount of financial assistance being granted to particular TARP recipients.[156] The Executive Compensation Rules went beyond the provisions in the Reinvestment Act in some areas by, for example, requiring additional disclosures related to compensation matters.[157] Like the Reinvestment Act, the Executive Compensation Rules abandoned the $500,000 salary cap while maintaining the exclusion for tax deductions over such amount.[158] The Rules maintain the grandfather clause for bonuses made pursuant to a valid employment contract and even extended the grandfathered period to agreements made on or before February 11, 2009.[159] The Executive Compensation Rules also appointed a special master for TARP Executive Compensation who has responsibility for interpreting the executive compensation and governance provisions under TARP.[160]

As the foregoing suggests, the government's response to the crisis consisted primarily of legislation providing for increased levels of support and intervention.

3. Some key initiatives from the Federal Reserve

The Fed initially responded to the crisis by lowering interest rates. In September 2007, the Fed made its first in a series of interest

155. TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. at 28,396.

156. *See* Sullivan & Cromwell, *Strict New Executive Compensation Standards Under TARP*, Feb. 5, 2009, http://www.sullcrom.com/files/Publication/b6b306e9-66cc-4c7a-8424-12ed3206f273/Presentation/PublicationAttachment/ec4d87cb-6f07-4e1b-9f06-770f8bc4b992/SC_Publication_Strict_New_Executive_Compensation_Standards_Under_TARP.pdf.

157. *See* Press Release, U.S. Dep't of the Treasury, Interim Final Rule on TARP Standards for Compensation and Corporate Governance (Jun. 10, 2009), http://www.ustreas.gov/press/releases/tg165.htm.

158. *See* TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. at 28,396. Presumably, the cap still applies to companies that have already agreed to such restriction. Moreover, the Treasury Department still has the ability to demand such a cap in future negotiations with companies needing exceptional assistance.

159. *Id.*

160. *Id.* at 28,397.

rate cuts.[161] The rate cuts were designed to "forestall some of the adverse effects" of the tightening credit market.[162] Thus, the Fed continued its rate cuts as the economy weakened in an effort to counteract the deteriorating conditions in the market. [163] The Fed also participated in coordinate rate cuts, such as the one in October 2008 with the central banks of the European Union, Britain, China, Canada, Sweden, and Switzerland.[164] By December 2008, the Fed established a target range for the federal funds rate of 0 to 0.25%, while lowering the discount rate to 0.5%.[165]

In addition to these interest rate cuts, the Fed instituted various formal and informal financial assistance programs aimed at stimulating the economy and revitalizing particular companies. As Part III.B reveals, the Fed played an instrumental role in assisting several financial institutions. Moreover, the Fed instituted various funding facilities including two aimed at directly at benefiting consumers and struggling businesses. Thus, on October 6, 2008, the Fed responded to the growing deterioration in the commercial paper market by establishing a Commercial Paper Funding Facility, which

161. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 18, 2007), http://www.federalreserve.gov/newsevents/press/monetary/20070918a.htm. On September 18, the Fed lowered its target rate fifty basis points to 4.75% and lowered the discount rate fifty basis points to 5.25%.

162. *Id.*

163. In October, both the target rate and the discount rate were lowered to 4.5% and 5% respectively. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Oct. 31, 2007), http://www.federalreserve.gov/newsevents/press/monetary/20071031a.htm. In January, the rate was lowered seventy-five basis points to 3.5% for the target rate and 4% for the discount rate, noting that market conditions had continued to deteriorate along with further tightening of the credit market. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Jan. 22, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20080122b.htm. Eight days later, the Fed lowered the target and discount rates again to 3% and 3.5% respectively. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Jan. 30, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20080130a.htm.

164. This action brought the federal funds rate to 1.5% and the discount rate to 1.75%. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Oct. 8, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081008a.htm. The interest rate was lowered again on October 29, 2008, to 1% and 1.25%. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Oct. 29, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081029a.htm.

165. On December 16, 2008, the rate was again lowered to a target range for the federal funds rate of 0 to .25% and a discount rate of .5%. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Dec. 16, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081216b.htm.

would purchase short-term loans (commercial paper) from banks.[166] The Facility aimed to provide liquidity to the commercial paper market, thereby seeking to provide vital assistance to the many companies that used commercial paper to finance their day-to-day operations.[167] On November 25, 2008, the Fed created the Term Asset–Backed Loan Facility ("TALF") to lend up to $200 billion to support consumer loan-backed securities with the aim of reviving the securitization market for consumer loans such as student loans, credit cards, and auto loans.[168] This market had virtually halted by the second half of 2008.[169] Eventually, available funds under TALF were expanded to $1 trillion, and TALF was expanded to cover additional assets including commercial and residential leases.[170] These more formal programs were in addition to periodic loans provided to various companies.

4. The automaker bailout

In mid-November 2008, representatives from the "Big Three" automakers—General Motors ("GM"), Ford Motor Co. ("Ford"), and Chrysler LLC ("Chrysler")—met with lawmakers to discuss their dire financial condition and testified before Congress requesting financial aid.[171] GM, whose shares plunged to a six-decade low, warned that it was almost out of cash and without aid it would likely declare bankruptcy by year's end.[172] The automakers faced

166. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Oct. 7, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081007c.htm. The Facility funds a special purpose vehicle that purchases three-month unsecured and asset-based commercial paper. The Facility became effective on October 27, 2008.

167. *See id.*

168. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Nov. 25, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081125a.htm.

169. Adam B. Ashcraft et al., The Term Asset-Backed Securities Lending Facility (Mar. 17, 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361712.

170. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Feb. 10, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20090210b.htm.

171. The CEOs flew to Washington on private jets, spurring significant criticism and outrage. *See, e.g.*, Dana Milbank, *Auto Execs Fly Corporate Jets to D.C., Tin Cups in Hand*, WASH. POST, Nov. 20, 2008, at A03 (quoting Rep. Gary Ackerman as saying, "There's a delicious irony in seeing private luxury jets flying into Washington, D.C., and people coming off of them with tin cups in their hands."). When they came again to Washington asking for funds, the CEOs flew commercial.

172. Chris Isidore, *GM: Almost Out of Cash*, CNNMONEY.COM, Nov. 7, 2008, http://money.cnn.com/2008/11/07/news/companies/gm/index.htm [hereinafter Isidore, *GM:*

opposition not only from those who balked at giving money to a sector deemed to be poorly managed, but also from those who believed that TARP funds should be used only to assist the financial sector.[173] In addition, Congress was reluctant to institute another bailout on the heels of the recently enacted Stabilization Act. However, after considerable negotiation, a $25 billion auto-bailout bill was introduced in the House, entitled the Auto Industry Financing and Restructuring Act, which pulled funds from the $700 billion TARP funds (the "Initial Auto Bill").[174] The Initial Auto Bill enabled the president to designate an executive, dubbed by many as an "auto czar," to administer the funds and oversee the plan.[175] Similar to provisions regarding TARP funds, the bill required the government to take warrants for an equity interest in the automakers. The equity taken would likely have ensured that the government owned a majority stake in all three automakers. The Bill also included executive compensation limits similar to TARP such as restrictions on bonuses to the top twenty-five highest paid officers and bans on golden parachutes.

Concerns regarding the size of the Bill and reliance on TARP funds led the House to abandon it in favor of a revised bill (the "Revised Bill") that cut the aid to $14 billion and, instead of TARP funds, drew on funds previously appropriated under the Energy Independence and Security Act—a source that many Democrats were reluctant to tap because it was designated for enhancing fuel-efficient vehicles.[176] The Revised Bill required automakers to issue warrants to the government equal to twenty percent of the loan amount in exchange for loans.[177] The Revised Bill also contained restrictions on executive compensation similar to TARP and

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Almost Out of Cash]; Chris Isidore, *GM: Bailout Push Can't Halt Stock Slide*, CNNMONEY.COM, Nov. 10, 2008, http://money.cnn.com/2008/11/10/news/companies/gm_stock/index.htm [hereinafter Isidore, *GM: Bailout Push*].

173. *See* Isidore, *GM: Almost Out of Cash*, *supra* note 172; Isidore, *GM: Bailout Push*, *supra* note 172.

174. *Senate to Take Up Auto Bailout Bill on Monday*, MSNBC.COM, Nov. 14, 2008, http://www.msnbc.msn.com/id/27718233/ns/business-autos//.

175. *Id.*

176. *See* Auto Industry Financing and Restructuring Act, H.R. 7321, 110th Cong. § 10(a)(1) (2007).

177. *Id.* § 12(a)(2)(A); Peter Valdes-Dapena, *Auto Bailout ABCs*, CNNMONEY.COM, Dec. 11, 2008, http://money.cnn.com/2008/12/11/autos/auto_bailout_outline/index.htm?cnn=yes.

prohibited dividend payments during the period when an automaker was receiving financial assistance.[178] Moreover, each automaker would have to submit a restructuring plan detailing its proposal for achieving long-term viability.[179] The Revised Bill retained the auto-czar, and gave the czar the ability to review and prohibit any transactions valued in excess of $100 million.[180] Although the Revised Bill passed the House on December 10, it died in the Senate one day later.[181]

The Revised Bill's death in the Senate compelled President Bush to provide automakers with a lifeline. Based on the belief that such a lifeline was necessary to prevent the collapse of the American auto industry, on December 19, 2008, President Bush announced a plan (the "Auto Plan") pursuant to which he would use funds from TARP to provide an emergency loan of up to $13.4 billion for GM and $4 billion for Chrysler.[182] In most respects the Auto Plan mirrored the Revised Bill. For example, the Auto Plan continued to require that automakers produce a long-term plan for their profitability by March 31, 2009.[183] The Auto Plan also included limits on executive pay, bans on golden parachutes, and provisions requiring companies to sell their corporate jets.[184] Moreover the Auto Plan required that companies reach an agreement with the unions on wage and benefit cuts.[185] Since the plan's implementation, while Ford has not taken any money pursuant to the Auto Plan, GM and Chrysler automakers have received some $80 billion in financial assistance.[186]

Despite significant federal assistance, both Chrysler and GM ultimately declared bankruptcy. On April 30, 2009, the government essentially forced Chrysler to file for bankruptcy protection so that it could pursue a transaction with a foreign automaker, in what the New York Times referred to as "yet another extraordinary

178. Valdes-Dapena, *supra* note 177.

179. *Id.*

180. *Id.*

181. *Auto Bailout Dies in Senate*, CNN.COM, Dec. 12, 2008, http://www.cnn.com/2008/US/12/11/auto.bailout/index.html.

182. David E. Sanger et al., *Bush Aids Detroit, but Hard Choices Wait for Obama*, N.Y. TIMES, Dec. 20, 2008, at A01.

183. *Id.*

184. *Id.*

185. *Id.*

186. Goldman, *supra* note 89.

intervention into private industry by the federal government."[187] On June 1, 2009, GM declared bankruptcy in one of the largest bankruptcies in history.[188] When GM emerged from bankruptcy on July 10, 2009, the government owned sixty percent of its stock as a result of its financial assistance.[189]

C. Concluding Assessments

The foregoing discussion makes clear that the financial crisis prompted an unprecedented response from the government. The legal origins theory purports to predict how countries respond to legal problems and crises based on their legal origins. In order to test the saliency of this theory, the next section seeks to examine whether America's crisis response can be viewed as consistent with its legal origins.

IV. A THEORY THROUGH THE PRISM OF CRISIS

A. The Wrong Tool Kit?

Even a casual examination of the government's actions during the crisis strongly suggests that many of the ways in which the United States has responded to the crisis contradict its legal tradition and instead resemble what one would consider a civil law response. This Section will describe the manner in which America's response to the crisis appears to run counter to its legal roots.

1. Over-reliance on legislation

As an initial matter, the very fact that the United States response has been dominated by legislative action, and in some cases executive action, poses problems for the legal origins theory. As the United States' legal origins are rooted in the common law tradition, the legal origins theory suggests that the United States response will emphasize judicial rulemaking over legislative response to social or

187. Jim Rutenberg & Bill Vlasic, *Chrysler Files to Seek Bankruptcy Protection*, N.Y. TIMES, May 1, 2009, at A01.

188. Bill Vlasic & Nick Bunkley, *Obama is Upbeat for G.M.'s Future*, N.Y. TIMES, June 2, 2009, at A01; Peter Whoriskey, *GM Emerges From Bankruptcy After Landmark Government Bailout*, WASH. POST, July 10, 2009, at A1.

189. Whoriskey, *supra* note 188.

economic problems.[190] In stark contrast to this prediction, however, the United States response has been marked by a series of far-reaching legislative and executive actions. This includes three major stimulus plans, comprising more than $1.7 trillion in government spending.[191] In addition to a general stimulus, Congress also enacted a housing bill with a $300 billion price tag.[192] With the enactment of the commercial paper facility and TALF, the Fed also seemed to embrace a legislative oriented response to the crisis. Furthermore, the fact that there were two, albeit unsuccessful, efforts to enact legislation directed at revitalizing the auto industry underscores the tendency to rely on legislative solutions to the problems created by the crisis. While we ultimately abandoned these legislative initiatives, they were replaced not by judicial rulemaking, but by executive actions. Since such actions essentially mirrored those embodied in the abandoned legislation, they could be viewed as tantamount to a legislative response, again appearing to reflect a preference for legislative solutions during this current crisis. This legislative preference is incompatible with the legal origins theory's emphasis on the common law tradition of de-emphasizing reliance on legislation.

In addition to the Auto Plan, we have seen a series of executive actions, such as those related to executive compensation, that closely resemble legislative initiatives and thus evidence an apparent reliance on legislation as the more appropriate response to severe economic problems. Given the extent of the credit and financial crisis, this flurry of legislative activity may not be surprising. Indeed, it may be that during times of crisis it is difficult to look to courts because of their inability to respond quickly in shaping the progression of law. Moreover, even legal origins theorists acknowledge that countries may have a mix of common law and civil law strategies.[193] However, those theorists also predict that a country's legal origins will dictate which strategies dominate. In this respect, because the United States response has relied heavily and extensively on legislative and executive action, it poses problems for the legal origins theory

190. *See* La Porta et al., *supra* note 4, at 308, 310.

191. *See supra* Parts III.B.1–2 (discussing the 2008 Stimulus Act, the 2008 Stabilization Act, and the 2009 Reinvestment Act).

192. *See supra* notes 113–16 and accompanying text.

193. *See* La Porta et al., *supra* note 4, at 309.

because that theory emphasizes America's reliance on judicial rulemaking for problem solving.

As will be expounded below, this increased reliance on legislation represents a familiar criticism of the legal origins theory: many common law nations increasingly have come to rely on legislation in a manner seemingly inconsistent with a supposed orientation towards judicial rule making.[194] The government's response to the current crisis echoes and appears to support those criticisms. This criticism seems especially potent in the context of the current crisis because of the significant reliance on legislation as a crisis response. Importantly, the breadth of America's dependence on legislation suggests that, at least during this crisis, the United States has moved quite dramatically away from a common law response and by so doing has strayed significantly from its legal origins.

To be sure, this reliance may be explained by political changes since both the White House and Congress changed political affiliations during the crisis. Of course, while the Obama administration has enacted legislation since its tenure, the Bush administration's legislative responses outpace those of President Obama's administration. The Bush administration was responsible for enacting three major housing and stimulus packages as well as the Auto Plan and a host of initiatives from the Fed. However, political changes may do little to explain the heavy reliance on legislation since that reliance appeared to remain constant despite those changes[195]

In derogation of the legal origins theory, it would appear that the economic climate and severity of the crisis explains not only the relatively unprecedented reliance on legislation, but also the shift away from America's common law traditions. If this observation is accurate, it indicates that economics rather than legal origins better predicts America's response to social and economic problems, while at the very least suggesting that legal origins may be less relevant in the context of this current economic turmoil.

194. *See id.* at 310.

195. To be sure, it may be that the nature of the legislation changed with the change in political parties.

2. An emergent administrative and executive state

The legal origins theory indicates that reliance on administrative power is the hallmark of the civil law system. However, the United States response has not only heavily relied on administrators and regulators, but has also spurred the growth of administrative power.

Since the inception of the crisis, the government's response has relied quite heavily on the Fed, placing increased discretion and authority in the hands of a single administrator. The Fed is an independent government body that oversees the nation's monetary policy and seeks to maintain the stability of the financial system. Consistent with that role, the Fed was on the front lines in setting monetary policy in response to the crisis and instituting programs aimed at stimulating the economy. However, the Fed's authority and responsibility increased as the crisis worsened. Fed Chairman Bernanke facilitated or orchestrated many of the initial bailouts, including those involving Bear Stearns, AIG, and Merrill Lynch.[196] The Fed Chairman also was intimately involved with structuring deal terms for these transactions in a manner that was both unprecedented and at odds with a common law tradition. Although the crisis may have necessitated the Fed's actions, and even made such actions predictable at some level, that predictability does not seem attributable to legal origins. As a result, those actions seem to undercut the force of the legal origins theory in the context of crisis.

The increased role and power of the Fed coincided with a heightened role for the Treasury Secretary. Like the Fed, the Treasury Secretary played an increasingly significant role in structuring bailout deals and setting financial policy. In this role, the Treasury was on the forefront of announcing corporate governance and executive compensation guidelines.[197] Notably, the Treasury Secretary developed the TARP concept, and hence the primary stimulus legislation responsible for more than $1 trillion in government expenditure can be traced directly to the Treasury's heightened involvement in the crisis.[198] Consistent with the expansion of the Treasury Secretary's role during the financial crisis, the Stabilization Act vests significant control and discretion in the

196. Davidoff and Zaring, *supra* note 40, at 3.

197. *See supra* notes 126–34, 141, 168 and accompanying text.

198. *See* Rosenkrantz, *supra* note 117 (describing the original Paulson Plan upon which the Stabilization Act and Recovery Act were based).

Treasury Secretary to implement the TARP funding program, purchase and manage assets, and give guidance on foreclosure efforts.[199]

Interestingly, most of America's legislative actions create a host of administrators and regulators, appearing to further enhance its reliance on administrative power. The Stabilization Act provides for some eight different regulators or oversight boards with some responsibility to oversee TARP.[200] In fact, the Act provides for four bodies with some oversight role: the Office of Financial Stability, the Financial Stability Oversight Board, the Credit Review Committee, and the Congressional Oversight Panel.[201] The Act also directs the Comptroller General to provide ongoing oversight of TARP and monitor the performance of the TARP program.[202] The Stabilization Act also creates the Office of the Special Inspector for TARP who must audit and investigate the activities of Treasury in connection with TARP.[203] Additionally, the Reinvestment Act as implemented by the Treasury appoints a special master to help implement TARP's executive compensation and governance standards.[204] As Professors Steve Davidoff and David Zaring emphasize, Treasury Secretary Paulson and Fed Chair Bernanke appeared to be the unspoken leaders of the unparalleled government intervention in the economy.[205] While many may dispute the appropriateness of their actions, most would likely concur that the fact that they wielded such authority does not align with a common law tradition.

Beyond the administration of TARP, the initial and revised auto bills contemplated the creation of a so-called "auto czar," a

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199. *See* Economic Stimulus Act of 2008, Pub. L. 110-185, 122 Stat. 613, § 101 (2008).

200. This includes the Treasury Secretary, Assistant Treasury Secretary, the Office of Financial Stability, the Financial Stability Oversight Board, the Credit Review Committee, the Comptroller General, the Inspector General, and the Congressional Oversight Panel.

201. The Congressional Oversight Panel consists of five members, one chosen by each of the Speaker of the House, the House minority leader, the Senate majority leader, the Senate minority leader, and both the Speaker of the House and Senate majority leader after consultation with the minority leaders. *See* Economic Stimulus Act § 125. The Financial Stability Oversight Board consists of the Chairman of the Fed, the Treasury Secretary, the Director of the Federal Housing Finance Agency, the SEC Chair, and the Secretary of HUD. *See id.* § 104.

202. *Id.* § 116.

203. *Id.* § 121.

204. TARP Standards for Compensation and Corporate Governance, 31 C.F.R. § 30.11(a) (2009).

205. Davidoff & Zaring, *supra* note 40, at 3.

contemplation that dramatically diverges from its common law tradition. Even though President Bush's Auto Plan rejected the concept of an "auto czar", his plan nonetheless vests discretion in the Treasury Secretary to implement the plan and hence continues to embrace a reliance on regulators. To be sure, the proliferation of legislation almost demands an increased reliance on administrators to ensure the proper administration of the various programs encompassed in the legislation. Such reliance reflects an inevitable outgrowth of the shift towards enhanced legislation. Yet, just like that shift, the over-reliance on these agents is not consistent with America's legal origins, and thus cannot be explained by those origins.

3. Government intervention and the ideology of crisis legislation

Several scholars have criticized the legal origins theory because of the growing importance of legislation and administrative power over judicial rule-making.[206] The architects of the theory call this criticism unwarranted, contending that the theory is nevertheless still salient most importantly because even when common law nations adopt legislative responses, those responses will express "the common law way of doing things."[207] According to legal origins theorists, there is a guiding ideology or "tool kit" germane to each legal system, and legislation enacted under particular systems will embrace tools from their appropriate kit.[208] In other words, the legislation will reflect America's common law ideologies. However, this prediction is not borne out by the examination of legislation passed in response to the financial crisis. In effect, the legislation enacted in response to the crisis fails to express a common law ideology, but rather borrows tools from the civil law kit.

Perhaps most problematic for proponents of the legal origins theory are legislative efforts seemingly aimed at controlling banks. The quintessential hallmark of a civil law system—and thus one of its primary tools—is control of the banking system.[209] Despite the United States' common law tradition, one of the primary and earliest legislative and regulatory responses to the crisis was exchanging

206. *See* La Porta et al., *supra* note 4, at 290–91.

207. *Id.*

208. *See id.* at 307–09.

209. *See id.* at 294.

capital for equity in banks, thereby granting the government a stake in such entities. Under TARP, the government has injected over $200 billion into the U.S. banking system, and such injection has been coupled with the government taking an equity position in hundreds of banks.[210] Some scholars maintain that the government's initial outlay of $125 billion to the nation's nine largest financial institutions in return for equity represents "a partial nationalization which the United States had never seen before."[211] Still others have referred to the government's efforts on behalf of the banking industry as "shadow nationalization."[212] This is because the government has managed to take significant stakes in some companies. For example, the government is the largest shareholder at Bank of America, and one expert has argued that the government's latest transaction with Citigroup "covers up the underlying reality that the government is already essentially the majority shareholder in Citigroup."[213] These actions significantly undermine the credibility of the legal origins theory in the context of the current crisis.[214] Even beyond equity positions, the U.S. government has implemented other strategies that increase its control over bank activities. Some of its transactions impose restrictions on divided payments to shareholders, and others regulate executive compensation by prohibiting golden parachutes, restricting executive salary, and even mandating "say on pay" votes for shareholders.[215] In addition to the reports and disclosures required for TARP recipients, in February 2009, new Treasury Secretary

210. *See supra* notes 126–30 and accompanying text.

211. Davidoff & Zaring, *supra* note 40, at 3.

212. Edmund L. Andrews, *Rescue of Banks Hints at Nationalization*, N.Y. TIMES, Jan.16, 2009, at B1 (quoting a managing partner at Federal Financial Analytics).

213. *Id.* (quoting a managing partner at Institutional Risk Analytics).

214. Ironically, one of the first countries to exchange government funding for equity in banks was England—the "mother" of the common law approach. Moreover, Britain nationalized one of its banks as early as February 2008, a decision wholly at odds with the common law tradition that shuns such control over the banking industry. *See supra* note 76; David Jolly, *In Europe, a Stronger Push to Oversee Banks*, NYTIMES.COM, Jan. 20, 2009, http://www.nytimes.com/2009/01/20/business/worldbusiness/20ukbanks.html?fta=y. Britain's actions further undermine the credibility of the legal origins theory in the context of the current crisis. Indeed, if that theory cannot be used to explain the behavior of common law's mother, then surely it cannot be used to predict the actions of her children.

215. *See supra* notes 131–36 and accompanying text.

Timothy Geithner unveiled the "stress tests" plan for large banks.[216] The test is aimed at enabling the government to determine the strength of a bank's balance sheet, and hence further enhances the government's involvement in the banking arena.[217] These actions, coupled with those involving direct equity positions in banks, indicate that the government is taking greater control over the banking system, which the legal origins theory suggests should not be a fundamental solution to America's economic and financial problems.

Outside of banking, the government has embraced actions that expand its control over industries in a manner that belies the legal origins theory's predictions. Like government control over banking, civil law is closely associated with a "heav[y] hand of government ownership and regulation."[218] And yet, despite its common law roots, the U.S. government has responded to the crisis in a similar vein. Three examples highlight this phenomenon. First, the government seized control of Fannie Mae and Freddie Mac. In so doing, the government became the owner or guarantor of some forty-two percent of American mortgages[219] and, therefore, directly regulates a sizeable chunk of the mortgage industry. One expert called the government's decision to take over Fannie Mae and Freddie Mac, "one of the most sweeping government interventions in private financial markets in decades."[220] Second, the government's actions related to AIG have resulted in the government injecting as much as $173 billion into AIG[221] and owning almost eighty percent of its shares, essentially reflecting a nationalization of AIG[222] at odds with the common law tradition.

A third example is the failed and then revitalized response to the problems in the automobile industry. Under the final Auto Plan, the government not only acquires a stake in auto companies, but its stake is even greater than those acquired in the banking arena.

216. *See* Deborah Solomon & Jon Hilsenrath, *Bank Capital Gets Stress Test*, WALL ST. J., Feb. 26, 2009, at A3.

217. *See id.*

218. La Porta et al., *supra* note 4, at 286, 298.

219. Davidoff & Zaring, *supra* note 40, at 25.

220. Zachary A. Goldfarb et al., *Treasury to Rescue Fannie and Freddie: Regulators Seek to Keep Firms' Troubles From Setting Off Wave of Bank Failures*, WASH. POST, Sept. 7, 2008, at A01.

221. Davidoff & Zaring, *supra* note 40, at 34.

222. *See id.* at 30–34.

Moreover, in addition to restrictions on dividends and executive compensation, the Auto Plan restricts certain expenditures and requires auto executives to submit restructuring plans that have a host of target goals, including restructuring contracts with various stakeholders. The fact that the first two auto bills provided for the creation of an auto czar emphasizes the levels of control embodied in the legislative response, and the final Auto Plan's reliance on the Treasury Secretary does little to negate this emphasis. Reflecting the extent of government intervention in the industry, one commentator referred to the government's actions as "Nationalizing Detroit."[223] From a legal origins perspective, the terms of all of the auto plans do not reflect America's common law ideologies, discrediting the notion that its origins would dictate the manner in which the United States responds to crisis. By straying from its origins, America's response suggests that factors beyond legal origins have played a greater role in shaping its behavior.

Another government response highlighting its interventionist tendencies is its active participation in deal structuring. For instance, the government was actively involved in structuring the deal to have JP Morgan purchase Bear Stearns. Its involvement included rejecting market-based solutions in favor of a government-controlled response to Bear Stearns's distress.[224] Similarly, the government played a critical role in structuring a deal for Wachovia, pursuant to which the FDIC selected Citigroup as a suitor and initially rebuffed attempts by Wells Fargo to participate in the transaction. As Professors Davidoff and Zaring note, these actions reveal a "preference for orderly as opposed to market solutions."[225] Of course, Wells Fargo eventually acquired Citigroup with the government's approval. However, the government continued its role as dealmaker so that when Citigroup sued Wells Fargo and Wachovia, the FDIC intervened and attempted to mediate among the parties.[226] The government also played an instrumental role in both the Washington Mutual and Bank of

223. *See* James L. Gattuso, *Auto Bailout Bill: Nationalizing Detroit?*, HERITAGE FOUNDATION WEB MEMO NO. 2164, Dec. 9, 2008, http://www.heritage.org/research/economy/wm2164.cfm.

224. *See* Davidoff & Zaring, *supra* note 40, at 12. Because only the Fed would provide financial assistance to JP Morgan, it essentially locked other potential bidders out of the process. *Id.*

225. *Id.* at 42.

226. *Id.* at 43.

America transactions.[227] Finally, the government structured transactions for the automakers, apparently forcing Chrysler to declare bankruptcy and enter into negotiations with particular parties.[228] Because common law countries are supposed to prefer market-based solutions over government-sponsored transactions, this kind of extensive interaction seems at odds with the United States common law tradition.

This discussion reveals that, from its role as dealmaker to its actions that serve to control banking activities and the actions of entities in other industries, the government embraced practices that ran counter to its legal origins.

4. *The marginalization of judicial review*

Perhaps more troubling than the reliance on legislation is the role that the legislation carves out for the courts. The bedrock of the common law system is reliance on judicial rulemaking to shape the law and respond to social and economic problems.[229] It is then notable that the Paulson Plan introducing the first TARP proposal made no role for judicial authority at all.[230] Instead, the Paulson Plan indicated that the Treasury Secretary's decisions "may not be reviewed by any court of law or any administrative agency."[231] The Paulson Plan provided for the Treasury Secretary to report to Congress, while authorizing the Treasury Secretary to take any actions it deemed necessary to carry out the purchases.[232] The ultimate Stabilization Act did provide for very limited judicial review under an arbitrary and capricious standard. While this is a standard used for all agency decisions, its deferential nature scarcely allows for significant judicial rulemaking.[233] Given the central role judicial

227. *See id.* at 41–42.

228. *See* Rutenberg & Vlasic, *supra* note 187, and accompanying text.

229. *See* La Porta et al., *supra* note 4, at 303–05.

230. The first TARP plan was only three pages and rested the sole discretion of the plan with the Treasury Secretary. *See* Davidoff and Zaring, *supra* note 40, at 47.

231. *See Draft of Paulson Plan*, *supra* note 109.

232. This means that the lack of judicial review is accompanied by an apparent lack of Congressional review. *See* Davidoff and Zaring, *supra* note 40, at 48–49 (noting that the bill may have unconstitutionally delegated an undefined amount of Congress's power to the Treasury and as a result, the bill likely would have been problematic under the nondelegation doctrine).

233. On the one hand, Professors Davidoff and Zaring do note that the government wins between 55–65% of cases under such a standard, *id.* at 52, suggesting that there is a substantial

rulemaking plays in the common law tool kit, this relatively minimal role also undermines the extent to which the legal origins theory may be viewed as influencing government actions in this area.

The Fed's prominent role in the crisis response further diminished the role for judicial oversight. This is because, in many respects, the Fed's actions apparently are removed from judicial review. Thus, courts have not substantively reviewed monetary policy decisions and bank financial assistance.[234] For example, when shareholders challenged the Bear Stearns deal, the Delaware Chancery court refused to review the decision.[235] Similarly, Bear Stearns shareholders opted to forgo challenging the deal in New York based on concerns that the court would be reluctant to review the deal.[236] In relying primarily on the Fed, the governmental response inevitably strayed from reliance on judicial rulemaking or review.

As the foregoing discussion reveals, the United States response has been guided by initiatives and tools that are distinctly civil law in nature. The embrace of these civil law devices not only suggests that the crisis prompted the United States to reject its origins, but also that other forces, such as social or political concerns, have driven its response more than any adherence to such origins.

B. A Second Look at the Kit and Tools

To be sure, if one looks more deeply at the United States crisis response, strands of its legal origins emerge. While those strands may not overcome the heavy focus on civil law strategies, they nevertheless suggest that the legal origins theory many have some predictive value even in the midst of crisis.

1. Nationalization by any other name . . .

As an initial matter, the characterization of America's relationship with banks as nationalization appears to be exaggerated. This is

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percentage of cases successfully challenged. On the other hand, because the Act prohibited any form of equitable relief, it leaves unclear how the judicial review would work in practice. *Id.* In other words, the Act itself may have stripped the teeth out of any purported judicial review. *See id.* ("[T]he bill appeared to grant judicial review in one section, and then took it away, by taking away equitable relief, in the other section.").

234. *Id.* at 15.

235. *Id.* at 19.

236. *Id.* at 10–20.

because the government's actions do not really amount to control over the banks. Indeed, the equity positions the government takes in the banks must either be nonvoting or taken with the agreement not to vote. Moreover, as is clear from the backlash associated with the government's apparent inability to prohibit problematic practices at banks and other institutions, much of the newly enacted legislation does not dictate bank lending practices nor does it require banks to account for how they spend government funds. The TARP program has been criticized because lawmakers cannot track how the money is spent, revealing that it has no real control over banks and how they operate or use their resources.[237] To be sure, all of these things have been viewed as causes for concern—and it seems like they will be altered going forward—but the lack of control over bank practices and procedures undermines the nationalization claim.[238] It also suggests that the legislation has been implemented in a way that is consistent with America's traditions of allowing the banking industry to shape its own policies, even if that implementation is detrimental and may breed fraud.

Moreover, the government has taken great pains to ensure that its investment activities did not amount to nationalization. Hence, with respect to Citigroup, instead of creating a relatively straightforward transaction that would lead to nationalization, the government created a complicated financing structure for some of its Citigroup investments to avoid the appearance of nationalization. In doing so, the government displayed its willingness to "'bend[] over backwards'" to prevent nationalization.[239] These concerted efforts indicate a strong allegiance to the common law's rejection of controlling banks even in the midst of crisis. As a result, they confirm the enduring influence of legal origins.

2. Paved with good intentions?

Another factor supporting the legal origins theory is the stated purpose behind America's regulation and legislation. Indeed, the

237. *See* Jack Healy, *Regulators Urge Better Oversight of Bailout Fund*, NYTIMES.COM, Feb. 5, 2009, http://www.nytimes.com/2009/02/05/business/worldbusiness/05iht-06tarp.19963306.html.

238. *See id.* (noting lack of oversight programs with TARP and that it was vulnerable to fraud).

239. Enrich & Solomon, *supra* note 95 (quoting the chief investment officer of Spectrum Asset Management).

legal origins theory would be irrelevant if it could not account for the growth of the regulatory state. However, proponents of the theory insist that legal origins predicts a distinction between common law and civil law countries based on their rationale for regulation. Common law oriented countries regulate for the purpose of supporting and rehabilitating markets.[240] This rationale certainly appears to be embedded in most of America's regulation aimed at responding to the crisis. The Paulson Plan provided that in exercising authority to distribute government funds, the Treasury consider two principles: "providing stability or preventing disruption to the financial markets or banking system[,] and protecting the taxpayer."[241] These considerations mirror the common law concern with protecting private property and supporting markets.

Such considerations find their counterpart in many other initiatives. The preamble of the Stimulus Act indicates that its purpose is to "provide economic stimulus . . . [and] incentives for business investment . . . ."[242] The preamble of the Stabilization Act indicates that its purpose is to stabilize the financial system and prevent disruption in the economy.[243] The Reinvestment Act's purpose included stabilizing government budgets and promoting economic recovery.[244] Along these lines, much of the Fed's actions were designed to shore up the credit markets and forestall a deepening crisis.[245] The Fed's commercial paper facility was designed to increase liquidity, while TALF was designed to increase the availability of credit and thereby support economic activity.[246] In each of these instances, the United States rhetoric and rationale coincide with a legal origins orientation. To the extent the rationale

240. *See* La Porta et al., *supra* note 4, at 308–09.

241. *Draft of Paulson Plan*, *supra* note 109.

242. Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613 (2008).

243. Emergency Economic Stabilization Act, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

244. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111–5, 123 Stat. 115. Of note, the Reinvestment Act's purposes sweeps more broadly, encompassing a desire to preserve and create jobs and assist those impacted by the recession. *See id.* These broader mandates are less compatible with a common law ideology, and perhaps reflect the influence of the political shift.

245. *See supra* notes 182–83.

246. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Nov. 25, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081125a.htm; *see also* Healy, *supra* note 237 (noting that the aim of the consumer lending program is to draw customers back to frozen student, car, and business loan markets).

for regulation matters more than the tools used to implement that regulation, these statements of purpose validate the influence of legal origins.

3. Ideology reconsidered

Another indication of the relevance of the legal origins theory may be in the difficulties with enacting legislation and other regulation. Certainly the Fed's refusal to bail out Lehman Brothers reflected its desire to adhere to legal origins, and hence prefer market forces to government intervention, even if those forces hastened the demise of a financial institution. The possibility that the refusal may have worsened the economic crisis only underscores the strength of the commitment to common law ideas. Congress's refusal to bailout the auto industry also stemmed in part from a desire to steer clear of government control. And this desire emerged with each successive stimulus package, making passage of such packages difficult even when lawmakers were informed that delay could have severe repercussions for the economy. Hence, despite the apparent need for government intervention, America's commitment to common law ideologies made it difficult to embrace that intervention without deep reservations. Echoing these reservations, Bush noted that he was "forced . . . to ignore many of the free-market principles he came to office embracing."[247]

Even after enactment, America's commitment to common law principles appears to have prompted it to engage in actions counter to its self-interest. For example, providing the necessary capital to the banking industry while avoiding equity stakes and other appearances of government control of the banking industry required the U.S. government to engage in unprecedented financial gymnastics.[248] Moreover, the administration of TARP is plagued with problems associated with the government not wanting to appear as if it owns banks.[249] These actions make administering TARP and other programs more opaque and difficult, but they reflect America's commitment to common law principles, even where civil ones may

247. David E. Sanger et al., *Bush Aids Detroit, but Hard Choices Wait for Obama*, N.Y. TIMES, Dec. 20, 2008, at A1.

248. *See* Andrews, *supra* note 212, at B1 (noting that aid packages to Bank of America and Citigroup reflected "displays of financial gymnastics aimed at providing capital without appearing to take commanding equity stakes").

249. *See id.*

be more efficient. Although its response was ultimately legislative in nature, the United States' deep reservations and financial gymnastics may highlight its core commitment to legal origins even in financial upheaval.

V. CONCLUSION

When you look at the United States response to financial crisis in light of its legal origins, what emerges is a potentially mixed story. On the one hand, the government appears to have adopted strategies wholly antithetical to its legal origins. Perhaps most troubling are the transactions that appear to result in nationalization of certain banks and certain industries. Equally troubling is the heavy government intervention—from bailouts to its role as direct and primary negotiator in a wide variety of transactions. These actions, combined with the government's embrace of steadily broader legislation, belie any prediction that America's response would gravitate towards common law strategies and ideologies. Hence, they pose problems for the predictive value of the legal origins theory, at least with respect to the current crisis.

On the other hand, some strands of the crisis legislation and the United States response firmly embrace its origins and at least reflect a rhetorical commitment to them. This may suggest that during times of severe crisis, political, social, and, most importantly, economic forces may compel the United States to adopt civil-law oriented solutions. However, those forces do not compel the United States to eliminate its fundamental orientation. In this regard, legal origins is relevant, because it may explain the way in which the United States' problem-solving is inherently limited, while also predicting the temporary nature of those civil-law oriented solutions.