

IS THE GOVERNMENT'S TAKEOVER OF AIG CONSTITUTIONALLY PERMISSIBLE?

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I. INTRODUCTION: THE CONTROVERSY SURROUNDING A FEDERAL TAKEOVER OF A PRIVATELY-RUN FINANCIAL INSTITUTION

A federal takeover of a private financial institution is a controversial move by a government founded on capitalistic principals, and perhaps an illegal attempt by the government to control private industry. Section 13(3) of the Federal Reserve Act allows the Federal Reserve to extend financial assistance to troubled companies under certain conditions.¹ Under the claimed authority from this section, the Federal Open Market Committee (FOMC), part of the executive branch of the United States Government, seized control of American International Group (AIG) on Wednesday, September 17, 2008, in an \$85 billion deal.² This takeover is allegedly justified in light of the chaotic economic conditions and potentially devastating consequences of allowing AIG to fail.³ The takeover effectively puts the federal government, which used taxpayer dollars to finance this transaction without prior direct congressional action, in control of a privately owned company.⁴ Such a direct and drastic move has never been conducted, and it is likely that the Federal Reserve has exceeded the authority granted to it by Congress under section 13(3) of the Federal Reserve Act.⁵ Even if the takeover of AIG was authorized by section 13(3), the FOMC and AIG have not shown evidence that proper procedural

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¹ Press Release, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, Sept. 16, 2008, *available at* <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm>.

² Steven M. Davidoff, *A.I.G.'s Bailout Terms Revealed*, N.Y. TIMES, Sept. 30, 2008, *available at* <http://dealbook.blogs.nytimes.com/2008/09/30/aigs-bailout-terms-revealed/>.

³ Matthew Karnitschnig, et al., *U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, THE WALL STREET JOURNAL, Sept. 17, 2008, *available at* <http://online.wsj.com/article/SB122165238916347677.html>.

⁴ Dale Oesterle, *AIG Bailout Details: What a Legal Mess*, Business Law Prof Blog, http://lawprofessors.typepad.com/business_law/2008/week41/index.html (Oct. 8, 2008).

⁵ Dale Oesterle, *Does the Fed Have the Power to Buy AIG?* Business Law Prof Blog, http://lawprofessors.typepad.com/business_law/2008/week38/index.html (Sept. 19, 2008).

guidelines, such as a ten day notice to shareholders of AIG before the issuance of convertible preferred stock, were followed.⁶ While it is too early for the outcome of this takeover to be determined, lawsuits challenging the bailout are currently being filed by AIG shareholders whose equity stakes in the company have mostly been eliminated by the massive dilution of AIG's shares following the takeover.⁷ Before evaluating AIG's bailout, it is important to first understand who AIG is in order to appreciate why this bailout occurred.

II. WHO IS AMERICAN INTERNATIONAL GROUP AND WHAT DO THEY DO?

American International Group is one of the world's largest insurers.⁸ It operates in more than 130 countries worldwide and is especially active in Britain as the top seller of investment bonds.⁹ Many individuals across the world have purchased travel, life, or household insurance coverage from AIG.¹⁰ However, AIG's insurance products are not limited to these traditional insurance packages, and include a wide array of complex financial instruments that are structured for commercial banks, investment banks, and hedge funds around the globe.¹¹ AIG's insurance on certain bonds, American mortgages, and mortgage-backed securities are of particular concern to the current economic crisis.¹² These insurance products are known as credit default swaps (CDS), many of which are directly or indirectly linked to the value of U.S. mortgages.¹³

Credit default swaps are insurance against default on risky assets, such as defaults on bonds and other debt instruments.¹⁴ Major bond holders often

⁶ Posting of Steven M. Davidoff to the DealBook Blog, *The A.I.G. Bailout Takes Shape*, N.Y. TIMES, Sept. 30, 2008, available at <http://dealbook.blogs.nytimes.com/2008/09/24/the-aig-bailout-takes-shape/>.

⁷ Phil Milford, *AIG Holder Wins Fast-Track Status for Bailout Suit (Update 2)*, BLOOMBERG, Nov. 7, 2008, <http://www.bloomberg.com/apps/news?pid=20601127&sid=aHbyDjTR3NhQ&refer=law>.

⁸ Miles Costello, *Q&A: What does the AIG bailout mean?*, TIMES ONLINE, Sept. 17, 2008, available at http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article4773292.ece.

⁹ *Id.*

¹⁰ *Id.*

¹¹ Jeannine Aversa, *Government Provides Record Aid Package to AIG – Gov't Provides \$150 Billion Aid Package to Insurance Giant AIG; Largest Ever Private Bailout*, ABC NEWS, Nov. 10, 2008, available at <http://abcnews.go.com/Business/Economy/wireStory?id=6219174>.

¹² Costello, *supra* note 8.

¹³ Aversa, *supra* note 11.

¹⁴ *AIG and The Trouble With "Credit Default Swaps"*, NPR, Sept. 18, 2008, available at <http://www.npr.org/templates/story/story.php?storyId=94748529>.

purchase CDS to protect themselves against the risk of debtor's failure.¹⁵ While the cost of purchasing CDS from a third party provider lowers the overall expected rate of return on a bond (not the bond's coupon rate, but the actual realized rate of return after subtracting the cost of the CDS from the bond coupon payments), it also substantially lowers the risk to the investor, assuming the insurance provider is still solvent at the time of default.¹⁶ This allows bond investors to purchase higher yielding bonds (those with more inherent risk, and thus a built in higher coupon rate) and simultaneously purchase insurance against their default.¹⁷ This practice often results in a higher overall return, despite the cost of the CDS, than the bond investor would have made by purchasing a safer, more traditional bond in the first place.¹⁸ Thus, CDS provide an incentive for institutional investors to purchase riskier assets than they otherwise would.¹⁹ Since the investor will be insured in the event of default, the default risk of the debtor is no longer a primary concern.²⁰ Rather, the institutional investor's goal is to achieve the highest coupon payment possible against the lowest cost of the CDS, disregarding risk valuation all together.²¹ As a corollary of this, the CDS issuer should realize that these insurance products are usually only purchased for investments in which the investor believes there is a substantial risk of default.²²

Insurance companies, like AIG, must maintain adequate capital reserves in order to meet the insurance claims of their customers.²³ In fact, insurance companies are regulated by state law with respect to minimum capital reserve levels.²⁴ A primary method of obtaining these funds is for the insurance company to offer deposit services in addition to saving the coupon payments their customers pay to them for the insurance coverage.²⁵ They may also offer hybrid insurance and savings plans, such as whole life insurance.²⁶

¹⁵ *Id.*

¹⁶ *Credit Default Swaps Explained*, ECONOMICS HELP, Nov. 11, 2008, <http://www.economicshelp.org/blog/finance/credit-default-swaps-explained/>.

¹⁷ *Id.*

¹⁸ F. William Engdahl, *Credit Default Swaps The Next Crisis: Sub Prime is Just 'Vorspeise'*, FINANCIAL SENSE EDITORIALS, June 6, 2008, available at <http://www.financialsense.com/editorials/engdahl/2008/0606.html>.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ Richard W. Kopcke, *Deposit Insurance, Capital Requirements, and Financial Stability*, FEDERAL RESERVE BANK OF BOSTON, Apr. 30, 2000, available at http://www.bos.frb.org/economic/wp/wp2000/wp00_3.pdf.

²⁴ Greg Schwab, *State Regulation of Insurance Authority, Recent Developments and Ohio Law*, Ohio Legislative Service Commission Member's Only Brief (Feb. 12, 2001), available at <http://www.lsc.state.oh.us/membersonly/124insurance.pdf>.

²⁵ Kopcke, *supra* note 23.

²⁶ *Id.*

Often, insurance companies will be a subsidiary of a much larger financial company, and have guaranteed access to a pool of funds from other owned subsidiaries, such as a sister commercial bank subsidiary in the same holding company as the insurance provider.²⁷ Regardless of how the insurance company generates these funds, it is essential that their capital reserves are adequate to pay off valid insurance claims.²⁸ The alternative is bankruptcy, which leaves the insurance companies' insured customers out of luck on any coverage claims they may make.²⁹ Thus, when the CDS issuer files for bankruptcy, suddenly the magnitude of risk on an institutional investor's portfolio of CDS-insured assets skyrockets.³⁰

AIG treated their CDS business the same as it treated their other insurance products: by betting that they will only have a few isolated claims at a time.³¹ For example, with traditional homeowner's insurance, when one customer's home burned down, the likelihood of the remaining customer's homes burning was not significantly increased.³² Thus, applying data collected over the years and appropriate risk management practices, the insurer can calculate a suitable amount of capital reserve to maintain in order to pay off these sporadic and isolated claims.³³ However, this fundamental capital requirement calculation does not apply to bond insurance, where defaults traditionally function in a domino-like scheme.³⁴ With bonds, one default can create a domino effect of failures because investors lose confidence in the market, interest rates fluctuate dramatically, and depository institutions become unable to find new capital to stay afloat as investors panic and withdraw their funds for safer havens.³⁵ Furthermore, bond defaults occur much more often in weak economic climates, when companies struggle with revenues and are unable to meet current cash demands.³⁶ Such a weak economic climate was present during AIG's collapse.

III. THE ECONOMIC CLIMATE AT THE TIME OF AIG'S BAILOUT: CRISIS

Part of the claimed justification, and more importantly, claimed authority, for AIG's unusual governmental bailout is related to the economic

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ NPR, *supra* note 14.

³² *Id.*

³³ *Id.*

³⁴ John Carney, *The AIG Collateral Call Domino Effect*, CLUSTERSTOCK, Nov. 3, 2008, <http://clusterstock.alleyinsider.com/2008/11/the-aig-collateral-call-domino-effect>.

³⁵ NPR, *supra* note 14.

³⁶ Carney, *supra* note 34.

conditions of the company and the general market at the time of the takeover.³⁷ Therefore, it is necessary to understand the events leading up to the credit crisis, as well as the crippled state of the market at the time of AIG's bailout.

The week of September 15, 2008 was one of the most dramatic and unusual weeks in history for Wall Street, and in particular, for financial companies.³⁸ Prior to this week, Wall Street had been battling to control a very serious credit crisis.³⁹ This crisis began in the subprime housing industry.⁴⁰ For several years prior to the subprime meltdown, the United States had experienced an ever expanding housing bubble, with rapid rises in home prices and decreased lending standards due in part to the securitization (and accompanying shift of default risk) of subprime mortgages away from the loan issuer.⁴¹ With default risk now shifted away from the lender's own balance sheets, lenders profited by making as many loans as possible (lender's profit was derived from the spread between the costs of originally issuing the loan and the price investors, such as Fannie Mae and Freddie Mac, were willing to pay for the right to collect the payments on those loans), rather than making as many *quality* loans as possible.⁴²

In addition to the problems created by the lessened lending standards, buyers wrongly assumed that home prices would continue to climb, and that they could refinance their homes with more favorable rates before their adjustable rate mortgages (ARM's) reset to a higher rate (an ARM is a mortgage which is traditionally characterized by a very low fixed initial interest rate which later resets to a variable rate that is often several times higher than the intro rate).⁴³ Alt A, Option ARMs, Interest Only, and Negam ARM's were several popular and exceptionally risky versions of the traditional adjustable rate mortgages that were also introduced.⁴⁴ These mortgage variations allowed borrowers to choose to pay less than the full amount of interest due, with the remaining interest owed to be added onto the outstanding

³⁷ Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill is Sold*, NEW YORK TIMES, Sept. 14, 2008, available at <http://www.nytimes.com/2008/09/15/business/15lehman.html?pagewanted=all>.

³⁸ *Id.*

³⁹ *Credit Crisis – The Essentials*, THE NEW YORK TIMES, Jan. 4, 2009, available at http://topics.nytimes.com/topics/reference/timestopics/subjects/c/credit_crisis/index.html.

⁴⁰ *Id.*

⁴¹ Susan Wachter, *Credit Crisis Interview: Susan Wachter on Securitizations and Deregulation*, KNOWLEDGE @ WHARTON, June 20, 2008, available at <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1993>.

⁴² *Id.*

⁴³ David Dapice, *Global Risk of US Credit Crisis – Part I*, YALEGLOBAL ONLINE, Sept. 21, 2007, <http://yaleglobal.yale.edu/display.article?id=9699>.

⁴⁴ *A Second Mortgage Disaster On The Horizon?* (60 Minutes television broadcast Dec. 14, 2008), available at <http://www.cbsnews.com/stories/2008/12/12/60minutes/main4666112.shtml>.

principal balance.⁴⁵ In this situation, the principal balance owed on the mortgage actually grew over time, causing future payments to increase even if the initial adjustable interest rate on the mortgage remained constant.⁴⁶ Many, if not most, buyers lacked sufficient understanding for how these risky variations of ARM's worked.⁴⁷

Eventually, home prices stopped their skyward climb, and many borrowers were unable to refinance at a lower interest rate.⁴⁸ With ARM's resetting to interest rates several times higher than their intro-teaser rates, and in cases of Interest Only and Negam ARM's, payments on principal becoming due, a wave of defaults began to spread across the subprime industry.⁴⁹ These defaults hurt the owners (financial companies such as Fannie Mae, Freddie Mac, Lehman Brothers, Bear Stearns, AIG, and Merrill Lynch) of these securitized mortgages, known as mortgage-backed securities (MBS).⁵⁰ The largest owners of mortgage debt, although supposedly not subprime mortgages, were Fannie Mae and Freddie Mac.⁵¹ These federally chartered companies owned 80% of the market share of outstanding mortgage debt totaling \$5.4 trillion.⁵² As such, they were the first companies to become crippled by the housing bust. On September 7, 2008, the federal government was forced to bail out and take over the mortgage giants.⁵³ This bailout put taxpayers on the line for up to \$200 billion in write-downs and costs, with the result of the government now backing over \$5 trillion of home loans across America.⁵⁴

After several months of balance sheet write-downs from the subprime meltdown totaling over \$400 billion,⁵⁵ many Wall Street financial companies were ready to implode.⁵⁶ Bear Stearns was the first investment bank to fail, and was bought at a deep discount by JPMorgan Chase in a Federal Reserve

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ Stephanie Armour & James R. Healey, *Taxpayers Take on Trillions in Risk in Fannie, Freddie Takeover*, USA TODAY, Sept. 7, 2008, available at http://www.usatoday.com/money/economy/housing/2008-09-07-fannie-freddie-plan_N.htm.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ David Ellis, *U.S. seizes Fannie and Freddie*, CNN Money, Sept. 7, 2008, http://money.cnn.com/2008/09/07/news/companies/fannie_freddie/index.htm.

⁵⁵ Yalman Onaran, *Subprime Losses Top \$379 Billion on Balance-Sheet Marks: Table*, BLOOMBERG, May 19, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aK4Z6C2kXs3A&refer=home>.

⁵⁶ Sorkin, *supra* note 37.

assisted sale.⁵⁷ This sale afforded a purchase price of \$2 per share, which was less than 10% of Bear Stearns' market value, and grossly lower than its January 2007 high stock price of \$172 per share.⁵⁸ Bear Stearns was only the beginning. After the renowned investment bank's failure in mid-March of 2008, market conditions continued to deteriorate over the next few months.⁵⁹

The week of September 15, 2008 started out with two of the largest investment banks in the world failing.⁶⁰ Lehman Brothers was forced to declare bankruptcy, and Merrill Lynch was frantically sold to Bank of America for \$50 billion in order to prevent another bankruptcy.⁶¹ By Tuesday, September 16, 2008, there were growing concerns about the nation's largest savings and loan bank, Washington Mutual, failing.⁶² (Washington Mutual did collapse the following week on September 25, 2008. It was seized by the government, and sold to JPMorgan Chase for \$1.9 billion⁶³). To make matters much worse, New York Governor David Patterson said that AIG had one day to raise up to \$80 billion to stave off bankruptcy.⁶⁴ Without immediate federal intervention, Lehman Brothers and Merrill Lynch would not have been the last financial corporations to fail that week.⁶⁵

IV. WHY AIG'S TAKEOVER WAS BELIEVED TO BE NECESSARY

Some government officials adamantly believed that a federal takeover of AIG was necessary to prevent a devastating blow to America's financial system.⁶⁶ A simple explanation would be that AIG was too big to fail.⁶⁷ Perhaps the most important reason why the AIG bailout was thought to be necessary was because of the impact that AIG's insolvency would have on the

⁵⁷ Matthew Goldstein, *JPMorgan Buys Bear on the Cheap*, BUSINESSWEEK, Mar. 16, 2008, available at http://www.businessweek.com/bwdaily/dnflash/content/mar2008/db20080316_356646.htm.

⁵⁸ *Id.*

⁵⁹ Sorkin, *supra* note 37.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² Eric Dash & Andrew Ross Sorkin, *Government Seizes WaMu and Sells Some Assets*, THE NEW YORK TIMES, Sept. 25, 2008, available at <http://www.nytimes.com/2008/09/26/business/26wamu.html>.

⁶³ *Id.*

⁶⁴ *AIG On the Brink as Fears Grow on Financial Crisis*. YAHOO FINANCE, Sept. 16, 2008, <http://uk.biz.yahoo.com/16092008/323/aig-brink-fears-grow-financial-crisis.html>.

⁶⁵ Sorkin, *supra* note 37.

⁶⁶ Karnitschnig, *supra* note 3.

⁶⁷ Tom Brennan, *AIG: Too Big to Fail* (Mad Money with Jim Cramer television broadcast Sept. 16, 2008), available at <http://www.cnbc.com/id/26740538>.

purchasers of its credit default swaps.⁶⁸ Without insurance on the assets backed by these CDS, institutional investors would immediately be exposed to incredibly higher risk levels on their investments.⁶⁹ In order to lower that risk, institutional investors would have to conduct a massive selloff of risky assets in a market with few capable buyers.⁷⁰ Underlying asset prices and stock market valuations would plummet in the face of this selloff.⁷¹ The sell-off and supply dump would then start a chain effect that would cause safer assets to decrease in value, affecting smaller and individual investors who didn't even rely on CDS.⁷² In short, an incalculable chaos was feared.⁷³ The Federal Reserve officials concluded that immediate federal intervention was needed, and that there was no time to wait for Congress to act.⁷⁴

Another reason the Federal Reserve decided to bail out AIG appears to be out of a concern that the Wall Street financial crisis could infiltrate traditionally safe investments held by small investors, such as money market funds.⁷⁵ If this happened, a panic to withdraw cash from these funds would have been likely to occur, further crippling financial companies who were already in desperate need of cash for capital reserve requirements.⁷⁶

The specific link from AIG to money market funds is that much of AIG's own commercial paper and short-term debt obligations were being held by these money market accounts.⁷⁷ Indeed, this worry was validated on the day before AIG's bailout, as three reserve money market funds "broke the buck." (Assets held in money market funds are traditionally considered very safe, short-term investments, and are valued at \$1 for every \$1 invested. When the valuation of such funds declines below \$1, an event referenced to as "breaking the buck," the concern is that some of the debt obligations that the fund holds will not make good on their notes.⁷⁸)

As Lehman Brothers, Inc. declared bankruptcy on Monday, September 15, 2008,⁷⁹ investors contemplated the further defaults and fund devaluation that would be caused in the event of the bankruptcy of one of the largest insurers in the world—AIG. At this point, the Federal Reserve had all the evidence that a federal intervention was needed in order to prevent a panic and

⁶⁸ NPR, *supra* note 14.

⁶⁹ *Id.*

⁷⁰ Karnitschnig, *supra* note 3.

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Reserve Primary Money Market Fund Breaks a Buck*, USA TODAY, Sept. 17, 2008, available at http://www.usatoday.com/money/perfi/basics/2008-09-16-damage_N.htm.

⁷⁹ Sorkin, *supra* note 37.

withdrawal spree on these money market accounts, which would further injure an already crippled financial sector.⁸⁰ However, their approach may not have been the most appropriate one available.

V. THE HYPOTHETICALLY APPROPRIATE APPROACH TO THE AIG BAILOUT

Ideally, the proper way to structure AIG's bailout would have been conducted with terms that Congress created and approved, for it is within Congress that the powers of spending taxpayers' monies are vested.⁸¹ After congressional approval, the President would then sign off on the bill or veto it, sending it back to Congress to be approved only with a two-thirds supermajority.⁸² Under this course of action, the claims of unauthorized spending of taxpayer monies would be eliminated, and any challenges to the bailout would have to be made on a constitutional level.

Unfortunately, congressional leaders lacked both the speed and skill necessary to act quickly enough to prevent AIG's bankruptcy.⁸³ If the Federal Reserve had not stepped in and acted, it is a near certainty that AIG would have been forced into bankruptcy.⁸⁴ Necessity, however, does not equate to legality, and the fact that AIG could only have been saved by the Federal Reserve is not a justification that grants authority to the Federal Reserve to save AIG with an unprecedented loan to a private financial corporation. In order for the Federal Reserve's bailout of AIG to be valid, the Federal Reserve must have been granted authority to act by Congress.⁸⁵

Congress may ratify the Federal Reserve's actions by creating and approving a bill that mimics the actions that were taken by the Federal Reserve. However, this does not necessarily cure the infirmities of the Federal Reserve's initial, unauthorized, and potentially unconstitutional action. Regardless of ratification and subsequent action by Congress, AIG's shareholders still have valid claims against the Federal Reserve's actions. A post ante endorsement by Congress does not void these claims. Despite these concerns, the Federal Reserve proceeded to bail out AIG on Wednesday, September 17, 2008.

⁸⁰ Karnitschnig, *supra* note 3.

⁸¹ U.S. Const. art. I, § 8, cl. 1.

⁸² Robert Longley, *About the Presidential Veto*, About.com US Government Info, <http://usgovinfo.about.com/od/thepresidentandcabinet/a/presveto.htm>.

⁸³ Ted Barrett, et al., *AIG bailout upsets Republican lawmakers*, CNN POLITICS.COM, Sept. 17, 2008, <http://www.cnn.com/2008/POLITICS/09/17/aig.bailout.congress/index.html>.

⁸⁴ Karnitschnig, *supra* note 3.

⁸⁵ David Schoenbrod & Jerry Taylor, *The Delegation of Legislative Powers*, Cato Handbook for Congress, available at <http://www.cato.org/pubs/handbook/hb105-4.html>.

VI. DETAILS OF THE ACTUAL TAKEOVER:
\$85 BILLION IS EXCHANGED FOR A 79.9% CONTROLLING
STAKE IN AIG

On Wednesday, September 17, 2008, the federal government seized control of American International Group Inc. in an \$85 billion deal.⁸⁶ In exchange for \$500,000 and extending the \$85 billion loan, the United States government will receive 100,000 shares of AIG convertible participating serial preferred stock.⁸⁷ Under the terms of this deal, the Federal Open Market Committee will lend up to \$85 billion to AIG in exchange for a 79.9% equity stake in the company in the form of warrants called equity participation notes.⁸⁸ This equity stake will entitle the government to 79.9% of any dividends that are paid on AIG's common stock, as well as 79.9% stake in any vote, common or otherwise.⁸⁹ The government's preferred stock will be convertible into common shares equaling a 79.9% stake in the common stock of AIG.⁹⁰ However, given the existing rights of the government's preferred stock, there is essentially no need or gain from this conversion.⁹¹ When the loan is fully paid off, the government's preferred stock will not simply be returned to AIG, as the government will continue to exercise 79.9% of the voting power over AIG.⁹² While there may be pressure for the government to sell its shares upon repayment of the loan, there is no formal requirement for the government to do so.⁹³ Therefore, for all effective purposes, the government is at control of the reins of AIG for an indefinite period of time.

A. Size of the Equity Stake, Ownership, and Terms of the Loan

Although several different explanations have been proposed, as of yet there is no definitive answer for why the equity stake was calculated to 79.9%.⁹⁴ Most importantly, among the possible explanations is that this number helps build a case that AIG is not now a government-controlled entity.⁹⁵ If AIG is a government-controlled entity, then the government's unique accounting rules would have to be adopted, section 163 of the Internal

⁸⁶ Davidoff, *supra* note 2.

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ Oesterle, *supra* note 4.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ Posting of Steven M. Davidoff to the DealBook blog, *Sizing Up A.I.G.'s New Bailout*, N.Y. TIMES, <http://dealbook.blogs.nytimes.com/2008/11/10/sizing-up-aigs-new-bailout/> (Nov. 10, 2008).

⁹⁵ *Id.*

Revenue Code would prevent AIG from deducting interest paid on their loans from the government, and the government would be jointly and severally liable for AIG's benefit plan liabilities under the Employee Retirement Income Security Act.⁹⁶

The preferred shares issued to the government are actually issued to a trust, of which the Treasury Department is the beneficiary, and not the Federal Reserve.⁹⁷ This way, taxpayers get the benefit of any gain on the equity, rather than the Federal Reserve itself, which is a privately-owned organization.⁹⁸ With respect to short-term partial repayment, the Federal Reserve will facilitate a process under which AIG will sell parts of its business enterprise to competing companies.⁹⁹ The Wall Street Journal has reported that AIG is considering selling up to fifteen of its core and subsidiary businesses, including its profitable aircraft leasing business, in an attempt to repay a part of this unprecedented governmental loan.¹⁰⁰

This loan will have a payback period of two years, maturing on September 22, 2010, and will carry an interest rate on borrowed balances of LIBOR plus 8.5%, and 8.5% on money committed but not used.¹⁰¹ (LIBOR is the London Interbank Offered Rate, which acts as a common short-term lending benchmark.¹⁰²) At current interest rates, this rate comes out to equal a crushing 11.5%.¹⁰³ In the event of a continued market decline, the Federal Reserve (and taxpayers as ultimate beneficiaries) will have some protection of repayment of the loan because it is secured by AIG's assets, including its subsidiary operations.¹⁰⁴ If market prices recover, taxpayers stand to make a sizeable profit through the government's equity stake in the company.¹⁰⁵

B. Control of AIG is Now, For All Effective Purposes, in the Hands of Uncle Sam

Perhaps the most interesting part of this AIG deal is that it puts the federal government in control of a private corporation.¹⁰⁶ In the case of AIG's bailout, the result is that the government, for all practical purposes, owns and controls a privately held insurance company.¹⁰⁷ A federal reserve bank has no

⁹⁶ *Id.*

⁹⁷ Davidoff, *supra* note 2.

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ Karnitschnig, *supra* note 3.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ Oesterle, *supra* note 5.

¹⁰⁷ *Id.*

explicit power to structure this type of transaction, and such a tactic has never been used before.¹⁰⁸

As part of the takeover deal, the Federal Reserve required the then current chief executive officer, Robert Willumstad, to step down.¹⁰⁹ In his place, Edward Liddy, the former head of insurer Allstate Corp., will become the chief executive officer of AIG.¹¹⁰ The government also has tight control over the composition of AIG's board of directors, as well the corporate governance standards.¹¹¹ In essence, the process works like this: taxpayers elect the President, who appoints the Secretary of Treasury, who appoints the trustee in control of the government's equity stake in AIG, who appoints the CEO of AIG and has control over the composition of AIG's board of director's and corporate governance standards.¹¹²

The government also has the right to veto the payment of dividends to common and preferred shareholders.¹¹³ Furthermore, under section 2.10 of the government's loan agreement, essentially all of the net proceeds of any sale, equity insurance, debt placement, any extraordinary receipt of cash greater than \$1 million, and any excess cash on hand goes toward repayment of the loan.¹¹⁴ Thus, the government has an exceptionally tight control on any meaningful asset or funds distribution, which suggests a general ability, but perhaps not a right, to control the operations of the entire private corporation.¹¹⁵

VII. DOES THE FEDERAL RESERVE HAVE THE CONSTITUTIONAL AUTHORITY FOR THE BAILOUT OF AIG?

There are several potential violations of applicable statutes, laws, rules, and regulations with respect to the AIG bailout. First, a preliminary question of whether existing AIG shareholders were entitled to a pre-approval vote must be answered when examining if the Federal Reserve has authority to take over AIG in the manner it did. Under New York Stock Exchange Rules and section 13(3) of the Federal Reserve Act, it is apparent that voting requirements on this type of transaction were in place.¹¹⁶ However, it appears

¹⁰⁸ *Id.*

¹⁰⁹ Karnitschnig, *supra* note 3.

¹¹⁰ *Id.*

¹¹¹ Davidoff, *supra* note 2.

¹¹² Oesterle, *supra* note 4.

¹¹³ Press Release, *supra* note 1.

¹¹⁴ Davidoff, *supra* note 2.

¹¹⁵ Oesterle, *supra* note 5.

¹¹⁶ NYSE Listed Company Manual, May, 22 2007, available at http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/nyse/1182508124422.html&displayPage=/lcm/lcm_section.html.

these voting requirements were not followed.¹¹⁷ Even if the voting requirements were followed, a more difficult question of whether the Federal Reserve has previously been delegated authority by Congress to act as it did must be answered. Congress was not involved in the AIG takeover, and the Federal Reserve's claim that it has been granted authority for the bailout of AIG under section 13(3) of the Federal Reserve Act is debatable.¹¹⁸ As AIG is a Delaware corporation trading on the New York Stock Exchange, Delaware statutory and case law, as well as the New York Stock Exchange Rules, must be examined when evaluating the legality of AIG's controversial takeover.¹¹⁹

A. Under New York Stock Exchange Rules, Were Existing AIG Stockholders Required to Pre-Approve the Bailout Terms?

New York Stock Exchange Rule 312.03(c)(1) requires shareholder approval of securities issuances when "the common stock has, or will have upon issuance, voting power equal to or in excess of 20% of the voting power outstanding before the issuance of such stock or of securities convertible into or exercisable for common stock."¹²⁰ There was no shareholder vote prior to the grant of the preferred shares carrying a 79.9% voting power to the United States Government.¹²¹ However, NYSE Rule 312.05 contains an exception, on which the government must rely on.¹²² This rule states:

Exceptions may be made to the shareholder approval policy in Para. 312.03 upon application to the Exchange when (1) the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise and (2) reliance by the company on this exception is expressly approved by the Audit Committee of the Board.

A company relying on this exception must mail to all shareholders not later than 10 days before issuance of the securities a letter alerting them to its omission to seek the shareholder approval that would otherwise be required under the policy of the Exchange and indicating that the Audit

¹¹⁷ Jef Feeley, *AIG Is Sued by Shareholder Over Government Bailout (Update2)*, BLOOMBERG, Nov. 5, 2008, <http://www.bloomberg.com/apps/news?pid=20601103&sid=aVycplP62daM&refer=news>.

¹¹⁸ Press Release, *supra* note 1.

¹¹⁹ Davidoff, *supra* note 94.

¹²⁰ NYSE Manual, *supra* note 116.

¹²¹ Davidoff, *supra* note 94.

¹²² NYSE Manual, *supra* note 116.

Committee of the Board has expressly approved the exception.¹²³

Even with this exception, however, assuming the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise, there is no evidence that the government notified shareholders not later than ten days before the equity issuance.¹²⁴ In fact, due to the swiftness of AIG's failure, there was no more than a couple days notice, at most, that AIG would be subjected to such dire liquidity problems.¹²⁵ The first lawsuit on this issue, *Wilma Walker v. American International Group, Inc.*, was filed in the Delaware Chancery Court on November 4, 2008.¹²⁶ Plaintiff shareholder Wilma Walker claims that the "directors must allow existing shareholders a separate vote on a bailout provision that gives the government a 79.9% stake in exchange for \$85 billion in loans."¹²⁷ Specifically, Walker seeks to have the judge disallow the conversion of preferred shares into common stock without a shareholder vote, and find that the AIG directors erred by agreeing to that part of the deal.¹²⁸ However, this case was brought under Delaware law, rather than under the NYSE rules for listed companies.¹²⁹

B. Does Section 13(3) of the Federal Reserve Act Grant Authority for the AIG Takeover?

Article 1, Section 8 of the United States Constitution vests the power to pass laws that spend taxpayers' money in Congress.¹³⁰ Congress did not directly act in the spending of taxpayer's money in the AIG bailout.¹³¹ Rather, it was the Federal Open Market Committee, part of the executive branch of government, that made the decision to spend taxpayer money on the bailout of a privately run financial company without prior, direct congressional approval for the transaction.¹³²

As a result of AIG's takeover, the U.S. Treasury Secretary, Henry Paulson, and the Federal Reserve Chairman, Ben Bernanke, are spending

¹²³ *Id.*

¹²⁴ Frank Reynolds, *Suit: AIG Board Broke Del. Law by Barring Vote on \$85B Bailout*, ANDREWS PUBLICATIONS, Nov. 7, 2008, available at http://news.findlaw.com/andrews/bf/dcl/20081107/20081107_walker.html.

¹²⁵ Karnitschnig, *supra* note 3.

¹²⁶ Feeley, *supra* note 117.

¹²⁷ Milford, *supra* note 7.

¹²⁸ Feeley, *supra* note 117.

¹²⁹ *Id.*

¹³⁰ U.S. Const. art. I, § 8.

¹³¹ Mark Hutcherson, *Bailout of AIG Is Illegal According To Some Constitutional Experts*, HUTCH REPORT, Sept. 17, 2008, available at <http://mhutch.blogspot.com/2008/09/bailout-of-aig-is-illegal-according-to.html>.

¹³² *Id.*

billions of taxpayer dollars without Congress or the President signing off on those expenditures.¹³³ Put another way, this is a situation where a government agency, which is run by the executive branch of the United States government, is spending vast sums of taxpayer dollars without Congress first passing an authorizing law, or delegation of authority, or the President signing his name to that legislation and taking responsibility for when and how that money is spent.¹³⁴ George W. Bush has all but directly said that the President's office did not have anything to do with the AIG bailout.¹³⁵ Dana Perino, the White House Press Secretary for President George W. Bush, has been quoted as saying "it is more appropriate to describe Bush's role [in the AIG takeover] as consulting on the move rather than approving it."¹³⁶

The Federal Reserve is claiming that their authority to take over AIG is granted by the Federal Reserve Act, which allows the Federal Reserve to lend to non-banks under unusual and exigent circumstances.¹³⁷ This same line of authority was invoked during the rescue of Bear Stearns Co. earlier this year.¹³⁸ Specifically, section 13(3) of the Federal Reserve Act was invoked for the AIG deal.¹³⁹ Section 13(3), titled Discounts for Individuals, Partnerships, and Corporations provides:

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: *Provided*, That before discounting any such note, draft, or bill of exchange for an individual, partnership, or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *White House Defends AIG Takeover*, ASSOCIATED PRESS, Sept. 26, 2008, available at <http://newsone.blackplanet.com/nation/white-house-defends-aig-takeover/>.

¹³⁶ *Id.*

¹³⁷ Karnitschnig, *supra* note 3.

¹³⁸ *Id.*

¹³⁹ Press Release, *supra* note 1.

be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.¹⁴⁰

From the clear language of section 13(3), there are several conditional terms that must be satisfied prior to any disbursement made by the Federal Reserve under authority of this section.¹⁴¹ First, the conditions for the loan must arise from “unusual and exigent circumstances.”¹⁴² Given the aforementioned existing market conditions at the time, no one will argue that conditions were not unusual and exigent.¹⁴³ Second, at least five members of the Board of Governors of the Federal Reserve System must cast a vote in favor of the disbursement.¹⁴⁴ At this time, there is no press release by the Federal Reserve with details on whether there was a vote, and how that vote came out.¹⁴⁵ Finally, there is a condition that “before discounting any such note, draft, or bill of exchange...the Federal Reserve Bank shall obtain evidence...that [the recipient of the loan] is unable to secure adequate credit accommodations from other banking institutions.”¹⁴⁶ In normal times, the private market would be able to come up with a suitable loan for AIG’s liquidity problem.¹⁴⁷ These were not normal times. With the commercial paper markets frozen, banks hoarding cash, and lenders panicking over their risk exposure to the credit contagion, AIG was unable to secure funds from private institutions.¹⁴⁸ It is the position of the Federal Reserve that they were indeed AIG’s last hope of rescue from their liquidity problems.¹⁴⁹

After the conditions for disbursement have been met, section 13(3)’s disbursement power is described as authorization to “discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange.”¹⁵⁰ These terms are of particular importance. Traditionally, “to discount a note” is to issue a debt obligation at a discount to par value.¹⁵¹ However, in this context, “to discount” simply means “to buy.” A note is a written promise by

¹⁴⁰ Federal Reserve Act, §13(3), 12 U.S.C. § 343 (2006), [hereinafter Federal Reserve Act], *available at* <http://www.federalreserve.gov/aboutthefed/section13.htm>.

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ Karnitschnig, *supra* note 3.

¹⁴⁴ Federal Reserve Act, *supra* note 140.

¹⁴⁵ Press Release, *supra* note 1.

¹⁴⁶ Federal Reserve Act, *supra* note 140.

¹⁴⁷ Posting of Steven M. Davidoff to the DealBook blog, *The Still Evolving A.I.G. Loan Terms*, N.Y. TIMES, Sept. 19, 2008, *available at* <http://dealbook.blogs.nytimes.com/2008/09/19/the-still-evolving-aig-loan-terms/>.

¹⁴⁸ *Id.*

¹⁴⁹ Karnitschnig, *supra* note 3.

¹⁵⁰ Federal Reserve Act, *supra* note 140.

¹⁵¹ *Discount Note*, INVESTOPEDIA, <http://www.investopedia.com/terms/d/discountnote.asp>. (last visited Mar 3, 2009).

the maker to pay money to the payee.¹⁵² A bill of exchange, also known as a draft, is similar to a note, but involves a middleman (usually a bank).¹⁵³ With a bill of exchange or draft, an unconditional order is issued by a drawer (a person or business) which directs the drawee (the bank) to pay a fixed sum of money to a payee (a third party).¹⁵⁴ The wording of section 13(3) necessarily involves a judgment call to determine if market conditions warrant federal intervention into a privately run company.¹⁵⁵ It is still debatable whether the requirements for exercising authority under section 13(3) were met prior to the FOMC exercising power to take over AIG to the detriment of AIG's existing shareholders.¹⁵⁶

*C. Has Section 242(b)(2) of the Delaware General Corporation Law
Been Violated in AIG's
Takeover?*

As part of the takeover of AIG, the government was issued a 79.9% equity stake in the company.¹⁵⁷ Section 242(b)(2) of the Delaware General Corporation Law entitles common stockholders to vote as a class respecting any amendment of a certificate of incorporation to increase the number of authorized common shares or reduce the par value of the common shares.¹⁵⁸ This section provides:

The holders of the outstanding shares of a class shall be entitled to vote as a class upon a proposed amendment, whether or not entitled to vote thereon by the certificate of incorporation, if the amendment would increase or decrease the aggregate number of authorized shares of such class, increase or decrease the par value of the shares of such class, or alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely. If any proposed amendment would alter or change the powers, preferences, or special rights of 1 or more series of any class so as to affect them adversely, but shall not so affect the

¹⁵² *Promissory Note*, INVESTORWORDS, available at http://www.investorwords.com/3896/promissory_note.html. (last visited Mar 3, 2009)

¹⁵³ *Bill of Exchange*, INVESTORWORDS, available at http://www.investorwords.com/477/bill_of_exchange.html. (last visited Mar 3, 2009).

¹⁵⁴ *Id.*

¹⁵⁵ Federal Reserve Act, *supra* note 140.

¹⁵⁶ Feeley, *supra* note 117.

¹⁵⁷ Davidoff, *supra* note 2.

¹⁵⁸ Davidoff, *supra* note 94.

entire class, then only the shares of the series so affected by the amendment shall be considered a separate class for the purposes of this paragraph. The number of authorized shares of any such class or classes of stock may be increased or decreased (but not below the number of shares thereof then outstanding) by the affirmative vote of the holders of a majority of the stock of the corporation entitled to vote irrespective of this subsection, if so provided in the original certificate of incorporation, in any amendment thereto which created such class or classes of stock or which was adopted prior to the issuance of any shares of such class or classes of stock, or in any amendment thereto which was authorized by a resolution or resolutions adopted by the affirmative vote of the holders of a majority of such class or classes of stock.¹⁵⁹

The fact that AIG issued preferred shares to the federal government in this takeover does not exonerate this transaction from section 242(b)(2) because the issued preferred shares were convertible into common.¹⁶⁰ As section 242(b)(2) summarizes, authorizations of this type of new shares requires current AIG common shareholders to authorize the issuance.¹⁶¹ This is something that shareholders of AIG did not do prior to the issuance of the equity stake to the federal government.¹⁶²

D. Was AIG's Takeover in Violation of the Common Law Enunciated by the Delaware Supreme Court in Hildreth v. Castle Dental Centers, Inc.?

In *Hildreth v. Castle Dental Centers, Inc.*, the Delaware Supreme Court ruled that preferred stock cannot convert into common stock if common shareholders have not voted as a class to increase the number of authorized shares of common stock.¹⁶³ This is exactly the situation involved in AIG's bailout: existing common shareholders have not been given a chance for a separate and isolated vote on the issue of the government's preferred shares' convertibility.¹⁶⁴ This common law holding simply adopts and enunciates the

¹⁵⁹ Del. Code Ann. tit. 8 § 242(b)(2) (2008), available at <http://delcode.delaware.gov/title8/c001/sc08/index.shtml>.

¹⁶⁰ Davidoff, *supra* note 94.

¹⁶¹ Del. Code Ann. tit. 8, § 242(b)(2) (2008), available at <http://delcode.delaware.gov/title8/c001/sc08/index.shtml>.

¹⁶² Feeley, *supra* note 117.

¹⁶³ *Hildreth v. Castle Dental Centers, Inc.*, 939 A.2d 1281, 1284 (Del. 2007).

¹⁶⁴ Davidoff, *supra* note 94.

proper interpretation of section 242(b)(2) of the Delaware General Corporation Law.¹⁶⁵

The Court in *Hildreth* also found that a “[c]orporation's failure to seek shareholder approval of charter amendment to increase the number of authorized shares of common stock in order to enable full conversion of preferred stock did not invalidate the preferred stock; the authorized share failure did not nullify the original issuance of preferred stock.”¹⁶⁶ Therefore, section 242(b)(2) cannot be used as an argument against issuance of the preferred shares in the first place, but only against their convertibility issue.¹⁶⁷ Even if a separate vote of existing AIG common shareholders is needed in order to authorize conversion of the government's preferred shares into common, this fact alone does not invalidate the issued preferred shares and the remaining details of the bailout.¹⁶⁸ Furthermore, the government does have the ability to coerce the existing AIG shareholders into voting for the conversion by putting penalties in the loan documents if this issue is not approved.¹⁶⁹ Thus, through penalties, the government can effectively punish the AIG shareholders for failure to approve the conversion aspect, to an economic extent, worse than what they would face under the dilution of the common shares when the preferred shares convert.¹⁷⁰ There is nothing under Delaware law preventing the use of such coercion.¹⁷¹

Although the original bailout of AIG amounted to the largest bailout of a private company in our history,¹⁷² recent developments have shown that it was not enough to prevent failure of the company.¹⁷³ Furthermore, the terms of the bailout, which were constructed under extreme time pressure, are still being modified and interpreted.¹⁷⁴

¹⁶⁵ Del. Code Ann. tit. 8, § 242(b)(2) (2008), *available at* <http://delcode.delaware.gov/title8/c001/sc08/index.shtml>.

¹⁶⁶ *Hildreth*, 939 A.2d at 1284.

¹⁶⁷ *Id.* at 1283.

¹⁶⁸ *Id.* at 1283-84.

¹⁶⁹ Davidoff, *supra* note 94.

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² Mark Felsenthal & Lilla Zuill, AIG Reworks Bailout; Fed Ups Support to \$150B, Lowers Interest Rate, INSURANCE JOURNAL, Nov. 9, 2008, *available at* <http://www.insurancejournal.com/news/national/2008/11/09/95371.htm>.

¹⁷³ *Id.*

¹⁷⁴ Posting of Steven M. Davidoff to the DealBook blog, *The Professor's Pop Quiz: Who Controls A.I.G.?*, THE N.Y. TIMES, *available at* <http://dealbook.blogs.nytimes.com/2008/11/19/the-professors-pop-quiz-who-controls-aig/> (Nov. 19, 2008).

VIII. RECENT DEVELOPMENTS

Recently, it has become apparent that the initial loan to AIG was inadequate to save the failing insurance company.¹⁷⁵ Both additional capital and a modification of the initial interest rate have been provided to AIG in order to prevent its bankruptcy.¹⁷⁶ Existing shareholder's rights, which were not properly enunciated due to the urgency in making the first loan, are still in debate.¹⁷⁷

A. Government Makes Modifications and Additional Loans to AIG

The initial bailout of AIG consisted of an \$85 billion loan at LIBOR plus 8.5% in which the government received a 79.9% stake in AIG along with the ability to remove senior management.¹⁷⁸ The outstanding value this loan as of November 19, 2008 was \$60 billion, with the Federal Reserve receiving the rights of a general creditor including senior security over AIG's unregulated subsidiaries, but no real governance rights except for some negative covenants limiting AIG's operations and expenditures.¹⁷⁹ That said, the ability to veto important expenditures of a private corporation is a significant power; a power which is currently in the hands of government.¹⁸⁰

Under the now \$60 billion initial loan, the preferred shares issued under this loan are now referred to as 100,000 Series C preferred shares convertible into a 77.9% of AIG's outstanding common stock.¹⁸¹ This stock has a vote equal to 77.9% of AIG's share capital and is entitled to the same percentage of any dividends paid on AIG's common shares.¹⁸² Therefore, whoever controls these shares controls AIG.¹⁸³ Currently, the shares have been issued to a trust (known as the AIG Credit Facility Trust) for the benefit of the Treasury Department (so taxpayers receive the benefit of any repayment or gains on the loan).¹⁸⁴ Under section 5.11 of the original credit agreement, the three trustees for this trust will be appointed by the Federal Reserve, and AIG "shall use all reasonable efforts to cause the composition of the board of directors of AIG to be satisfactory to the Trust in its sole discretion."¹⁸⁵ The

¹⁷⁵ Felsenthal, *supra* note 172.

¹⁷⁶ *Id.*

¹⁷⁷ Davidoff, *supra* note 94.

¹⁷⁸ Ieva M. Augstums, *AIG Repays More of \$85 Billion Fed Loan*, THE DAILY NEWS, Nov. 10, 2008, available at <http://www.memphisdailynews.com/editorial/Article.aspx?id=39375>.

¹⁷⁹ Davidoff, *supra* 174.

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

effect of this language is that the government is in voting control of AIG, and such control does not appear to be authorized under Delaware statutory or common law.¹⁸⁶

In addition to the original loan, weeks later it became apparent more capital was needed by AIG, and the government lent an additional \$37.8 billion as well as further assistance under the Troubled Asset Relief Program (TARP).¹⁸⁷ In exchange for these monies, the government is getting \$40 billion of preferred shares carrying a 10% dividend, AIG's agreement to restrictions on lobbying, limitations on executive compensation and bonus pools for senior partners not to exceed 2007 and 2006 levels, and compliance with an expense policy.¹⁸⁸ These preferred shares are non-voting except on certain major issues affecting the preferred, such as if AIG misses dividend payments for four consecutive quarters; then the Treasury has the right under the terms of this preferred stock to elect 20% of the total number of directors after giving effect to such election.¹⁸⁹

In addition to the existing loans, the government will buy up to \$52.2 billion of AIG's troubled assets, mainly collateralized debt obligations (CDO's) and residential mortgage-backed securities (MBS).¹⁹⁰ The government will also allow AIG access to the Federal Reserve's commercial paper program, which is available to all companies that issued commercial paper before the credit markets froze.¹⁹¹ Under this program, AIG has access to borrow up to \$20.9 billion.¹⁹² Furthermore, the original \$85 billion loan rate has been modified to a lower rate of LIBOR plus 3.0% after it became apparent that AIG was continuing its demise under the weight of the prior, more expensive terms.¹⁹³ As it stands, the government's total potential support for AIG may be as high as \$173 billion.¹⁹⁴ The size of this loan makes it the largest bailout of a single company in the history of our government.¹⁹⁵ The voting power giving to the government for consideration of their loan still appears to be a violation of constitutional and Delaware law.¹⁹⁶

¹⁸⁶ Feeley, *supra* note 117.

¹⁸⁷ Augstums, *supra* note 178.

¹⁸⁸ Davidoff, *supra* 174.

¹⁸⁹ *Id.*

¹⁹⁰ Davidoff, *supra* note 94.

¹⁹¹ Andrew R. Sorkin & Mary W. Walsh, *US Provides More Aid to Big Insurer*, THE NEW YORK TIMES, Nov. 10, 2008, available at

http://www.nytimes.com/2008/11/11/business/economy/11aig.html?_r=1.

¹⁹² *Id.*

¹⁹³ Davidoff, *supra* note 94.

¹⁹⁴ *Id.*

¹⁹⁵ Felsenthal, *supra* note 172.

¹⁹⁶ Feeley, *supra* note 117.

B. Do Existing AIG Shareholders Get a Separate Vote on the Government's Preferred Shares' Convertibility Issue?

On Friday, November 7, 2008, there was a telephone conference in the Delaware Chancery Court before Judge William B. Chandler III on the issues surrounding AIG's bailout.¹⁹⁷ Of particular interest was the issue of the convertibility of the issued preferred shares.¹⁹⁸ During this conference, AIG's attorneys claimed that there would be a separate class vote among existing common shareholders of AIG in order to approve the conversion of the federal government's preferred shares into common.¹⁹⁹ This statement appears to be in conflict with prior statements by AIG that explained that the preferred shares issued to the government would also have a vote on the conversion issue.²⁰⁰ Since the preferred shares total a 79.9% equity stake in the company, the government could simply decide by itself when and whether to convert its own preferred shares into common.²⁰¹ However, according to AIG's attorney's latest comments on this issue, it appears conversion may not be so easy for the government, as existing common shareholders of AIG will get a separate vote to approve or disprove of the convertibility issue on the government's preferred shares.²⁰² If the government maintains this position concerning the convertibility of its preferred shares, such a compromise may effectively be construed as an admission that the original terms of AIG's bailout were both illegal and ineffective under constitutional and Delaware law.

C. When Will Governmental Control of AIG be Relinquished?

As it stands, there is no specified deadline for when the government will sell its interest in AIG back to private shareholders.²⁰³ With the current restructuring of the existing loans, the new bailout terms appear to make the government more of a long-term investor, rather than a temporary savior of AIG.²⁰⁴ Along with traditional capitalistic view of the role of government in the private economy, that is something that Treasury Secretary Henry Paulson has stated he hoped to avoid.²⁰⁵

The Federal Reserve and the Treasury Department have said that the federal government "intends to exit its support of AIG over time in a

¹⁹⁷ Davidoff, *supra* note 94.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² *Id.*

²⁰³ Sorkin, *supra* note 191.

²⁰⁴ *Id.*

²⁰⁵ *Id.*

disciplined manner consistent with maximizing the value of its investments and promoting financial stability.”²⁰⁶ Additionally, newly appointed CEO of AIG, Edward Liddy, initially said that he believed “the Fed money would be like water pouring into a bathtub – a lot might be needed at first, but eventually the tub would be filled and the facet could be turned off.”²⁰⁷ However, since this statement, AIG has continued to need more money than was expected and it has not been able to sell off some of its assets and subsidiaries fast enough to pay down the loan as required.²⁰⁸

D. Even with Unprecedented Governmental Assistance, is AIG Still Safe from Bankruptcy?

As government aid approaches \$170 billion dollars,²⁰⁹ many are beginning to worry if the government is simply throwing money down a black hole.²¹⁰ On Monday, November 11, 2008, AIG posted its largest quarterly loss in the history of its eighty-nine years of incorporation at \$24.5 billion.²¹¹ This figure is in comparison to \$3.09 billion of profit for the same period last year.²¹² This third quarter loss is the fourth straight quarter of losses for AIG, now totaling over \$43 billion in losses over the past year.²¹³ AIG’s market value, once at \$180 billion in 2007, has now been reduced to \$5 billion.²¹⁴ Now that the government has effectively issued \$170 billion of aid to AIG,²¹⁵ AIG’s problems are now our problems, and the same question continues to arise: is it enough?

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ *Id.*

²⁰⁹ Davidoff, *supra* note 94.

²¹⁰ Carol J. Loomis, *AIG's Rescue has a Long Way to Go*, CNN MONEY.COM, Dec. 29, 2008, http://money.cnn.com/2008/12/23/news/companies/AIG_150bailout_Loomis.fortune/index.htm.

²¹¹ Mohit Joshi, *US Insurer AIG Reports Record Q3 Loss of \$24.5 Billion Dollars*, TOPNEWS.IN, Nov. 11, 2008, <http://www.topnews.in/us-insurer-aig-reports-record-q3-loss-245-billion-dollars-286702>.

²¹² *Id.*

²¹³ *Id.*

²¹⁴ Loomis, *supra* note 210.

²¹⁵ Davidoff, *supra* note 94.

IX. CONCLUSION:
CONTROVERSY REMAINS SURROUNDING THE TERMS OF AIG'S
FEDERAL BAILOUT

As AIG's federal bailout terms continue to evolve, it is clear that the controversy surrounding this deal is not likely to end anytime soon.²¹⁶ Part of the delay is due simply to the fact that the deal was structured awkwardly and in terms not easily understood upon first glance. More importantly, the Federal Reserve still has not proven that its actions surrounding the bailout were in accordance with the powers granted under section 13(3) of the Federal Reserve Act.²¹⁷ Furthermore, AIG's existing shareholders did not receive a class voting right concerning the issue of the government's preferred shares' convertibility.²¹⁸ The absence of such vote is a clear violation of both Delaware statutory and common law.²¹⁹ Although the government may be changing its stance considering its eligibility for a conversion right,²²⁰ Wilma Walker will not be the first plaintiff suing AIG and the federal government over this deal.²²¹ Common shareholders of AIG were undeniably hurt from the substantial drop in AIG's share price following the news of massive dilution from the government's equity stake. This issue will likely not be settled for several years to come.

²¹⁶ *Id.*

²¹⁷ Oesterle, *supra* note 5.

²¹⁸ Feeley, *supra* note 117.

²¹⁹ Del. Code Ann. tit. 8, § 242(b)(2) (2008) available at <http://delcode.delaware.gov/title8/c001/sc08/index.shtml>. See also *Hildreth*, 939 A.2d at 1281.

²²⁰ Davidoff, *supra* note 94.

²²¹ Feeley, *supra* note 117.

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