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THE U.S. GOVERNMENT AS DOMINANT SHAREHOLDER: HOW SHOULD
TAXPAYERS' OWNERSHIP RIGHTS BE EXERCISED?

TESTIMONY

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Chairman Kucinich, Ranking Member Jordan, and distinguished members of the Committee, it is a privilege to testify in this forum today. My name is J.W. Verret. I am an Assistant Professor of Law at George Mason Law School, a Senior Scholar at the Mercatus Center at George Mason University and a member of the Mercatus Center Financial Markets Working Group. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of state and federal authority in corporate governance.

The past year has seen some unprecedented events in the history of American business. Through the bailout our government has become a controlling shareholder in Citigroup, AIG, Bank of America, Fannie Mae, Freddie Mac, General Motors, GMAC, and a host of other TARP recipients.

Some political leaders have argued that since the government owns these companies, it should seek to control their day-to-day business decisions. The reason I have joined you today is to explain why this view is not only misguided, but downright dangerous to the taxpayer's investment as well as the pension funds and retirement funds of ordinary Americans. For more on this issue please see my paper forthcoming in the *Yale Journal on Regulation*, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*.

Government ownership in private companies perverts the accountability of both government and business. To understand why, one must appreciate that government leaders and business leaders are held accountable by entirely different means. Governments are accountable to voters based on their ability to get re-elected by voters.

Business leaders are held accountable by their ability to maximize profits for their shareholders. And the overwhelming majority of those profits for shareholders go to main street investors. Teachers, firefighters, policeman, and other working Americans depend upon this mechanism to fund their retirements.

Maintaining a buffer between short-term political interests and long-term financial soundness is critical. The economic evidence from around the globe is overwhelmingly clear that political ownership of private banks and financial companies results in lower GDP growth, increased need for government bailout, and politicized lending practices.

For instance, in Italy, banks with government ownership lend at lower interest rates in the South, as that region is the Prime Minister's base of support. I am concerned that we may see TARP banks encouraged to subsidize lending in battleground states.

The Treasury Department owns one-third of Citigroup. This fact has given the government enormous power over Citigroup's operations. But holding shares alongside government shareholders is a particularly dangerous proposition for shareholders. Consider the case of Andrew Hall, the legendary commodities trader who ran the Phibro unit of Citigroup.

Mr. Hall was a banker who produced an average of \$250 million per year over the last 5 years for Citigroup and its investors. He was paid a percentage of what he earned for the bank. His annual salary was high, but was an entirely performance-based pay package.

The pay czar decided that his salary was just too large to justify to populist pressures, and so Citigroup was forced to sell off his Division at a discount. Make no mistake, losing Andrew Hall will cost Citigroup hundreds of millions of dollars per year. And that cost will fall on Citi's investors, including the taxpayer and pensioners who invest in Citi. But the decision was politically advantageous to the executive branch in the short term, and so it was inevitable.

The case of General Motors is even worse. GM has been pressured by political leaders, responding to alliances with failed automobile dealerships, to keep those failed dealerships open. Political leaders have exerted pressure to force GM to overpay on its shipping contracts so that truckers using politically favored unions, like the Teamsters, win the bids. Make no mistake, the cost of this crony capitalism is borne by the American taxpayer.

In corporate and securities law, shareholders with control over companies face the same corporate and securities liability to other shareholders as the board of directors and the executives of the company. Government shareholders that exercise control, however, have sovereign immunity from liability. The Treasury department is also given an express exemption from insider trading laws. Government shareholders don't have to play by the same rules as the rest of us, a fact which will strain the governance mechanisms of the capital markets at a time when they are already in crisis.

Bi-partisan legislation pending in the House (H.R. 3594) and Senate (S. 1280) stand to address these drawbacks and create a buffer between the taxpayer's investment and the politicians who would use that investment to pander to special interests. The "TARP Recipient Ownership Trust Act of 2009," would require the Secretary of the Treasury to place ownership of TARP investments in trust to be held on behalf of the American people. The Act would task those trustees with a fiduciary duty to maximize the value of that investment. It would also include a sunset provision requiring that the Treasury sell its investment in these companies by December 24, 2011.

The prospect of the government actively voting their shares in TARP recipients holds grave risks. Political leaders have stuffed the federal budget with pork barrel projects at great cost to the American taxpayer. We must not permit them to do the same to the budgets of privately held companies. If we do, the taxpayer will be left holding the tab.