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Claire Hill

Richard Painter

Article

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Claire Hill[†] **and Richard Painter**[††]

INTRODUCTION

In the present financial crisis, the government has become extensively involved in managing companies, at times undertaking massive bailouts. Its involvement has generated significant criticism.[1] Elizabeth Warren, then-chair of the five-member Congressional Oversight Panel (COP) created by Congress to oversee implementation of the Emergency Economic Stabilization Act of 2008,[2] criticized the bailouts as having been implemented in a manner that helped the banks but not consumers and the economy as a whole.[3] Many of the problems pointed out by COP involved loose government oversight of the

† Professor and Solly Robins Distinguished Research Fellow, University of Minnesota Law School.

†† S. Walter Richey Professor of Corporate Law, University of Minnesota Law School. The authors thank the participants at the University of Minnesota Symposium on Government Ethics and Bailouts for their helpful comments.

1. Scholarly articles critical of government involvement in managing business include J.W. Verret's article on the Treasury Department's Troubled Asset Relief Program (TARP), a major government bailout program. *See* J.W. Verret, *Treasury, Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283, 315–25 (2010). The article argues that under any of the prevailing theories about the aims of corporate governance—including agency, nexus of contracts, shareholder primacy, and director primacy—corporate governance functions badly when there is a controlling government shareholder. Two other commentators, Marcel Kahan and Edward Rock, argue that in companies in which the government is the controlling shareholder, the rights of minority shareholders cannot be properly protected under current law. *See generally* Marcel Kahan & Edward Rock, *When the Government Is the Controlling Shareholder: Implications for Delaware*, 35 DEL. J. CORP. L. 409 (2010).

2. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 125, 122 Stat. 3765, 3791.

3. CONG. OVERSIGHT PANEL, ACCOUNTABILITY FOR THE TROUBLED ASSET RELIEF PROGRAM: THE SECOND REPORT OF THE CONGRESSIONAL OVERSIGHT PANEL 6–11 (2009).

banks and other financial institutions that received money through the Troubled Asset Relief Program (TARP). COP also identified conflicts of interest involving dozens of the government contractors that were hired by the Treasury Department to assist with TARP.[4] The Inspector General for TARP has also pointed to conflicts of interest in and outside of government as a serious problem.[5]

The results of government involvement in business are at best mixed. By some accounts, the government's involvement in the domestic auto industry has gotten the industry back onto a

4. As COP pointed out in a recent report:

> [P]rivate companies today perform many of the TARP's most critical functions, operating under 96 different contracts and agreements worth a total of $436.7 million. These private businesses do not take an oath of office, nor do they stand for election. They may have conflicts of interests, are not directly responsible to the public, and are not subject to the same disclosure requirements as government actors.

CONG. OVERSIGHT PANEL, OCTOBER OVERSIGHT REPORT: EXAMINING TREASURY'S USE OF FINANCIAL CRISIS CONTRACTING AUTHORITY 1 (2010). Indeed, this is a general problem when government is involved in managing business. Government does not have the expertise or capability to manage bailed-out companies or the assets it acquires from those companies, and often contracts those jobs out to private entities. These contractors are not bound by government ethics rules. *See* Kathleen Clark, *Fiduciary-Based Standards for Bailout Contractors: What Treasury Got Right and Wrong in TARP*, 95 MINN. L. REV. 1612 (2011) (discussing problems with BlackRock, a money management firm, and other Treasury Department contractors and various solutions); Richard W. Painter, *Bailouts: An Essay on Conflicts of Interest and Ethics when Government Pays the Tab*, 41 MCGEORGE L. REV. 131, 153 (2009) (highlighting this problem in the insider trading context); Eric Lipton & Michael J. de la Merced, *Wall St. Firm Draws Scrutiny as U.S. Adviser*, N.Y. TIMES, May 19, 2009, at A1, *available at* 2009 WLNR 9506375 (discussing how BlackRock has won multimillion dollar contracts to help the government manage the rescues of Bear Stearns, AIG, and Citigroup).

5. *See* OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 4 (2009), *available at* http://www.sigtarp.gov/reports/congress/2009/April2009_Quarterly_Report_to_Congress.pdf ("Both from the Hotline and from other leads, SIGTARP has initiated, to date, almost 20 preliminary and full criminal investigations. Although the details of those investigations generally will not be discussed unless and until public action is taken, the cases vary widely in subject matter and include large corporate and securities fraud matters affecting TARP investments, tax matters, insider trading, public corruption, and mortgage-modification fraud."); *id.* at 7 ("Aspects of [the Public-Private Investment Program] make it inherently vulnerable to fraud, waste, and abuse, including significant issues relating to conflicts of interest facing fund managers, collusion between participants, and vulnerabilities to money laundering."). Despite these pronouncements of suspected criminal wrongdoing, very few criminal cases have been brought in connection with TARP to date, which suggests that many of the conflicts of interest involved are either not criminal or are difficult to prosecute.

profitable footing, at relatively low cost to the taxpayers.[6] Indeed, taxpayers may actually profit.[7] Nonetheless, the bailout program on the whole still cost taxpayers billions of dollars that could have been spent on relieving the economic suffering of people rather than companies, and the future of many of the bailed-out companies remains uncertain.[8] Moreover, the public is deeply skeptical of the bailouts; they have been a substantial factor in public dissatisfaction with government.[9]

However we judge success or failure, government involvement in managing companies is sometimes inevitable. It is therefore important to consider how it can be improved. There are many reasons why government might perform poorly, but one critical reason is conflicts of interest. Conflicts are an issue not just when government is "involved" in business, but also when it is simply regulating it in the normal course.

In its capacity as a regulator of business, government aims to ensure that businesses are run consistent with what it identifies as the interests of its citizens—the "public interest." When it manages a business, it still has these same interests to consider. But other interests become relevant as well: the interests of the business's shareholders, employees, and other constituencies. Moreover, the "public interest" is scarcely a monolith: many legitimate interests exist that government could appropriately be advancing. Furthermore, the individuals

6. *See* CONG. OVERSIGHT PANEL, JANUARY OVERSIGHT REPORT: AN UPDATE ON TARP SUPPORT FOR THE DOMESTIC AUTOMOTIVE INDUSTRY 1, 95–98 (2011); *see also* Bill Vlasic, *In G.M.'s Comeback Story, a Pivotal Role Played by Washington,* N.Y. TIMES, Nov. 3, 2010, at B1, *available at* 2010 WLNR 21952943.

7. *Id. But see* Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727, 729 (2010) (observing that the Chrysler bankruptcy did not comply with good bankruptcy practice and was unfair to some creditors). Other bailouts that might cost taxpayers less than anticipated include those of Fannie Mae and Freddie Mac. *See* Binyamin Appelbaum, *Dividends from Fannie and Freddie Surpass Aid*, N.Y. TIMES, Nov. 6, 2010, at B1, *available at* 2010 WLNR 22206573. But the Fannie and Freddie bailouts will still be expensive. *See* Chris Isidore, *Fannie, Freddie Bailout: $153 Billion . . . and Counting*, CNNMONEY, Mar. 22, 2011, http://money.cnn.com/2011/02/11/news/companies/fannie_freddie_losses/index.htm.

8. *See, e.g.*, Michael Rapoport, *Bailed-Out Banks Slip Toward Failure*, WALL ST. J., Dec. 27, 2010, at C1, *available at* 2010 WLNR 25509277 ("[T]hird-quarter results show 98 banks that received more than $4.2 billion in federal aid could be in danger of failing.").

9. *See* CONG. OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT: ASSESSING THE TARP ON THE EVE OF ITS EXPIRATION 102 (2010) ("The public's frustration [with TARP] has led to a general rise in populist political rhetoric and has polluted the policy discussion in many other areas.").

involved in managing the business—both the government employees and the businesspeople—have their own interests. These interests may be antithetical to the government, the business, or both. Given the conflicts of interest that arise at multiple levels of decisionmaking in both government and private companies, it should not be surprising that government management of companies is often problematic.

Conflicts of interest are notoriously difficult to address. Government ethics laws address them with substantive rules that control government employees' behavior[10] and disclosure rules covering their private-sector employment, investments, and other subjects.[11] Corporate law and securities law, as well as industry-specific regulations such as those applicable to banks and broker dealers, address problems in companies with substantive rules and disclosure rules. In both government and business, law has had mixed success in changing the way individuals behave. Conflicts of interest and their concealment continue on a scale that most observers find troubling. This Article discusses the difficulties conflicts pose for law, how law attempts to deal with conflicts, and why law often falls short. This Article also discusses ways to limit the damage conflicts of interest can cause. We focus on one important reason why conflicts of interest have not been well-addressed: the set of conflicts that can effectively be regulated using standard legal rules is a small subset of the potential conflicts that may arise. We explore why this is so, showing why the conflicts that arise when government is involved in business are particularly difficult for the law to address.

In both business and government, we can distinguish between two types of conflicts. One type traditionally and more effectively dealt with by law is a direct conflict, involving self-interest narrowly construed. Two common examples are the government official who is negotiating for a private sector job with an employer with whom he is doing business on behalf of the government and the corporate executive who is seeking to hire his close relative. These types of acts can simply be prohibited or scrutinized carefully. For expository ease, we will call these the easy cases.

10. *See, e.g.*, 18 U.S.C. § 208 (2006) (prohibiting government officials from participating in certain matters in which they have a financial interest).

11. *See, e.g.*, Ethics in Government Act of 1978, Pub. L. No. 95-521, 92 Stat. 1824, *amended by* Ethics Reform Act of 1989, Pub. L. No. 101-194, 103 Stat. 1716 (requiring periodic financial disclosure by government officials).

But the other type of conflict—the hard cases—presents considerably more difficulties. *Any time* a government or corporate official acts (or does not act), he could be seeking to advance interests other than those he is supposed to be advancing. These illegitimate interests include self-interest narrowly construed; they also include interests of others with whom the official may feel personal or professional kinship, such as a former colleague, or someone similarly situated to the official or whose favor the official would like to curry. Some of these interests could be characterized as self-interest broadly construed. Others are more a matter of bias or perspective, such as a former corporate executive who becomes a government official favoring his former colleagues. Cases are hard enough when the question to be determined is whether an illegitimate interest is present. Complicating matters, a conflict might exist among several legitimate interests a corporate or government official could simultaneously be seeking to advance, as well as what may be an illegitimate interest. Law cannot be ever-present, micromanaging the conduct of so many actors and making intricate determinations of true intent. In this Article, we argue that these hard cases present a critical challenge, one that must be far better met if business and government are to function well both independently and when government is involved in business.

We sometimes refer to the hard cases as cases of "structural bias." The term comes from corporate law: it refers to the biases board members may have, consciously and unconsciously, to defer to management and to one another. They defer because their interests are best served by doing so, because they share a similar perspective on many matters, including compensation and appropriate (high) levels of deference to management, and because they are connected to one another through a web of business ties.[12] Substituting government positions for "board member" and "manager," and "political ties" for "business ties," the term and concept does an excellent job of delineating the hard cases in government as well.

Part I discusses the conflict-of-interest problem in general as well as the fiduciary principle, and considers the particular conflicts at issue when government is involved in business. This Part also elaborates on our characterization of conflicts cases as "easy" or "hard" and contrasts the law's relative suc-

12. *See generally* Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 824 (2004).

cess in dealing with the former with its lack of success in dealing with the latter.

Part II discusses how corporate law deals with conflicts of interest for business managers, including both easy cases—breaches of the traditional duty of loyalty—and hard cases. The easy cases are easy because triggering facts are usually straightforward to identify; the law then provides for close scrutiny. But close scrutiny is not appropriate or feasible for all matters. The law's choice is to defer to the board's business judgment unless there are strong indications that it should not do so.[13] Some, and perhaps many, commentators think the law generally defers too much.[14] But no one has thus far developed a viable alternative that would sufficiently address the hard cases. Law's power in dealing with conflicts of interest in business is thus limited, leaving many problematic conflicts unaddressed.

Part III discusses how some conflicts of interest in government are addressed in government ethics law. Personal conflicts of interest, the revolving door between government and business, and the influence of private money on political campaigns are several of the most serious problems. The law effectively addresses some of these conflicts but many of them are not effectively addressed, particularly those that concern the systematic corruption of government. Ethics laws forbid government officials from holding certain stocks,[15] preclude their participation in certain matters involving their spouses, and even forbid them from participating in particular party matters in which recent prior employers are a party.[16] But ethics laws cannot prevent people from acting in all ways that advance illegitimate interests over those of the public. When government depends upon private contractors to do its work, these problems are even more difficult to resolve.

13. *See, e.g.*, Shlensky v. Wrigley, 95 Ill. App. 2d. 173, 181–83 (1968) (holding that the court would not intervene in the business decisions of directors absent "fraud, illegality or conflict of interest").

14. *See, e.g.*, Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 394, 409–10 (2005) (stating that "our society has tacitly agreed to spare [corporate directors] any significant legal liability for failing to perform their duties as board members" and that the business judgment rule is just one manifestation of directors' legal untouchability).

15. *See* 18 U.S.C. § 208.

16. *See* 5 C.F.R. § 2635.502 (2010).

Part IV gives examples of how conflicts of interest can compound when government manages companies. This problem is not new: the earliest examples we discuss involve events that occurred several hundred years ago. England's South Sea Company, a government-sponsored trading company, was actually used as an investment bank to finance government debt and enrich Tory sympathizers until its stock crashed in 1720.[17] Another example involves Alexander Hamilton's First Bank of the United States and Nicholas Biddle's Second Bank of the United States, institutions that served an important purpose in our financial system but that were sufficiently tainted by corruption that they could not survive politically.[18] More recent examples include Fannie Mae and Freddie Mac, the government-sponsored mortgage companies that had a substantial role in the 2008 financial crisis.[19]

In Part V, we discuss how both business and government can address the hard cases of conflicts of interest. The first step will be recognizing that conflicts are pervasive. The best counterweight to conflicts of interest is a strong commitment to personal and professional responsibility that empowers a business or government decisionmaker to overcome the motivation to advance interests other than those he is supposed to be advancing. Decisionmakers in business and in government should be firmly committed to principles of ethics, not just to obeying narrowly defined rules.

Next, it is important to look for other ways to mitigate the effects of conflicts of interest. Dispersing decisionmaking among different groups of people—for example, shareholders as well as directors in a corporation or different agencies in government—could be part of the solution. Both shareholder oversight and congressional oversight should be more aggressive. Furthermore, collective decisionmaking and oversight functions are aided by transparency. The more information that can be disclosed about factors that might create conflicts of interest—for example, personal relationships of company directors, and prior employment and client relationships of government officials—the better. Finally, the greatest source of conflicts of interest in government is campaign contributions. Unless and until something is done about our system of campaign finance, conflicts of interest will be an ever-present threat.

17. *See infra* notes 141–49.
18. *See infra* notes 150–67.
19. *See infra* notes 170–90.

I. THE FIDUCIARY PRINCIPLE AND CONFLICTS OF INTEREST IN GOVERNMENT AND BUSINESS

The antithesis of conflicts of interest is the fiduciary principle: government and business actors are agents who are supposed to be acting for their principals, not for their own interests (or the interests of others besides their principals). Agents and principals not infrequently have conflicting interests; the agents have both the ability and the incentive to serve interests other than those of their principals, and they sometimes do so at their principals' expense.

Government ethics law and corporate law on fiduciary duty both have as their objective to reinforce the fiduciary principle. Persons trusted with positions of responsibility are fiduciaries, charged with serving the interests of persons to whom they owe fiduciary duties, preferring those interests to any other interests. Officials in all branches of government owe fiduciary obligations to the public.[20] Corporate officials serve the corporation and its shareholders, and owe some duties to corporate employees, customers, and the community.[21] William Henry Vanderbilt was wrong when he said "the public be d—ned."[22] Busi-

20. *See* Kathleen Clark, *Do We Have Enough Ethics in Government Yet? An Answer from Fiduciary Theory,* 1996 U. ILL. L. REV. 57, 74 ("Numerous courts have recognized the fiduciary obligation of government employees, even in the absence of specific legislative or regulatory endorsements of such duties, and these courts have imposed fiduciary-like remedies in response to violations of the conflict and influence components of that obligation."); *see also* Exec. Order No. 12,674 § 101(a), 3 C.F.R. 215 (1990) ("Public service is a public trust."), *as modified by* Exec. Order No. 12,731, 3 C.F.R. 306 (1991) (codified at 5 U.S.C. §§ 7301, 7351, 7353 (2006)).

21. Commentators are divided as to the extent of duties owed to parties who are not shareholders. Some commentators emphasize duties to shareholders; others emphasize duties also owed to "other constituencies." *See, e.g.*, Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 954–65 (1993) (arguing that the fiduciary duties of directors should be extended to employees). Most of this debate is over what directors should do, not what they are required to do. There are very few (if any) cases where courts have required managers to favor shareholders over other constituencies absent a conflict of interest for the managers themselves, such as management resistance to a hostile takeover where they may be acting to preserve their own jobs.

22. *See* DOW'S DICTIONARY OF RAILWAY QUOTES 287 (Andrew Dow ed., 2006). William Henry Vanderbilt, president of the New York Central Railroad and numerous other railroads, was widely reported to have uttered these words on October 8, 1882. Vanderbilt was in his private railroad car when Clarence Dresser, a reporter, entered the car and demanded an interview, vaguely referring to the public's right to know. *Id.* Vanderbilt angrily blurted out his response, which was immediately published in newspapers around the country. *Id.*

ness people have an obligation to seek profits, but they also have an obligation to contribute to the general welfare. Business people violate that obligation when they engage in conduct that imposes negative externalities on people not in a position to seek appropriate redress. Indeed, business people have an obligation to do their best to prevent destruction ensuing from their activities. Both government officials and business managers have an obligation to deal openly and honestly with other people and to use prudence in dealing with other people's property.[23]

Fiduciary principles in government ethics law have evolved differently than fiduciary principles in corporate law.[24] In corporate law, shareholders can sue corporate directors and officers for breach of fiduciary duty as well as vote directors out of office. Government ethics law, on the other hand, does not allow citizens to sue for breach of fiduciary duty. Voting politicians out of office is, in many cases, the only direct remedy for the public. Federal ethics laws, congressional oversight laws, procurement laws, and other regulations supposedly fill the gap.[25]

Transparency and accountability are the twin objectives of most regulatory schemes designed to uphold the fiduciary principle, whether in business organizations or in government.[26] In laws regulating public companies, securities law traditionally has addressed transparency and corporate law has addressed accountability. After the Sarbanes-Oxley Act of 2002[27] and the

23. Trust is a critical part of the fiduciary principle in business as it is in government. As Professor Tamar Frankel has pointed out, commentators and policymakers have too often assumed that business managers are selfish economic actors. There has been insufficient attention paid to promoting trust as a moral value. This cynical approach has been partially to blame for our problems with corporate governance as manager opportunism becomes a self-fulfilling prophecy. *See* TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 76–77 (2006) (arguing that financial dishonesty should be repudiated by citizens who aspire to honesty and reject attitudes and assumptions that underlie corporate scandals); *see also* Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 809–11 (1983) (explaining that from the very structure and nature of the fiduciary relationship stems the risk that the fiduciary will abuse the power entrusted to her, creating the need for legal protections).

24. *See* RICHARD W. PAINTER, GETTING THE GOVERNMENT AMERICA DESERVES: HOW ETHICS REFORM CAN MAKE A DIFFERENCE 3 (2009).

25. *See id.*

26. *See id.* at 4.

27. Sarbanes-Oxley Act of 2002, Pub L. No. 107-204, 116 Stat. 745.

Dodd-Frank Act of 2010,[28] federal securities law, and sometimes, the criminal law, have reached aggressively into both areas.[29] As discussed more fully in Part II below, these laws do not effectively address a broad range of problems in corporate management—sometimes mismanagement—that are attributable to the types of conflicts that we identify as the hard cases.

In government ethics, both transparency and accountability rules come from the government itself, which presents the unique situation that the largest economic actor in our society is essentially self-regulating. As discussed below, government does a relatively good job of addressing problems arising from some isolated and easily identifiable conflicts of interest—such as personal financial holdings—and a relatively poor job of addressing broader concerns arising out of the hard cases of conflicting interest that potentially affect every decision. The hardest conflicts to resolve—for example, conflicting loyalties based upon personal and business ties to special interests—are not effectively addressed by substantive ethics rules.[30]

When government is involved in bailing out or managing a business, the potential for conflicts is pervasive, and some of the conflicts may be intractable. The government has an obligation to protect taxpayers' stake in the bailed-out companies; however, it also has broader obligations such as having a prudent monetary policy and protecting investors from inflated markets. When the government wants to sell some of its stake in General Motors, AIG, and other bailed-out companies, it is in a position to influence—even inflate—the markets in which those securities will be sold, the apparent value of financial as-

28. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

29. *See* PAINTER, *supra* note 24, at 14 ("Criminal statutes and prosecutions . . . are increasingly used to address misconduct by corporate officers and directors. This trend was already prevalent by the 1990s, but accelerated after the Enron scandal and passage of the Sarbanes-Oxley Act of 2002.").

30. Another comparison can usefully be made between business and government:

> Corporate managers and government officials also share another similarity: the power of incumbency. Absent egregious neglect of transparency in their dealings with investors or egregious departures from the accountability principle, corporate managers have enormous staying power. It is difficult for shareholders to throw them out. Dishonest or self-serving conduct falling short of the worst is difficult to control. In government also, officeholders have an advantage over anyone who challenges their authority. In both contexts, poorly performing fiduciaries are often hard to get rid of.

Id. at 5.

sets held by those companies, and the market value of its own investment. Not all of the things government might do to maximize the value of its own position in these bailout transactions will help investors or the economy generally, yet there are compelling political, if not budgetary, reasons for government to do everything it can to maximize the value of its own holdings. No government official wants to tell the public that taxpayers took a huge loss bailing out companies, particularly when executives of these companies still get paid far more than the average taxpayer.

Difficult ethical questions arise. What should the government do to increase the value of its stake in these companies? What should government not do? How should government balance its interest as an investor with its role as a regulator of financial markets? Is the benefit to taxpayers if the government gains more money from selling its stake in these companies an appropriate reason for the government to temporarily prop up markets into which that stock will be sold? If so, what are legitimate ways for government to prop up these markets?

These are scarcely the only ethical issues when government is involved in managing companies. AIG, Fannie Mae, and Freddie Mac are notable examples in which government funds were used to pay outsized executive bonuses.[31] Both the government decisionmakers who invested taxpayer money in these enterprises and the business decisionmakers who were their political allies and got the bonuses had many conflicts of interest. To what extent were these decisions affected by conflicts of interest in both government and business?

In hard cases such as those described in the preceding paragraph, it is not clear if the fiduciary is acting in furtherance of one or more legitimate interests, an illegitimate interest, or some combination thereof. This is what makes hard cases hard: because of the multitude of interests involved, sorting out the legitimate from the illegitimate can be close to impossible. The law will necessarily fall short in dealing with this category. Inquiries into motives are not the law's strong suit, and where there are several legitimate interests, the case may be hard conceptually as well as practically. An outright prohibition is unwarranted and in any event infeasible, and close scrutiny

31. *See, e.g.*, Edmund L. Andrews & Peter Baker, *At A.I.G., Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES, Mar. 15, 2009, at A1, *available at* 2009 WLNR 4926991; Charles Duhigg, *Big Bonuses at Fannie and Freddie Draw Fire*, N.Y. TIMES, Apr. 4, 2009, at B1, *available at* 2009 WLNR 6331273.

would be exceedingly expensive. Corporate law and government ethics law have some doctrines designed to deal with these hard cases, but their success is quite limited. As a conceptual matter, the ideal course is apparent: the actor's motive determines whether his action was conflicted. But the inquiry is difficult and expensive; moreover, mixed motives are always a possibility.[32]

The following are examples where there may be two possible interests, one legitimate and one illegitimate.

(1) A government official dealing with a private contractor may be interested in obtaining a job with the contractor. As long as no job negotiations are occurring, how would the government official's interest be sufficiently obvious that law can address the problem? Presumably, it is not feasible to prohibit all dealings between government officials and those who might later offer them a job. Moreover, whether or not the official wants a job with the contractor, his dealings with the contractor on behalf of the government may properly serve the government's interests.

(2) A corporate executive who is CEO of company A and also a director of company B may vote for a generous compensation package for company B's CEO because he thinks the company CEO warrants this package. He may (or merely) be hoping to raise the threshold of CEO pay and to reinforce a norm of director acquiescence to high CEO pay packages.[33]

(3) An ex-banker in government may make decisions that favor bankers at his old firm, perhaps out of a genuine conviction that the decisions best serve the public interest, and (or) because he empathizes with his former colleagues.

Even more difficult are situations involving several legitimate interests, as well as, perhaps, an illegitimate interest. A few examples follow.

(1) A successful financial institution might be deciding whether to expand into other business areas that are potentially lucrative but that also pose a risk for its creditors. Among

32. The potential for self-serving bias compounds the difficulty of determining whether a conflict exists. A person might convince himself that the course of action that is in his self-interest is in fact in the interests of the person or entity he is supposed to be serving. For example, the CEO may convince himself that the friend from whom he may want favors in the future really is the best person for the company to hire.

33. *See* Claire A. Hill & Brett H. McDonnell, Disney*, Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 853 (2007) [hereinafter Hill & McDonnell, Disney].

the legitimate interests potentially benefiting from the expansion are diversified shareholders, who would gain if the new business areas are profitable. The creditors, who do not share in the upside profits from a risky venture, will probably see the situation differently. The financial institution's management, however, might have its own illegitimate motives: for instance, the new business areas may be ones in which companies often pay very large bonuses to their executives.[34]

(2) A company may have to choose whether to automate some of its operations in order to ultimately lower its costs. Among the competing legitimate interests are those of the shareholders in higher profits and those of employees in keeping their jobs. The management may also have its own illegitimate motives; the CEO may have personal ties with the CEO of the company likely to be hired to do the automation.

(3) A government official might decide to prefer labor creditors over other creditors in bailing out an automobile company, both because labor unions contributed to his political campaign and because he believes his constituents want him to prefer labor over other interests.

(4) A high-ranking Treasury Department official has been required by government ethics lawyers to sell all of his stock in his prior employer, an investment bank, but many of his close friends still work at the investment bank. He made most of his fortune there, and but for his successful career at the investment bank, he would not have the prestigious government job he now has. When the investment bank wants something from the Treasury Department—for example, a bailout of some other entity that owes the investment bank money—the official may find it difficult to say "no" to the bank, whatever his view may be of the merits. The request, however, also might be for something that the official believes is in the best interests of the overall economy, or perhaps even something that the official believes is necessary to prevent economic collapse. Sorting out why the official did what he did in this situation could be extremely difficult, and in any event would be an exercise of little practical value.

34. This is not merely hypothetical; after the repeal of the Glass-Steagall Act's restrictions on mixing commercial banking and investment banking, many commercial bank holding companies faced exactly this choice, and many decided to enter these more lucrative—and riskier—lines of business, perhaps to benefit their shareholders, but perhaps also to benefit their managers.

We next consider how corporate law and government ethics law approach these types of conflicts.

II. CONFLICTS OF INTEREST IN BUSINESS

Corporate law is in some respects better situated to deal with the problem of conflicts than is government ethics law. Business conflicts are more tractable, and there are people with ability, incentive, and an appropriate forum—shareholders, who can pursue lawsuits (and use proxy contests and other remedies)—to call the corporate officers to account. Still, the law falls short.

In business, as in any activity conducted by agents, the potential for conflicts of interest is pervasive. State corporate law addresses conflicts of interest by imposing a fiduciary duty on directors and officers.[35] Directors and officers owe fiduciary duties to their principal, the corporation (and its shareholders). They may have duties to other constituencies, such as employees, customers, and the greater community. But there are other interests that are clearly illegitimate. They should not be serving these interests, or their own interests, at the expense of the principal.

For certain types of breaches of fiduciary duty, law does a passable job. These are the cases where conflicts are straightforward, stark, and amenable of somewhat formulaic description—easy cases, where an outright prohibition, or at least close scrutiny, is appropriate. Corporate law typically adopts the latter approach, as discussed below. Difficulties quickly arise in other cases, where a corporate actor may or may not be serving illegitimate interests. The law has adopted a number of intermediate standards providing for some scrutiny, although less than the scrutiny involved in the easy cases.[36] Law in this area has not been nearly as successful as it has in the easy cases.[37]

Recall the two categories of conflicts of interest described in the Introduction. The first category, the easy cases, corresponds with the duty of loyalty as traditionally conceived. The

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35. See generally Claire A. Hill & Brett H. McDonnell, Stone v. Ritter*: The Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769 (2007) [hereinafter Hill & McDonnell, Stone v. Ritter], and Hill & McDonnell, Disney, *supra* note 33, from which some of this Part is adapted.

36. *See* Hill & McDonnell, Disney, *supra* note 33, at 837–40; Hill & McDonnell, Stone v. Ritter, *supra* note 35, at 1791–94.

37. *See* Hill & McDonnell, Disney, *supra* note 33, at 837–40.

second category consists of the hard cases. A fiduciary may be pursuing a legitimate interest, an illegitimate interest, or both. In some instances, there are only two possibilities—the interest is legitimate or it is not. A common example in corporate law involves doing something because it favors a crony. The very act that is problematic when motivated by cronyism might be acceptable if not so motivated. The difficulty arises because the law is quite poor at discerning true motives. Complications multiply where there are several possible legitimate interests as well as possible illegitimate interests. Should a company be moving some of its operations to a tax haven to lower its taxes? How should a company balance the interests of employees in keeping their jobs with those of shareholders in higher profits? The law does not generally get involved in such decisions, leaving them to the managers' business judgment. This is so even though the managers may actually be motivated by cronyism or some other illegitimate interest. For instance, the CEO's good friend is an executive at the company that can provide equipment to automate the company's operations; the company can reduce its labor costs by automating, but the CEO's motivation is to send business to his friend. The law only gets involved in a small subset of mixed-motive situations, such as those involving *Revlon* duties[38] when a company is up for sale. In scrutinizing a transaction under *Revlon*, a court might find that a board's claim to be acting in the interests of its employees in rejecting a takeover bid of an acquirer contemplating workforce reductions in favor of a more management-solicitous bid was a pretext for preferring its own interests.[39] But again, absent *Revlon*-type considerations, the law generally will defer to management's choice as between legitimate interests, even though the more legitimate interests there are, the easier it may be to disguise an illegitimate interest.

We begin with the first category—the easy cases. The best example is self-dealing "where a director, officer, or controlling

38. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179–80 (Del. 1986).

39. This is akin to what happened in *Revlon*. Directors justified their action in accepting a bid to be acquired by a company that would "support" the value of certain Revlon promissory notes in part by arguing that it was taken to advance the interests of creditors. The court noted that "while concern for various corporate constituencies is proper when addressing a takeover threat, that principle is limited by the requirement that there be some rationally related benefit accruing to the stockholders." *Id.* at 176. Indeed, the court believed that the directors were principally acting to benefit themselves—to avoid lawsuits by the holders of the notes.

shareholder has clearly identifiable, specific monetary interests at stake in a decision that puts her own self-interest at odds with the interests of the corporation."[40] Recurring fact situations include hiring of a spouse or other close family member and transactions between a director or officer and the corporation.

Courts carefully scrutinize transactions involving self-dealing. When there is enough reason to suppose the transactions may be tainted, close scrutiny is warranted; moreover, discouraging such transactions may be desirable. The law specifies methods by which transactions between an officer or director and the corporation may be "cleansed:"

> In Delaware, these three methods come from section 144 of the Delaware General Corporation Law; most states have a variant of this statute. One method of validating a conflicted transaction is to get approval of the transaction by the disinterested and independent members of the board. . . . The second method of validating conflicted transactions is to get approval of disinterested shareholders. . . . The third method for validating conflicted transactions is for the defendant to show that the transaction was entirely fair to the corporation. This involves demonstrating both that the corporation followed a fair procedure and that the transaction was on substantively fair terms.[41]

If one of these methods is used, a defendant director or officer is unlikely to be found liable for breach. The transaction will be subject to judicial review, but the standard of review will be deferential to the defendants.

The Model Business Corporation Act (MBCA) also has provisions on "Directors' Conflicting Interest Transactions."[42] The MBCA provides for validation via disinterested director or disinterested shareholder approval, defining in great specificity all relevant terms.

Other common conflict situations include taking a corporate opportunity and competing with the corporation. Here too, there are varying approaches specified, with disclosure and approval of disinterested parties being typical solutions.[43]

The law is most comfortable dealing with these and other classic loyalty breaches, where the officer or director's interest is clearly opposed to that of the corporation.[44] The easiest cases

40. Hill & McDonnell, Disney, *supra* note 33, at 835.

41. *Id.* at 835–36 (citations omitted).

42. MODEL BUS. CORP. ACT §§ 8.60–.63 (1985).

43. *See generally id.* intro. cmt., subch. F, § 4; *id.* § 8.70; FRANKLIN A. GEVURTZ, CORPORATION LAW 382–407 (2d ed. 2010).

44. The law should probably be less comfortable than it is giving deference to an interested decision sanitized by disinterested directors, given that

are those where discouraging the types of transactions at issue is usually appropriate. A corporation can presumably function quite well without engaging in transactions with its officers or directors or hiring their family members. The law has more difficulty appropriately defining what constitutes taking a corporate opportunity and competing with the corporation. There are obvious perils to both too-broad and too-narrow definitions. The more limits a corporation puts on an officer or director's behavior, the more the corporation may discourage good candidates from taking the job.[45] But an unduly narrow definition is also unsatisfactory, allowing for behavior that benefits the officer or director while harming the corporation.

The law has yet more difficulty when the conduct at issue is not paradigmatic self-dealing. Consider the following scenario. X is an elementary school principal. The father of some students at the school, the CEO of a huge entertainment company, chooses her to be on the board of the company. The fee for board attendance for each meeting is more than X's entire annual salary. X effectively serves at the CEO's pleasure. What is the law to do about this situation—consider any vote of X's a product of an illegitimate interest? To many people, common sense would suggest an affirmative answer to the question. But a court faced with precisely this situation deemed this director to be independent and not dominated by the CEO who selected her.

The case in question involved the Disney Corporation.[46] Shareholders challenged a decision by the Disney board to hire a friend of the CEO as president, to give the president a generous severance package and, one year after he became president, and when it became clear that his employment with Disney was not a success, to pay him severance in excess of $140 million. One argument shareholders made was that the board was dominated by Michael Eisner, the CEO. The court held that most of the board of directors—including the principal of the elementary school that Eisner's children had once attended and

even these directors probably have some structural bias. *See infra* notes 56–59 and accompanying text. One of the authors of this Article is co-writing an article suggesting how courts should deal with independent director cleansing of interested transactions.

45. This is of course a far more significant concern as to outside directors, who only devote some of their time to the corporation, than officers, who presumably have limited time to be involved in an outside venture.

46. For a discussion of the case, see generally Hill & McDonnell, Disney, *supra* note 33, at 843–45.

whose salary as a teacher was low relative to her director compensation—was not dominated by Eisner.[47]

The court reasoned that to deem the elementary school principal dominated

> would be to discourage the membership on corporate boards of people of less-than extraordinary means. Such "regular folks" would face allegations of being dominated by other board members, merely because of the relatively substantial compensation provided by the board membership compared to their outside salaries. I am especially unwilling to facilitate such a result.[48]

Regardless of the court's finding that Disney's board met the legal standard for independence, the general consensus was that as a practical matter, the board was not independent. An article in *BusinessWeek* around the time of these events stated that:

> Disney's directors have won the dubious distinction of being named the worst board in America in *BusinessWeek*'s second annual analysis of the state of corporate governance. Institutional investors and boardroom watchers scorn what they see as a meek, handpicked group, many of whom have long ties to Eisner or the company.[49]

Another Disney director was the president of Georgetown University, to which Eisner had donated $1 million (and from which one of Eisner's sons had graduated).[50] The court found that this director also was not dominated by Eisner.[51] One reason the court gave is that the director was a Jesuit, and hence unable to keep his director's fee.[52]

To be fair, the court did find some of the directors to be dominated, including Eisner's personal lawyer[53] and an architect whose firm received fees from Disney.[54] And the plaintiffs successfully repled their allegations and were granted a trial. The plaintiffs lost, but the record developed at trial did suggest more independence in the directors' actions than might initially have seemed to be the case. The Delaware Court of Chancery, in announcing why the defendants would prevail, articulated a

47. *See In re* Walt Disney Co. Derivative Litig. (*Disney I*), 731 A.2d 342, 356–61, 380 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

48. *Id.* at 360.

49. John A. Byrne et al., *The Best and Worst Boards*, BUS. WK., Dec. 8, 1997, at 90, 90.

50. *See Disney I*, 731 A.2d at 359.

51. *See id.* at 360.

52. *See id.* at 358–59.

53. *See id.* at 360.

54. *See id.* at 357–58.

very high bar for plaintiff success where traditional self-dealing or other canonical duty of loyalty claims are not at issue: that the directors have to act in "bad faith."[55] In the final opinion issued in this series of cases, the Delaware Supreme Court held that

> [a] failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.[56]

The doctrinal label for issues raised by the Disney board is "structural bias." The term has not been precisely defined, but one commentator's definition captures what it means:

> The term "structural bias" generally refers to the prejudice that members of the board of directors may have in favor of one another and of management. It is said to be the result of the "common cultural bond" and "natural empathy and collegiality" shared by most directors, the "economic[] or psychological dependen[cy] upon or tie[s] to the corporation's executives, particularly its chief executive," and the "process of director selection and socialization, which incumbent management dominates."[57]

The "pernicious golden rule"—a corporate manager's credo to treat another manager as he would like to be treated—aptly describes one facet of structural bias.[58] Many directors are CEOs of other companies. Director A of company X is CEO of company Y. He defers to X CEO because he, in his capacity as Y CEO, would like his board to defer to him. The phenomenon is particularly evident in the case of compensation decisions.

The bulk of the hard cases are classic structural bias cases. Another closely related category is where board members may be acting to further their own interests instead of, or in addition to, those of their cronies. These cases can be classified as "suspect motive" cases.[59] The board favors a takeover by A rather than B (perhaps) because A will retain both the officers

55. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 753–55 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006). Of course, the other intermediate standards established for particular types of fact patterns might yield liability under different doctrines. The court did not establish "good faith" as the sole alternative duty to the traditional duty of loyalty.

56. *Id.* at 755–56.

57. Velasco, *supra* note 12, at 824.

58. *See* Hill & McDonnell, Disney, *supra* note 33, at 853.

59. *See* Hill & McDonnell, Stone v. Ritter, *supra* note 35, at 1780–81.

and directors. For purposes of this Article, we will refer to many of these cases as structural bias cases as well: while the doctrinal specifics may differ, the differences are not important for our thesis.

These types of potential conflicts are pervasive. Every decision a board member makes may reflect a conflict of interest. Not surprisingly, courts are hard pressed to deal with the issue. They can scarcely micromanage every business decision. Indeed, they typically do just the opposite, giving considerable business judgment deference, unless confronted with a case of clear conflict. When boards are inclined to be overly deferential to corporate management and when there is considerable mutual back-scratching, some of what occurs at corporations will serve the interests of corporate managers at the expense of the interests they are supposed to serve, most notably those of the corporation and its shareholders.

In the last decade and a half there has been increasing emphasis on encouraging more independent boards in hopes that they will be better monitors.[60] This sounds sensible, but the key is the definition of "independence." What is needed is independence in spirit, not independence determined by reference to some relationship one can formulaically describe, such as close kinship or a business partnership or contractual connection. There is no good way to discern independence in spirit.[61] Thus, kinship and business relationships are used as proxies, with the relationships at issue being narrowly and specifically defined.[62] People like the elementary school principal and the Georgetown president are treated as independent, as are CEOs of other companies, even though each of these may

60. *See, e.g.*, Claire A. Hill & Erin Ann O'Hara, *A Cognitive Theory of Trust*, 84 WASH. U. L. REV. 1717, 1781 (2006).

61. *See* Nell Minow, Editor, The Corporate Library, Remarks at the National Investor Relations Institute and Public Affairs Council's Symposium on Corporate Governance and Shareholder Activism (Dec. 12, 2002) (transcript on file with authors).

62. It should be noted, though, that while the text mostly discusses state corporate law, much of the law governing independence of directors is federal law. *See generally* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003); Mark J. Roe, *Delaware's Politics,* 118 HARV. L. REV 2491 (2005). It also should be noted that there is significant pressure for "independent" boards from institutional shareholder groups. Again, independence is defined by formula. *See, e.g.*, CAL. PUB. EMPS. RET. SYS., GLOBAL PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE 8–9 (2010) [hereinafter CALPERS, GLOBAL PRINCIPLES], *available at* http://www.calpers-governance.org/docs-sof/principles/2010-5-2-global-principles-of-accountable-corp-gov.pdf.

be biased for the reasons previously discussed. People who do not meet the formal criteria for independence for some reason such as having contractual relationships with the company might be truly independent and able to monitor management effectively. Increasingly, state law in this area is being supplemented with federal law. Indeed, "independence" as state corporate law—and the Sarbanes-Oxley Act—has defined it can be the worst of all worlds: "independent" directors may not know enough about the company's business to be good monitors of its management but may still have a structural bias in favor of management such that they do not want to know—and may not care—if management is hurting the company. "Independent" and willfully ignorant directors can stick their heads in the sand while management does as it pleases.[63] Meanwhile, because of the requirements and pressure to have mostly "independent" boards and particular board committees that are all or majority independent,[64] well-qualified directors who know a great deal about the company and do not meet formulaic standards of independence are selected less often.

An excellent example of structural bias manifesting itself in board inaction occurred at Enron. Of its fourteen members, only three were employees or former employees of Enron. The other eleven included various well-respected (and business-savvy) individuals such as Robert Jaedicke, an emeritus accounting professor and former dean of the Stanford Business School, who headed the Audit Committee.[65]

But "[i]t turn[ed] out that the independence of virtually every board member, including Audit Committee members, was undermined by side payments of one kind or another. Independence also was compromised by the bonds of long service

63. The American approach to board "independence" differs markedly from the approach to corporate governance in some other countries where most directors have a contractual relationship—or work for a financial institution having a contractual relationship—with the company. *See* Wulf A. Kaal & Richard W. Painter, *Initial Reflections on an Evolving Standard: Constraints on Risk Taking by Directors and Officers in Germany and the United States*, 40 SETON HALL L. REV. 1433, 1452–53 (2010). Commentators in those countries are skeptical about whether the American approach to "independence" actually works, or instead burdens companies with directors who are unfamiliar with the company's operations while still being subject to structural bias. *See id.* at 1473–74.

64. *See, e.g.*, NYSE LISTED COMPANY MANUAL § 303A (2010), *available at* http://nysemanual.nyse.com/LCM/Sections/; *see also* CALPERS, GLOBAL PRINCIPLES, *supra* note 62, at 8–9.

65. *See* Hill & O'Hara, *supra* note 60, at 1783.

and familiarity."[66] Enron's board did not look hard at what was happening in the company, allowing it to run a shell game and eventually collapse.[67] In one glaring example, it approved a waiver of its conflict-of-interest policies to allow its chief financial officer, Andrew Fastow, to run (as a general partner) a partnership doing business with Enron.[68]

As the Enron case, and most recently the debacle at Citigroup, Lehman Brothers, and many other large financial institutions, demonstrated, board inaction and/or willful ignorance sometimes rooted in structural bias can be far more devastating for shareholders and the economy as a whole than the board actions that prompted the *Disney* case.

To be fair, courts sometimes make the fact-intensive inquiry that exposes and may defeat structural bias. Consider the following language from Vice Chancellor Strine's opinion in *In re Oracle Co. Derivative Litigation*, in which a committee of "independent" directors was formed to decide whether to terminate a lawsuit against some of Oracle's executives for insider trading.[69] The Special Litigation Committee (SLC) decided to terminate the lawsuit.[70] The court, however, held that the SLC had not met its burden of showing that it was independent:

> Of course, the SLC says these facts [alleging connections between Larry Ellison of Oracle and Stanford, where two members of the SLC were professors] are meaningless because Stanford rejected Ellison's child for admission. I am not sure what to make of this fact, but it surely cannot bear the heavy weight the SLC gives it. The aftermath of denying Ellison's child admission might, after all, as likely manifest itself in a desire on the part of the Stanford community never to offend Ellison again, lest he permanently write off Stanford as a possible object of his charitable aims—as the sort of thing that acts as not one, but two strikes, leading the batter to choke up on the bat so as to be even more careful not to miss the next pitch. Suffice to say that after the rejection took place, it did not keep Ellison from making public statements in *Fortune* magazine on August 13, 2001 about his consideration of making a huge donation to Stanford, at the same time when the two SLC members were being courted to join the Oracle board.[71]

66. Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1241–42 (2002).

67. *See id.* at 1233–35.

68. Complaint ¶ 7, SEC v. Fastow, No. H-02-3666 (S.D. Tex. Oct. 2, 2002), *available at* http://www.sec.gov/litigation/complaints/comp17762.htm.

69. *In re* Oracle Co. Derivative Litig., 824 A.2d 917, 928 (Del. Ch. 2003).

70. *See id.*

71. *Id.* at 946.

The court therefore denied the SLC's motion to terminate the lawsuit.

It seems unlikely, however, that this caliber and level of inquiry would be routinely made. And it is not even clear that making such an inquiry on a regular basis would be desirable. It would add considerable costs and uncertainty, and it would embolden plaintiffs' lawyers, who have their own conflicts of interest when they represent a corporation's shareholders.

One of the most difficult cases involving two competing interests was the government-orchestrated merger of Merrill Lynch and Bank of America (BofA) in 2008.[72] The deal turned out to be a bad one for BofA shareholders,[73] and it became clear that BofA management may have misrepresented critical facts about Merrill's financial health to its shareholders.[74] The Treasury Department and other parts of the government were eager to get the deal done to stave off further erosion of confidence in the financial system. Treasury officials, including former Secretary Henry Paulson, apparently exerted exceptional pressure on BofA management to close the deal.[75] The government also may have known that BofA managers were not tell-

72. For a description of the events leading up to and following the merger, see Letter from Andrew Cuomo, Attorney Gen., N.Y., to Senator Christopher Dodd, Chairman, Senate Comm. on Banking, Housing & Urban Affairs 2–4 (Apr. 23, 2009), *available at* http://online.wsj.com/public/resources/documents/BofAmergLetter-Cuomo4232009.pdf.

73. *See id.* at 1–2.

74. *See id.* at 2, 4.

75. *See id.* at 2–4. Attorney General Cuomo's letter suggests that Secretary Paulson and other government officials threatened to replace BofA's management and its board if BofA backed out of the deal as Merrill's losses mounted, and that BofA management was now claiming that the Treasury Department did not want disclosure of the true facts to BofA shareholders. *See id.* at 3. The predicament BofA management was in when they tried to justify the deal is apparent in Attorney General Cuomo's rendition of an interview his office had with BofA CEO Ken Lewis:

> Q. Wasn't Mr. Paulson, by his instruction, really asking Bank of America shareholders to take a good part of the hit of the Merrill losses?
>
> A. What he was doing was trying to stem a financial disaster in the financial markets, from his perspective.
>
> Q. From your perspective, wasn't that one of the effects of what he was doing?
>
> A. Over the short term, yes, but we still thought we had an entity that filled two big strategic holes for us and over long term would still be an interest to the shareholders.
>
> Q. What do you mean by "short-term"?
>
> A. Two to three years.

Id. at 5.

ing their own shareholders the true story, yet for the greater good the government may have looked the other way. BofA shareholders had a legitimate interest in the value of their investment, but another legitimate interest—preserving confidence in the financial system by doing something about an insolvent Merrill Lynch—apparently dominated both corporate and government decisionmaking. The Securities and Exchange Commission (SEC) subsequently brought suit against BofA for lying to its shareholders,[76] and a $150 million settlement of the suit was only grudgingly approved by federal Judge Jed S. Rakoff.[77] Questions not yet answered are whether the government itself was an aider and abetter of this fraud against shareholders and whether the government allowed this deal to happen the way it did because, in this extraordinary circumstance, the ends were believed to justify the means.

Of course, many corporate decisions are not so seriously conflicted as to undermine legitimate corporate interests. But the foregoing suggests that top decisionmakers at corporations sometimes are not in an ideal position to make decisions that advance the interests that those decisions are supposed to advance. Where there is a stark conflict, the law has plausible procedures. But people are naturally influenced by many types of personal and professional ties. It may be difficult to distinguish between decisions that appear to favor illegitimate interests but in fact favor legitimate interests and decisions that favor illegitimate interests whether or not they appear to do so. The problems are pervasive and do not lend themselves to any easy resolution. The law cannot closely scrutinize every board action (or inaction). Its general rule is strong deference to the board's business judgment unless there is a clear conflict or a showing of bad faith, or in a few other circumscribed fact patterns such as failure to make disclosures required by securities laws (as in the BofA case).[78] Thus, even if board behavior is challenged, in most cases the board will prevail.

76. Complaint ¶¶ 1–7, SEC v. Bank of Am. Corp., Nos. 09 Civ. 6829, 10 Civ. 0215 (S.D.N.Y. Jan. 12, 2010).

77. *See* Louise Story, *Bank's Deal with SEC Is Approved*, N.Y. TIMES, Feb. 23, 2010, at B1, *available at* 2010 WLNR 3771779 (discussing Judge Rakoff's displeasure with the settlement of the SEC's case, which had arisen out of BofA's failure to disclose to its shareholders Merrill's losses and hefty bonus payouts that eventually led to a second government bailout of $20 billion).

78. *See* Kaal & Painter, *supra* note 63, at 1459–61.

III. CONFLICTS OF INTEREST IN GOVERNMENT

Government ethics law contains both broad principles and specific rules. The principles include impartiality and other aspects of decisionmaker independence. As illustrated in the discussion that follows, however, the rules do little to eliminate or even mitigate the hard cases of conflicts of interest.

A 1989 Executive Order of President George H.W. Bush set forth fourteen principles of ethical conduct for government employees,[79] which were then included in Office of Government Ethics (OGE) regulations known as the Standards of Conduct.[80] The standards included a specific provision that government employees shall not only avoid violating the standards but also endeavor to avoid actions creating an appearance that they are violating the law or the standards. This is the fourteenth principle set forth in the Executive Order as well as the fourteenth standard of conduct set forth in the OGE regulations.[81] The other thirteen standards are:

> (1) Public service is a public trust, requiring employees to place loyalty to the Constitution, the laws and ethical principles above private gain. (2) Employees shall not hold financial interests that conflict with the conscientious performance of duty. (3) Employees shall not engage in financial transactions using nonpublic Government information or allow the improper use of such information to further any private interest. (4) An employee shall not, except as permitted by subpart B of this part, solicit or accept any gift or other item of monetary value from any person or entity seeking official action from, doing business with, or conducting activities regulated by the employee's agency, or whose interests may be substantially affected by the performance or nonperformance of the employee's duties. (5) Employees shall put forth honest effort in the performance of their duties. (6) Employees shall not knowingly make unauthorized commitments or promises of any kind purporting to bind the Government. (7) Employees shall not use public office for private gain. (8) Employees shall act impartially and not give preferential treatment to any private organization or individual. (9) Employees shall protect and conserve Federal property and shall not use it for other than authorized activities. (10) Employees shall not engage in outside employment or activities, including seeking or negotiating for employment, that conflict with official Government duties and responsibilities. (11) Employees shall disclose waste, fraud, abuse, and corruption to appropriate authorities. (12) Employees shall satisfy in good faith their obligations as citizens, including all just financial obligations, espe-

79. *See* Exec. Order No. 12,674, 3 C.F.R. 215 (1990), *as modified by* Exec. Order No. 12,731, 3 C.F.R. 306 (1991) (codified at 5 U.S.C. §§ 7301, 7351, 7353 (2006)).

80. *See* 5 C.F.R. § 2635.101 (1992).

81. *See id.*

> cially those—such as Federal, State, or local taxes—that are imposed by law. (13) Employees shall adhere to all laws and regulations that provide equal opportunity for all Americans regardless of race, color, religion, sex, national origin, age, or handicap.[82]

Federal ethics regulations seek to implement the standards by addressing specific threats to the fiduciary principle—and in particular, certain enumerated biases that undermine impartiality. Government ethics law, like corporate law, thus targets the specific threats that lawmakers and regulators want to address and believe they can address with legal rules. As explained more fully below, other influences that bias government officials' decisionmaking are not addressed.

First among the influences that government ethics law does address is personal financial conflicts of interest. Government ethics law is obsessed with stockholding and other personal financial interests that could bias public officials; it includes extensive transparency and accountability rules in this area.

The financial disclosure regime was introduced by the Ethics in Government Act of 1978[83] and covers all three branches of government. Disclosure is intended to increase public confidence in government, demonstrate the integrity of most government officials, deter conflicts of interest, deter persons from entering public service if their personal finances cannot withstand public scrutiny, and facilitate public assessment of government officials in light of outside financial interests.[84] A more cynical view is that financial disclosure, along with, perhaps, some other aspects of federal ethics regulation, is intended to create the appearance of impartiality while the more serious conflicts of interest in government go unregulated.

Form 278 (Public Financial Disclosure) is required of all presidential candidates, nominees to presidentially appointed, senate-confirmed (PAS) positions in the executive branch, senior agency employees above the GS-15 level on the Executive Schedule, and commissioned officers in the White House.[85] The

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82. *Id.*

83. Ethics in Government Act of 1978, Pub. L. No. 95-521, 92 Stat. 1824, *amended by* Ethics Reform Act of 1989, Pub. L. No. 101-194, 103 Stat. 1716.

84. *See* OFFICE OF GOV'T ETHICS, REPORT TO CONGRESS EVALUATING THE FINANCIAL DISCLOSURE PROCESS FOR EMPLOYEES OF THE EXECUTIVE BRANCH, AND RECOMMENDING IMPROVEMENTS TO IT 2 (2005) [hereinafter OGE, REPORT TO CONGRESS], *available at* http://www.usoge.gov/ethics_docs/publications/reports_plans/rpogc_fin_dis_03_05.pdf.

85. Employees holding positions not under the General Schedule must file if their basic pay is equal to or greater than 120 percent of the minimum rate

required disclosures about personal financial holdings are extensive and include the underlying assets of some investment funds.[86] A limited number of government officials put their assets in blind trusts, the contents of which are not disclosed, but most do not have blind trusts and those officials' assets are disclosed.[87] There is some required disclosure of recent private sector relationships such as consulting engagements for two years prior to and during government service. Form 278 requires disclosure of spousal income and assets, but not the assets, employment, or other private-sector relationships of parents, siblings, grown children, or other family members. Form 278 also does not include investments and other interest of close friends or former business associates.

A great deal of effort is expended by government officials, their lawyers, their agencies, and the OGE to determine what does and does not have to be reported on the Form 278 and when investments such as hedge funds and private equity funds have to be broken out on the form into their component

of basic pay for GS-15 of the General Schedule. *See* OFFICE OF GOV'T ETHICS, PUBLIC FINANCIAL DISCLOSURE: A REVIEWER'S REFERENCE (2008), *available at* http://www.usoge.gov/ethics_docs/publications/reference_publications/rf278guide_
04.pdf; *see also* 5 C.F.R. pt. 2634 (2000).

86. Form 278 requires for each reporting period—usually the calendar year—disclosure for the filer, the filer's spouse, and minor children of all assets valued over $1000; income from any nonfederal source over $200 (Schedule A); purchases, sales, or exchanges of assets (Schedule B, Part I); gifts received over $335 from any single source other than family members during the reporting period; and payments of travel expenses in cash or kind (Schedule B, Part II). A noticeable exception is that there need be no report on Form 278 or anywhere else of political travel reported to the Federal Election Commission. Form 278 also requires disclosure of liabilities outstanding during the reporting period (Schedule C, Part I); agreements and arrangements with nonfederal persons, such as continued participation in an employee benefit plan, continued payments by a former employer including severance payments, and agreements for future employment (Schedule C, Part II); and positions held outside the federal government, whether compensated or not, such as officer, director, trustee, general partner, employee, or consultant (Schedule D, Part I). New employees coming into the federal government are required to disclose most of the same information back to the beginning of the prior calendar year. New employees are also required to disclose for the prior two years all sources of outside income over $5000 annually received from any one source. *See* 5 C.F.R. pt. 2634 (2010).

87. The underlying assets of a "qualified blind trust" do not have to be reported on Form 278, because public disclosure would defeat the purpose of a blind trust. However, rules for blind trusts in the executive branch are very strict. The requirements for a qualified blind trust are set forth in 5 C.F.R. § 2634.403.

parts.[88] For wealthy filers, often political appointees at the highest levels of government, Form 278 can be dozens of pages long.[89] The form reveals almost nothing, however, about these persons' involvement in the system of campaign finance—donating money and raising money—that may have helped them get government appointments in the first place.

Form 278 filings are publicly available upon request from OGE or from the filer's agency.[90] For the most part, if someone wants to find out what a senior government official or his or her spouse own, this information is publicly available, leading to a media feeding frenzy for trivia when the president files his form. Given the failure of Form 278 to address many types of structural bias, however, this financial information often is not very useful for identifying factors that bias government decisionmaking. As explained more fully below, financial assets that would be listed on the form and that could cause bias most

88. All individual investments must be listed separately, including underlying holdings of brokerage accounts, trusts, partnerships, and investment funds. Only if an investment fund qualifies as an "excepted investment fund" (EIF), a term created by Congress, is disclosure of underlying assets in the fund not required. The term EIF designates a pooled investment vehicle that meets all three of the following requirements: (1) the fund is widely held (a widely held fund has more than one hundred investors); (2) the fund is either (a) publicly traded (or available), or (b) widely diversified (a widely diversified fund holds no more than five percent of the value of its portfolio in the securities of any one issuer other than the U.S. government and no more than twenty percent of the value of its portfolio in any single economic or geographic sector); and (3) the fund is independently managed so that the filer does not have the ability to exercise control over fund investments. Mutual funds, money-market funds, annuities, defined-contribution pension plans, and similar investments qualify as EIFs, but some private-equity funds, venture-capital funds, hedge funds, and other funds are not EIFs, usually because they are not "widely held." If a fund is not an EIF, each and every separate investment in the fund must be identified and listed on Form 278. This has led some filers' Forms 278 to be dozens of pages long, even if they invest in only a few funds that are not EIFs.

89. OGE has recommended that Congress simplify the financial disclosure regime, and pare back unnecessary details in disclosure. *See* OGE, REPORT TO CONGRESS, *supra* note 84, at 11–12. So far, Congress has done nothing, perhaps because doing so would give the appearance of loosening ethics regulations. Meanwhile, as pointed out in this Article, many undisclosed conflicts of interest—particularly those involving contributors to political campaigns—go unaddressed.

90. Form 450 (Confidential Financial Disclosure) is required of other government employees below the senior executive service who have been designated by their agencies to file the report. The form is retained by agency ethics officials, but is not available for public inspection. Form 450 is substantially similar to Form 278, but in some areas does not require as detailed a disclosure. *See* Instructions for OGE Form 450 (codified at 5 C.F.R. pt. 2634, Subpart I (2002)), *available at* http://www.nasa.gov/pdf/144336main_fr450fill_04-3.pdf.

likely will have been sold to comply with financial conflict-of-interest rules. The remaining factors that could cause bias do not appear on the form.

Accountability rules governing financial conflicts of interest appear to be strict at least insofar as an official's personal financial holdings are concerned. The financial conflict-of-interest rule is in a criminal statute[91] that prohibits any government employee from participating personally and substantially in a particular matter having a direct and predictable effect on the financial interest of the employee, the employee's spouse or minor child (but not a grown child, parent, or sibling), or an organization of which the employee is a director, officer, or trustee, or any person or organization with whom the employee is negotiating for employment. This latter aspect of the prohibition, however, is easy to circumvent because it does not apply to casual conversations about prospective employment and other situations where it is likely that the government official working on a matter that affects a company will be offered a job in the company or another company in the same industry upon leaving government. Specific employers with whom the government official is negotiating for employment—usually toward the end of government service—are covered by the prohibition, but the wide range of prospective employers that benefit from the official's decisions are not covered. The official may continue to participate personally and substantially in government matters that have a direct and predictable impact on those employers.

When private sector officials come into government, ethics rules also require relatively little by way of recusal. In general, all that has been required is divestment of any financial interest in the former employer and other holdings that create problems under the conflict-of-interest statute.[92] There is also a requirement to recuse oneself for one year from particular matters in which the former employer is a party, but this does not include matters in which the former employer is not a party even if the matter has an effect on the former employer.[93] This

91. 18 U.S.C. § 208 (2006).

92. *See id.* The head of an agency is permitted to waive this prohibition after consultation with the OGE.

93. *See* 5 C.F.R. § 2635.502(a) (2010) (requiring recusal from particular matters involving specific parties if the government employee has a "covered relationship" with one of the parties or with someone who represents a party); *id.* § 2635.502(b)(1)(iv) (defining "covered relationship" to include employers for whom the government employee worked within the past year). An agency-

recusal requirement appears in an OGE regulation that is called the "impartiality rule,"[94] a label suggesting that it is designed to eliminate or mitigate partiality of government decisionmakers. The rule, however, is extremely narrow in its limited time duration and its limited scope: it applies only to particular party matters in which the former employer is a party.[95] Other matters affecting the former employer or its industry are excluded. The rule also says nothing about executive branch officials having to recuse themselves from matters involving persons and companies that contributed to the president's political campaign or political party. Even if the official met such persons at a political fundraiser and discussed official government business with them at the fundraiser, the impartiality rule does not require recusal. In sum, many, if not most, sources of conflicts of interest are excluded from the impartiality rule, and the rule thus does relatively little to assure that government officials are impartial.

President Obama's Executive Order of January 21, 2009[96] imposed more stringent requirements on incoming government officials, perhaps mitigating some of the harder to address conflicts of interest, but not by much. Among other things, President Obama's order requires incoming administration appointees[97] to sign a pledge that they will not work on particular matters involving specific parties, including regulations and contracts that are "directly and substantially" related to their former employers or former clients for a period of two years after they enter the administration.[98] Incoming appointees who

designated ethics official can grant an authorization for an agency employee to participate in such a matter if the need for the official to participate outweighs the appearance of impropriety. *See id.* § 2635.502(d). This rule does not cover matters, such as regulation of an entire industry, that do not have specific identifiable parties.

94. *Id.* § 2635.502.

95. *See id.* § 2635.502(a) (covering "a particular matter involving specific parties").

96. Exec. Order No. 13,490, 74 Fed. Reg. 4673 (Jan. 21, 2009).

97. *See id.* § 2(b) ("'Appointee' shall include every full-time, non-career Presidential or Vice-Presidential appointee, non-career appointee in the Senior Executive Service (or other SES-type system), and appointee to a position that has been excepted from the competitive service by reason of being of a confidential or policymaking character (Schedule C and other positions excepted under comparable criteria) in an executive agency. It does not include any person appointed as a member of the Senior Foreign Service or solely as a uniformed service commissioned officer.").

98. *See id.* § 1 ("2. Revolving Door Ban—All Appointees Entering Government. I will not for a period of 2 years from the date of my appointment

are registered lobbyists are bound by stricter rules.[99] A close reading of the order, however, reveals that for the most part it only applies to a narrow range of matters—once again, particular party matters—and that most sources of structural bias remain untouched.

The revolving door out of government is more strictly regulated than the revolving door into government, but here also the regulation is narrow in scope. After leaving government, an official is subject to one or more bans on "representing back" to the government.[100] Former government employees at all levels are prohibited from representing back to the government on behalf of another person with respect to the same particular matters *involving specific parties* that they participated in personally and substantially while in government service.[101] This rule would cover, for example, an investigation of a particular company or a particular government contract. This ban does not apply to the majority of government business such as policymaking or regulation of particular industries.[102] "Senior employees"[103] in the executive branch are subject to a one-year

participate in any particular matter involving specific parties that is directly and substantially related to my former employer or former clients, including regulations and contracts.").

99. *See id.* (prohibiting appointees who were registered lobbyists within two years of their appointment from "participat[ing] in any particular matter on which [they] lobbied," "participating in the specific issue area in which that particular matter falls," or "seek[ing] or accept[ing] employment with any executive agency [they] lobbied").

100. 18 U.S.C. § 207 (2006).

101. *Id.* § 207(a)(1)(C).

102. One problem with § 207(a) is its ambiguity. What constitutes "personal[] and substantial[]" participation while in government service? *Id.* § 207(a)(1)(B). What constitutes a "particular matter" "involv[ing] specific parties"? *Id.* § 207(a)(1)(C). When are two matters, such as two federal contracts that are part of a single umbrella contract or contracting program, separate "particular matter[s] . . . which involv[e] specific parties," *id.* § 207(a)(1), and when are they a single matter so a former employee who worked on one is barred from representing back to the government with respect to them all? Can two previously separate matters later converge into a single particular matter involving specific parties? OGE has sought to clarify some of these issues in new rules interpreting § 207(a) that were proposed in 2003, and then revised and issued as final rules in June 2008. *See* Post-Employment Conflict of Interest Restrictions, 73 Fed. Reg. 36,168, 36,168 (June 25, 2008) (to be codified at 5 C.F.R. pts. 2637, 2641).

103. *See* 18 U.S.C. § 207(c)(2) (defining "senior" government employees based on pay grade). The pay threshold was $143,953 for 2008. *See* Memorandum from Don W. Fox, Gen. Counsel, Office of Gov't Ethics, to Designated Agency Ethics Officials 3 (Nov. 6, 2008), *available at* http://www.usoge.gov/ethics_guidance/daeograms/dgr_files/2008/do08037.pdf. Certain other employees

"cooling off period" during which they may not represent back on behalf of other persons or companies to any department or agency in which they previously served.[104] This includes face-to-face contact, phone calls, email, or any other communications made to agency officials with intent to influence official actions. "Very senior"[105] employees, such as cabinet officers and assistants to the president in the White House, are required to defer representing back not only to the agencies or entities where they served, but also to other senior or very senior employees anywhere in the executive branch.[106] Section 101 of the 2007 Honest Leadership and Open Government Act[107] extends from one year to two years this "cooling off period" for former very senior employees.

Once again, these rules do little to combat the conflicts of interest of government officials who may be predisposed to favor persons in the private sector who used to be their colleagues in government. The generally-applicable particular-party-matter ban is very narrow and is easy to circumvent by keeping communications to one's former agency on a general level. Thus, it is permitted to say that "the SEC needs to ease up on its aggressive pursuit of alleged wrongdoing in the financial industry; the SEC was way too aggressive when I was there and you are still being too aggressive now." Yet, it is prohibited to state that "I worked on the SEC investigation of Company X and now that I work for Company X, I think the SEC should abandon the investigation of Company X." Is there really a difference between the two? The additional post-employment bans on former senior and very senior employees representing back to the government are of relatively short duration, and once again they exclude social contact and other indirect ways of influencing government decisionmaking.

President Obama has sought to tighten up ethics rules in this area also. His January 2009 Executive Order requires senior officials in his administration to agree to a two-year post-employment ban on representing back to their former agen-

who may earn less than this amount, including Deputy Assistants to the President, also fall into this category.

104. 18 U.S.C. § 207(c).

105. *See id.* § 207(d) (defining "very senior" government employees). This category includes, among others, agency heads and Assistants to the President in the White House. *See id.*

106. *See id.* § 207(d)(2).

107. Honest Leadership and Open Government Act, tit. 1, § 101(a), Pub. L. No. 110-81, 121 Stat. 735, 736–77 (2007) (amending 18 U.S.C. § 207(d)(1)).

cy,[108] and requires that administration officials who leave to lobby agree not to lobby the administration at all for the entire time he is president.[109] President Obama's order, however, is difficult to enforce against persons who have left the government.[110] Unlike the statutory prohibition, it is not a criminal statute. The order also does not ban social contact, and in particular, it does not ban contact with former government colleagues at political fundraisers and other events.

A brief look at all of these rules and their shortcomings shows how difficult it is for existing regulation—and probably any regulation—to mitigate the corrupting influence from private employment either before or after government service. Ethics rules purport to accomplish a great deal, but actually may prohibit relatively little. The problem of government officials' bias toward private sector employers past and future remains, as does the problem of bias toward the opinions of former government colleagues who have departed for the private sector.

The problem of unresolved conflicts of interest—or at least the appearance of a problem in the eyes of many outside observers—is illustrated most clearly by the political controversy surrounding movement of high-ranking officials from one particular Wall Street firm to and from government, a phenomenon sometimes referred to as "Government Sachs."[111] Two recent treasury secretaries, Robert Rubin and Henry Paulson, came directly from Goldman Sachs. Many observers, including some of Goldman's competitors on Wall Street, have complained that because of these government connections Goldman Sachs has an unfair advantage.[112] These complaints are not about violations of ethics rules per se; the evidence thus far

108. Exec. Order No. 13,490, 74 Fed. Reg. 4673 (Jan. 21, 2009) ("4. Revolving Door Ban—Appointees Leaving Government. If, upon my departure from the Government, I am covered by the post-employment restrictions on communicating with employees of my former executive agency set forth in section 207(c) of title 18, United States Code, I agree that I will abide by those restrictions for a period of 2 years following the end of my appointment.").

109. *See id.* ("5. Revolving Door Ban—Appointees Leaving Government to Lobby. In addition to abiding by the limitations of paragraph 4, I also agree, upon leaving Government service, not to lobby any covered executive branch official or non-career Senior Executive Service appointee for the remainder of the Administration.").

110. *See* 18 U.S.C. § 207.

111. *See, e.g.*, Julie Creswell & Ben White, *The Guys from "Government Sachs"*, N.Y. TIMES, Oct. 19, 2008, at BU1, *available at* 2008 WLNR 19879549.

112. *See id.*

suggests that few if any ethics rules were violated. These complaints are about the hard cases of conflicts of interest that ethics rules do not reach.

For both Rubin and Paulson, financial conflicts of interest were addressed by requiring the incoming Secretary of the Treasury, and anyone else coming in with him, to sell their financial interest in Goldman or any other financial services firm.[113] Once the incoming secretary and his subordinates sold their interest in Goldman, it was presumed that there would be no conflict of interest because their financial holdings were no longer influenced by the fortunes of Goldman. The secretary was free to participate in particular government matters that had a direct and predictable impact on Goldman.[114] It did not matter that the secretary had spent much of his professional life and made almost his entire fortune at Goldman. It did not matter that many of the secretary's closest business associates were still at Goldman and that he was indebted to them for his professional success as well as his financial success. The conflict of interest specifically identified in the statute—the equity stake in Goldman—had been eliminated. Psychological factors and other factors that could continue to foster favoritism apparently could not be dealt with through regulation.

During Secretary Rubin's term in office the issue came up several times. In 1995, the U.S. government participated in a bailout of Mexico, a country in which Goldman had invested heavily.[115] Rubin arguably had a conflict of interest under the analysis we propose here—but not under the conflict-of-interest analysis in the statute.[116] In 1998 came the Asian currency bailout. Once again, Goldman was one of several banks with substantial exposure in Asia. Rubin was allowed to participate in these bailouts because he had divested completely from Goldman when he became Secretary of the Treasury.[117] From the vantage point of government ethics rules, that was enough.

Rubin's reign during the 1990s was also a period of substantial deregulation in the banking industry coinciding with the rapid development of new financial products such as more

113. Gretchen Morgenson & Don Van Natta, Jr., *Paulson's Calls to Goldman Tested Ethics During Crisis*, N.Y. TIMES, Aug. 9, 2009, at A1, *available at* 2009 WLNR 15396094.

114. *See* Creswell & White, *supra* note 111, at BU1.

115. *See* Painter, *supra* note 4, at 141.

116. 18 U.S.C. § 208 (2006).

117. *See* Painter, *supra* note 4, at 141.

exotic forms of mortgage-backed securities and collateralized debt obligations. Goldman Sachs benefited from both deregulation of its existing business and from innovation in new lines of business free of new regulation. Secretary Rubin was often on the side of deregulation and was often reluctant to regulate new financial products, meaning a Democratic administration put up relatively little resistance to the deregulatory agenda of a Republican Congress. Once again, nothing in conflict-of-interest statutes or the Standards of Conduct for Federal Employees prohibited Secretary Rubin from participating in these decisions, or sometimes leading the charge against persons in the Clinton administration who pressed for more regulation. Any structural bias he might have had toward Goldman—or Citibank, his future employer once he left Treasury—cannot be demonstrated conclusively, and what types of favoritism were involved (conscious bias, unconscious bias, both, or none) is not clear. Still, for persons dissatisfied with the aftermath of the deregulatory era of the 1990s, there is lingering concern that Secretary Rubin and other Treasury officials from Wall Street may have favored Wall Street at the expense of the rest of the country.[118]

The next Treasury secretary from Goldman Sachs, Henry Paulson, was instrumental in the bailouts of 2008 and 2009. Goldman was not directly a party to bailouts, but gained from bailouts given to other banks such as AIG, which owed Goldman $20 billion as a counterparty in derivative contracts: although Goldman had insured a portion of its AIG exposure, its insurance counterparties might not have been able to pay. Goldman also may have benefited when a bailout was denied to long-standing rival Lehman Brothers.

Secretary Paulson was allowed to participate in these bailouts. He had sold off his interest in Goldman Sachs, and that was all that was required.[119] He had even gone beyond what

118. It should be noted that Secretary Rubin's successor, Lawrence Summers, came from academia, not Wall Street. In many areas he shared Secretary Rubin's deregulatory views. Not all persons who enter government from Wall Street firms will have structural bias; not all persons from outside Wall Street will lack structural bias. That being said, structural bias can influence government officials' decisionmaking, including decisions about the selection of one's deputy and likely successor. Academics also are subject to their own structural biases—particularly a tendency to gravitate toward prevailing views of other academics—that are beyond the scope of this Article.

119. *See* Painter, *supra* note 4, at 141–43. The conflict of interest statute, 18 U.S.C. § 208, does not prohibit a government official's participation in a matter affecting a former employer if the official resigns his position with the

was required and agreed not to participate in particular matters in which Goldman Sachs was a party or represented a party for his entire term in office[120] (a dispute later arose over whether he had fully complied with this agreement when he met with Goldman officials in the fall of 2008).[121]

Given the time constraints, Secretary Paulson and his colleagues had limited room to maneuver and little time to make decisions. Treasury Department lawyers could not disable the secretary or his staff simply because the department went into the crisis with senior ranks top heavy with former employees of Goldman and other investment banks. Federal ethics regulations did not address the hard cases of conflict of interest. In a time of crisis, the government and the public had to live with them.[122]

It has not been established thus far that there was any specific improper influence from Goldman or any other bank on former employees in the government. Nonetheless, many observers have speculated about the Treasury Department's motives in various bailout decisions. Similarly questioned is the decision not to intervene in the deteriorating market for mortgage-backed securities in 2007 and early 2008, government inaction which gave Goldman and some other banks time to un-

former employer, does not engage in negotiations with respect to future employment, and retains no financial interest in the former employer.

120. *See* Letter from Henry Paulson, Sec'y, U.S. Dep't of the Treasury, to John P. Schorn, Deputy Assistant Gen. Counsel and Designated Agency Ethics Official, U.S. Dep't of the Treasury (June 19, 2006), *available at* http://devel.philstockworld.com/2009/08/11/the-paulson-ethics-waiver ("As a prudential matter I will not participate in any particular matter involving specific parties in which the Goldman Sachs Group Inc. (Goldman Sachs) is or represents a party for the duration of my tenure as Secretary of the Treasury unless my participation is in accordance with 5 C.F.R. § 2635.502(d).").

121. *See* Morgenson & Van Natta, *supra* note 113, at A1. Paulson also was given an ethics waiver by the White House and another waiver by Treasury Department ethics lawyers so he could participate in matters affecting Goldman.

122. Controversy over Goldman's influence has lasted beyond the departure of Secretary Paulson. Stephen Friedman, a former chairman of Goldman, served as a senior economic advisor under President George W. Bush. He then went back into the private sector and served on Goldman's board of directors while serving the administration as a special government employee (SGE) in a variety of capacities, and then continued to serve during the Obama administration as a director of the Federal Reserve Bank of New York. Friedman also allegedly purchased Goldman stock in December 2008 and January 2009. *See* Jon Hilsenrath & Kate Kelly, *Chairman of New York Fed Quits Amidst Questions*, WALL ST. J., May 8, 2009, at A1, *available at* http://online.wsj.com/article/SB124173340275898051.html. Friedman resigned his Fed post in May 2009, presumably because of the conflict. *See id.*

load their holdings and/or hedge their bets. From an appearances perspective, it may not have been enough to require Treasury officials coming in from Goldman or other investment banks to dispose of their stock and stock options when they retained close ties to their former employers. From the vantage point of many observers, structural bias remained intact.

Yet another source of conflicts of interest in government is from the political process by which government is chosen. For better or worse, government is about politics and politics creates structural bias in favor of political supporters, potential political supporters, and, of course, political contributors. Commentary from the perspective of public choice theory analyzes how political factors play out when economic resources are allocated by government instead of by markets.[123] Looking at a recent example, it should not be surprising that when the auto companies were bailed out in 2009, a Democratic administration that owed its election in part to labor unions would favor labor union creditors over other creditors of the auto companies in its bailout plan. A pro-labor bias appears to have been present, although it is not clear how much this bias steered government decisionmaking away from the fiduciary principle. The voters may have elected President Obama because he would favor labor interests over bank creditors; alternatively, the voters may not have had any such intention. The combination of structural bias and politics is thus difficult to untangle, and the impact of political structural bias on the fiduciary principle is sometimes uncertain. Political structural bias is, however, persistently present in government, and at times it can steer government officials away from their fiduciary obligations to the public.

Political operatives have varying degrees of access to government officials. Political operatives have more access and more influence when government officials participate in personal capacity partisan political activity. Until it was closed down by President Obama in 2011, the White House Office of Political Affairs (OPA) had a critical role in organizing this activity.[124] OPA staff members moonlighted in their personal ca-

123. *See generally* FRED S. MCCHESNEY, MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION AND POLITICAL EXTORTION 1 (1997) ("[L]egislation and regulation are sold to the highest bidder in political markets, just as other goods and services are sold in more familiar commercial markets.").

124. *See* Richard W. Painter, *The Separation of Politics and State*, N.Y. TIMES, June 14, 2010, at A23, *available at* 2010 WLNR 12057868.

pacity for the president's political party—among other things, speaking at campaign events, coordinating strategy with candidates, and facilitating political work by other administration officials. OPA officials also recruited political appointees in the agencies, including sometimes cabinet members and their deputies, to speak at political events and perform other duties for the party.[125] When political appointees in government participate in partisan political activity and then make decisions that affect private interests, it should not be surprising that these decisions are influenced by private interests that are also engaged in partisan politics. Curtailing political activity of high-ranking executive branch officials, including those in the White

125. The Hatch Act, 5 U.S.C. §§ 7321–7326 (2006), prohibits partisan political activity by government employees while on duty, in government buildings, using official titles, or at government expense. *See id.* There is, however, an exception in the regulations that allows some senior political appointees to conduct personal capacity partisan political activity in government buildings during normal working hours. Official titles still cannot be used, nor can government expense be incurred (separate communications equipment is usually provided for these officials by the RNC or the DNC). One of the authors of this Article has criticized this exception and called for closure of the White House Office of Political Affairs (OPA), which orchestrates much of this activity. *See* PAINTER, *supra* note 24, at 245–53; Painter, *supra* note 124, at A23.

In January 2011 the Office of Special Counsel issued a report finding Hatch Act violations in the Bush White House during the 2006 election cycle. *See* OFFICE OF SPECIAL COUNSEL, INVESTIGATION OF POLITICAL ACTIVITIES BY WHITE HOUSE AND FEDERAL AGENCY OFFICIALS DURING THE 2006 MIDTERM ELECTIONS (January 2011), *available at* http://www.osc.gov/documents/hatchact/STF%20Report%20Final.pdf. The Report narrowly construed the exception, allowing political activity in government buildings during normal working hours, and also emphasized the practical difficulties officials have complying with the Hatch Act when performing political and official work at or about the same time. *See id.* at 68 ("'[C]oncurrent political and official roles put people in a position that is difficult and arguably untenable. Critics will blame OPA staff members and other officials who engage in political activity for poor ethical judgment when problems arise. These problems, however, may be inevitable if government officials continue to be asked to perform official and political roles concurrently. The public image of the White House and the rest of the government will suffer as a consequence.'" (quoting PAINTER, *supra* note 24, at 252)); *id.* at 72 (quoting PAINTER, *supra* note 24, at 249, on the difficulties government ethics lawyers have giving Hatch Act advice in this context); *id.* at 75 (quoting PAINTER, *supra* note 24, at 249, on the role of the OPA in recruiting other administration officials to engage in partisan political activity and on the observation that the OPA is "not a necessary or even desirable component" of the White House).

A few days before this Office of Special Counsel Report was issued, President Obama ordered that the OPA be closed and that his political operations be moved outside the government to Chicago. *See* Jeff Zeleny, *Obama Will Move Political Operations to Chicago*, N.Y. TIMES, Jan. 21, 2011, at A27, *available at* 2011 WLNR 1263918.

House other than the president and vice president, would alleviate this form of favoritism.[126] So far, however, this has not happened, although President Obama has perhaps reduced the direct influence of partisan politics in the White House by closing OPA and moving his campaign operations to Chicago.

Campaign contributions are the most notorious form of political influence, and probably create the worst form of favoritism in government. Contributors get access to government officials at political fundraisers and in other ways. Government officials may not solicit campaign contributions, but they may give personal-capacity speeches at fundraisers, and these speeches usually are about government business. At these events, contributors who want preferential treatment for certain constituencies—such as large investment banks—make their views known.[127]

Thus far, the law has been ineffective at dealing with the problem of undue political influence of the persons and companies that pay for elections. Some money is contributed directly to political campaigns and most of those contributions are disclosed and regulated. The problem is that yet more money is contributed to off-balance-sheet transactions implemented through 527s and other organizations that support political campaigns while evading much of the Federal Election Commission reporting system.[128] It would be naive to assume that this money does not have a direct influence on members of Congress, the president and vice president, or their staffs.

Banks and other financial services firms spend an enormous amount of money on political campaigns. According to the Center for Responsive Politics (CRP), financial services, insurance, and real estate firms have spent $60,913,366 on Political Action Committee (PAC) contributions to federal candidates in the 2010 election cycle, almost evenly split between Democrats and Republicans.[129] These firms had spent $62,607,881 on PAC contributions in the 2008 election cycle, once again almost

126. *See* Painter, *supra* note 124, at A23.

127. *See* Painter, *supra* note 4, at 139.

128. *See* PAINTER, *supra* note 24, at 207–43 (discussing 527s and other vehicles of campaign finance). Section 527 of the Internal Revenue Code defines the tax status of organizations that seek to influence federal elections, including political parties and political action committees (PACs). *See* 26 I.R.C. § 527 (2006).

129. *Finance, Insurance & Real Estate PAC Contributions to Federal Candidates*, OPENSECRETS.ORG, http://www.opensecrets.org/pacs/sector.php?txt=F01&cycle=2010 (last visited Apr. 13, 2011) (2010 cycle).

evenly split between the two parties.[130] They spent $58,544,271 on PAC contributions in 2006, almost two thirds on Republicans who controlled Congress and the White House at the time.[131] This compares with lawyers and lobbyists who are reported to have spent $15,520,896 on PAC contributions in the 2010 election cycle, and who spent $16,618,130 on PAC contributions in 2008.[132] Even the defense industry was comparatively modest in its spending compared with real estate and financial services firms. Defense firms spent $14,075,964 on PAC contributions to federal candidates in the 2010 election cycle, and they spent $11,872,992 in the 2008 election cycle.[133] In addition to direct contributions to federal candidates and the national parties, many financial services firms also spend money on their own to influence elections through "independent expenditures."[134] The election of 2004 saw an enormous upswing in independent expenditures on issue ads and other attempts to sway voters. CRP reports about $270 million in total independent expenditures in 2004 and 2006 (there is no industry break down) and over $300 million in 2008.[135]

The Supreme Court last year opened the floodgates yet wider. Congress had tried to curtail political spending by corporations and other special interests in the 2002 McCain-Feingold Act, but the Court ruled in 2010 that a critical part of this Act was unconstitutional.[136] The Supreme Court ruled 5-4 in *Citi-*

130. *Finance, Insurance & Real Estate PAC Contributions to Federal Candidates*, OPENSECRETS.ORG, http://www.opensecrets.org/pacs/sector.php?cycle=2008&txt=F01 (last visited Apr. 13, 2011) (2008 cycle).

131. *Finance, Insurance & Real Estate PAC Contributions to Federal Candidates*, OPENSECRETS.ORG, http://www.opensecrets.org/pacs/sector.php?cycle=2006&txt=F01 (last visited Apr. 13, 2011) (2006 cycle).

132. *Lawyers and Lobbyists PAC Contributions to Federal Candidates*, OPENSECRETS.ORG, http://www.opensecrets.org/pacs/sector.php?cycle=2010&txt=K01 (last visited Apr. 13, 2011).

133. *Defense*, OPENSECRETS.ORG, http://www.opensecrets.org/pacs/sector.php?cycle=2010&txt=D01 (last visited Apr. 13, 2011).

134. The McCain-Feingold Act defines "independent expenditure" as

> an expenditure by a person (A) expressly advocating the election or defeat of a clearly identified candidate; and (B) that is not made in concert or cooperation with or at the request or suggestion of such candidate, the candidate's authorized political committee, or their agents, or a political party committee or its agents.

Bipartisan Campaign Reform Act of 2002, tit. II, subtitle B, Pub. L. No. 107-155, 116 Stat. 81, 92–93.

135. *Outside Spending*, OPENSECRETS.ORG, http://www.opensecrets.org/outsidespending/index.php (last visited Apr. 13, 2011).

136. Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876 (2010).

zens United v. FEC that corporations could use their treasuries to pay for independent political broadcasts in candidate elections, and that these broadcasts could not be regulated because they were protected speech under the First Amendment.[137] The case concerned a film that was critical of Hillary Clinton advertised in broadcast ads featuring Clinton's image.[138] The Court held that the McCain-Feingold Act could not regulate the broadcasts because they were protected speech.[139]

Curiously, the Court premised its holding on the observation that corporations have free speech rights similar to those of individuals.[140] The Court adopted this premise even though corporations are not people. Corporations are run by people, but limited liability means that the people who run corporations do not have to accept responsibility when the corporations fail. In the latest round of bailouts, the government, not the people who ran the corporations, accepted responsibility for failure. Nonetheless, the Court has bestowed on corporate speech all of the First Amendment protections of individual speech, including a right to use corporate money to influence government. Unlimited influence coupled with limited liability is a curious combination—but the Court has enshrined it in the Constitution.

Money always has flowed steadily from the financial services industry into federal elections. After *Citizens United*, that steady flow will likely become a flood. President Obama has asked Congress for legislation that would at least make corporate campaign spending more transparent, but so far Congress has not addressed the issue.

Government thus will continue to have a strong bias in favor of the people and organizations that pay for the way we choose our government. Executive branch officials who do not themselves run for office identify with the people, companies, trade associations and others that support the president. These contributors know they have friends throughout the executive branch and in Congress as well. They know about this bias, they know how to buy it, and they know how to use it.

137. *Id.* at 979.
138. *Id.* at 887.
139. *Id.* at 886.
140. *See id.* at 897.

IV. SOME EXAMPLES: CONFLICTS OF INTEREST WHEN GOVERNMENT IS INVOLVED IN MANAGING BUSINESS

History provides many examples of debacles when government has been involved in business. Some of the most serious have resulted from easy-case conflicts of interest—the type that laws can effectively regulate—coexisting with hard-case conflicts of interest. Conflicts of interest are an important reason why business managers and government officials acted the way they did, and the hard case conflicts are not easy for the law to address.

One type of government involvement in business is government sponsorship. An example is England's South Sea Company, which in 1711 was chartered by Tory politicians and their cronies.[141] Parliament gave the company a monopoly on trade in the South Seas, while a competitor company with Whig roots received considerably less favorable treatment.[142] Ostensibly a trading enterprise, the company was quickly converted into an investment bank for refinancing large quantities of government debt England had from its wars with Spain.[143] The South Sea Company promoters' scheme presumably was beneficial to the public purse, to the promoters themselves, and to investors who were making money from the company's ever-increasing stock price, a typical case of mixed motives. This government-sponsored enterprise was a win-win situation for everybody—for a while.[144]

Easy-case conflicts of interest arose when members of Parliament (MPs) were given free stock in the company and began trading in the stock.[145] Even the King's mistress—but apparently not the Queen—had a stake in the company.[146]

When the South Sea Company stock crashed in 1720, many people were left in financial ruin.[147] A few of the promoters were sent to the Tower of London, and many others lost all of

141. *See* Richard W. Painter, *Ethics and Corruption in Business and Government: Lessons from the South Sea Bubble and the Bank of the United States* 4 (Minn. Legal Studies Research Paper No. 06-32, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920912.

142. *See id.*

143. *See id.* at 4–5 ("[T]he Company agreed to assume a significant portion . . . of floating army and navy debt at a rate of 6% per year.").

144. *See id.* at 5–6 (discussing the various problems the company encountered—bribery, deception, self-dealing, and poor trade).

145. *See id.* at 6.

146. *See id.*

147. *See id.* at 8.

their property. Parliament quickly covered its own tracks by passing the Bubble Act of 1720, which forbade publicly traded limited liability company interests without a specific grant of authority from Parliament.[148] Ironically, it was just such a parliamentary grant of authority to the South Sea Company that had created the problem in the first place, but this did not seem to matter.[149]

Many different motives—and many different conflicts of interest, some easy and some hard—converge in this story. MPs who owed South Sea stock had an incentive to approve the company's plan for refinancing government debt. Indeed, the company gave many members their shares, presumably to motivate them to favor the company's interests. The government—and the politicians who ran the government—also stood to benefit from the company's plan. Moreover, the company's promoters were close friends of the Tories who controlled Parliament. Combined, these conflicts of interest led Parliament to sponsor a company that brought England to economic disaster.

Some aspects of this problem—for example, the personal financial holdings of MPs and Treasury officials—are regulated today by prohibitions on financial conflicts of interest for government officials, as well as disclosure of their financial holdings. Even this aspect of the problem, however, is not so easily separable from the more difficult conflicts of interest that arise out of personal friendships and mixed motives. While a company today could not give free stock to legislators and Treasury officials, it could still buy their favor by paying for political campaigns. The end result is the same. Then, as now, the influence of money on politics is extremely difficult, if not impossible, to eliminate.

In the early years of the United States, conflicts of interest severely compromised two efforts to establish a government-sponsored national bank. The first of these was Alexander Hamilton's Bank of the United States.[150] The Bank was a private bank with a government charter and special privileges; it was used to finance the national debt and the individual states'

148. *See* Painter, *supra* note 141, at 7 ("The Act prohibited formation of joint stock companies or other partnerships with freely transferable shares. . . . The Bubble Act thus proclaimed that there shall be no bubbles but those bubbles officially sanctioned by Parliament.").

149. *See id.* at 8.

150. *See id.* at 13.

debt from the Revolutionary War.[151] Hamilton, the first Treasury Secretary, decided to push through Congress a plan to pay off that debt for one hundred cents on the dollar.[152] Many of the beneficiaries, however, were not the original holders of that debt—farmers and war veterans—but instead were speculators who had purchased the notes at twenty to thirty percent of par on advance notice of Hamilton's plan to pay them off at one hundred percent of par.[153] Many of these speculators were closely tied to Hamilton's Federalist political party.[154] Hamilton himself apparently did not buy the notes, but his friends, members of Congress, and their friends, did.[155]

Congress passed Hamilton's bill.[156] Mixed motives existed here also. Hamilton had a powerful argument that honoring the debt was crucial to the credit of the United States. The plan, however, also benefited many of his political allies and some members of Congress who had bought the notes. Some of the conflicts of interest would have been easier to regulate—the members' own purchases of the notes would today be considered illegal insider trading. Other conflicts of interest—such as politicians taking care of their "friends"—were far more difficult to regulate.

Hamilton's bank, in any event, was short-lived. Thomas Jefferson hated the bank and undermined it as president.[157] Twenty years after its founding, its charter was allowed to expire.[158] The controversy over insider dealing in the government notes was one of the reasons the bank fell out of popular favor.[159]

A second Bank of the United States was founded after the War of 1812 when once again the government sought out a vehicle for financing its debt.[160] Its president, Nicholas Biddle, confronted hostility to the bank from Jacksonian Democrats and chose to deal with the problem by retaining several mem-

151. *See id.* at 11, 13.

152. *See id.* at 11 ("Alexander Hamilton . . . wanted an economic system that would include . . . payment in full of obligations including public debt.").

153. *See id.*

154. *See id.* at 12 ("How much Hamilton and his associates leaked inside information to friends who in turn traded is still a subject of debate.").

155. *See id.* at 13.

156. *See id.*

157. *See id.* at 14.

158. *See id.*

159. *See id.*

160. *See id.* at 14–15.

bers of Congress as lawyers and consultants for the Bank.[161] One of these was Senator Daniel Webster of Massachusetts.[162] Some of Senator Webster's constituents were wealthy Boston merchants who were also predisposed to favor a strong banking system.[163] They also helped support Webster financially.[164]

In the end, President Andrew Jackson was successful in his effort to abolish the bank.[165] Once again, corruption played a part in the bank's demise.[166] The retainers Biddle had paid to members of Congress were widely known and cast the bank and its supporters, in general, in an unfavorable light.[167]

These were easy-case conflicts of interest—the direct retainers and other payments that today would probably be characterized as illegal bribes and, in any event, would violate bans on outside earned income for members of Congress. Nonetheless, it is difficult to distinguish these payments conceptually from the campaign contributions that financial services firms and other interested parties provide to members of Congress today.[168] Another complicating factor was decisionmakers' mixed motives. Wealthy merchants, who also showered favors upon members of Congress, tended to support the bank; the Whig political philosophy of Webster, and many other members of Congress, favored a strong financial system. At the same time, the Jacksonian Democrats disliked these political constituencies as well as the bank and were philosophically predisposed to oppose the bank.[169] Members of Congress from both political parties thus were motivated in part by what they believed was right, and in part by other, less principled reasons. Legitimate and corrupt influences on government decisionmaking were in many ways inextricably linked.

161. *See id.* at 15–16.

162. *See id.*

163. *See* Robert Gordon, *The Devil and Daniel Webster*, 94 YALE L.J. 445, 456 (1984) (noting that Webster had Boston merchant constituents whose interests were often aligned with his own).

164. *See* Painter, *supra* note 141, at 16 n.46.

165. *See id.* at 17.

166. *See id.* ("The Bank's corruption of Congress also helped give Jackson the moral upper hand.").

167. *See id.*

168. *See supra* text accompanying notes 129–31 (discussing campaign contributions from the financial services industry in the 2004, 2006, 2008, and 2010 election cycles).

169. *See* Painter, *supra* note 141, at 16–17 (noting President Jackson's objections to the bank).

The payments to members of Congress can be condemned as easy cases of conflicts of interest: they constitute straightforward corruption that is arguably easy to identify and prohibit. The payments, however, might have been necessary to assure the bank's very existence, and in the end they were not enough. Congress had set up a bank that was dependent upon Congress for renewal of its charter every twenty years, putting the bank and its officers in a position of dependency on the government. The bank's officers apparently thought that they had no choice but to corrupt the government upon which they depended. In the end, the conflicts of interest inherent in this arrangement brought discredit to both the bank and to Congress. It took until 1913, over two centuries after establishment of the Bank of England in 1694, but Congress finally established a central bank for the United States that did not have private stockholders and did not need to obtain regular renewal of its charter from Congress: the Federal Reserve Bank.

More recently, government notoriously and catastrophically has been involved in the business of housing finance with Fannie Mae and Freddie Mac, both government-sponsored enterprises (GSEs). These entities became for-profit corporations with shareholders in 1968 (Fannie Mae)[170] and 1970 (Freddie Mac).[171] Notwithstanding their status as GSEs, both were in many respects similar to typical for-profit corporations. Until they were taken over by the government, they had shareholders who were seeking profits, and CEOs compensated for "performance."

Fannie Mae and Freddie Mac are excellent examples of what can go wrong when government is too involved with business. Fannie Mae and Freddie Mac securitized mortgages and sold securities consisting of interests in those mortgages.[172] They also held their own portfolios of mortgages. In both these activities, they effectively were subsidized by the govern-

170. *See About Fannie Mae*, FANNIE MAE, http://www.fanniemae.com/aboutfm/charter.jhtml?p=About+Fannie+Mae&searchid=1288392247853 (last visited Apr. 13, 2011) ("The 1968 Charter Act . . . transformed [Fannie Mae] into a 'government-sponsored private corporation.'").

171. *See Timeline: A History of Freddie Mac and Fannie* Mae, FIN. TIMES, July 15, 2008, http://us.ft.com/ftgateway/superpage.ft?news_id=fto071520081225260084 ("[In] 1970 Freddie Mac [was] created to provide competition in the secondary mortgage market and end Fannie Mae's monopoly.").

172. *See generally* CONG. BUDGET OFFICE, FEDERAL SUBSIDIES AND THE HOUSING GSES (2001) [hereinafter CBO, SUBSIDIES REPORT], *available at* http://www.cbo.gov/ftpdocs/28xx/doc2841/GSEs.pdf.

ment.[173] Investors believed that securities issued by Fannie Mae and Freddie Mac were implicitly guaranteed by the government. Similarly, investors believed that the debt issued by Fannie Mae and Freddie Mac to buy their portfolios of mortgages implicitly was guaranteed by the government. Investors paid for these implicit government guarantees, providing the GSEs with financing on more favorable terms.[174] Other government subsidies included exemptions from state and local taxes. While some of the benefits were passed along to borrowers, the GSEs profited enormously. Their CEOs were compensated handsomely, at levels similar to those of CEOs of nongovernment companies.[175] Private companies' results were adversely affected by this "unfair" competition.[176] In the early- to mid-2000s, both Fannie Mae and Freddie Mac were found to have grievously misstated their accounting results; the accounting results had to be restated, and their CEOs were ousted.[177]

173. *See id.* (noting the implicit guarantee and other tax and regulatory exemptions due to their GSE status).

174. *See* Dwight Jaffee, *The Role of the GSEs and Housing Policy in the Financial Crisis* 6–7 (Feb. 25, 2010) (paper presented to the Financial Crisis Inquiry Commission) (on file with the authors).

175. *See* Julie Hirschfeld Davis, *Congress Floats Fannie, Freddie Salary Caps*, ABC NEWS, July 22, 2008, http://abcnews.go.com/Business/story?id=5423870&page=1 ("Freddie Mac paid Chairman and Chief Executive Richard Syron nearly $19.8 million in compensation even though the mortgage company's stock lost half its value. During the same period, Fannie Mae President and Chief Executive Daniel Mudd got compensation valued by the company at $12.2 million, including a $2.2 million bonus.").

176. *See* CBO, SUBSIDIES REPORT, *supra* note 172, at 3.

177. *See* Eric Dash, *Fannie Mae to Restate Results by $6.3 Billion Because of Accounting*, N.Y. TIMES, Dec. 7, 2006, at C1, *available at* 2006 WLNR 21115548; Jonathan D. Glater, *Freddie Mac Understated Its Earnings by $5 Billion*, N.Y. TIMES, Nov. 22, 2003, at C1, *available at* 2003 WLNR 5659894; *see also Freddie Mac's Dean, Chowdhury Latest to Leave Amid Restatement*, BLOOMBERG.COM, Oct. 28, 2003, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aqzi4p5OqNw0&refer=us ("The departure of the four employees followed the ouster of newly installed CEO Parseghian after the Baker Botts report showed he had knowledge of derivatives trades used by Freddie Mac in 2000, 2001 and 2002 to lower earnings in an effort to reduce volatility. . . . Parseghian took over from Leland Brendsel, who was ousted in June along with President David Glenn and Chief Financial Officer Vaughn Clarke after the extent of the accounting errors became known to company investigators. Company officials wanted to defer profits resulting from a change in accounting rules in 2001. . . . Gains in the derivatives as interest rates fell would have boosted profit in current quarters and made it harder for the company to maintain the pace of earnings growth.").

The purchases and securitization of mortgages had a public mission: to increase the availability of mortgage funding, including in distressed markets and to low-income borrowers, and to equalize mortgage rates throughout the country.[178] Holding mortgages in the portfolios of the GSEs had far less of a role in such a mission. Rather, it mostly served to increase yield, which inured to the benefit of the GSEs' executives and shareholders, and to increase risk, which ultimately cost the taxpayers a considerable amount of money.[179]

Three hundred fifty-four lawmakers, including both Democrats and Republicans, received campaign contributions from Fannie Mae and Freddie Mac.[180] Here are the top six recipients in the period between 1989 and 2008, according to the blog OpenSecrets:[181]

Name	**Office**	**State**	**Party**	**Grand Total**	**Total from PACs**	**Total from Individuals**
Dodd, Christopher J.	S	CT	D	$165,400	$48,500	$116,900
Obama, Barack	S	IL	D	$126,349	$6,000	$120,349
Kerry, John	S	MA	D	$111,000	$2,000	$109,000

178. *See* CBO, SUBSIDIES REPORT, *supra* note 172, at 3–4; Dwight M. Jaffee, The Future Role of Fannie Mae and Freddie Mac in the U.S. Mortgage Market 11 (Dec. 18, 2009) (unpublished manuscript), *available at* http://faculty.haas.berkeley.edu/jaffee/Papers/JaffeeGSEAtlanta.pdf.

179. *See* CBO, SUBSIDIES REPORT, *supra* note 172, at 3–4; *see also* Jaffee, *supra* note 174, at 15 ("Risk-taking—whether interest rate risk or credit risk—can maximize the expected benefits for the GSEs' management and shareholders because they profit greatly when there are favorable outcomes, whereas the bondholders (if the GSEs were to become bankrupt), or the taxpayers (if they bailout the bondholders) suffer the major losses when there are unfavorable outcomes. Furthermore, the normal deterrence to risk-taking created by bondholder discipline was largely absent for the GSEs because their bondholders assumed—correctly—that they were protected by an implicit government guarantee. Finally, the GSE penetration of its primary market for conforming mortgages had effectively reached 100 percent, so only by expanding to riskier ventures could the firms had [sic] hoped to continue to report growing earnings. The bottom line is that GSE managers long understood that they and their shareholders would benefit from risk-taking as long as the higher risks created higher expected returns.").

180. *See* Lindsay Renick Mayer, *Update: Fannie Mae and Freddie Mac Invest in Lawmakers*, OPENSECRETS.ORG (Sept. 11, 2008), http://www.opensecrets.org/news/2008/09/update-fannie-mae-and-freddie.html.

181. *Id.*

Bennett, Robert F.	S	UT	R	$107,999	$71,499	$36,500
Bachus, Spencer	H	AL	R	$103,300	$70,500	$32,800
Blunt, Roy	H	MO	R	$96,950	$78,500	$18,450

The total of all the 354 lawmakers' contributions is $4,844,572.[182]

On September 7, 2008, the government placed Fannie Mae and Freddie Mac into conservatorship.[183] Recent estimates are that the bailout may cost $154 billion or even more.[184] Fannie Mae and Freddie Mac seem to have done fairly well under government conservatorship,[185] but it is difficult to determine how much of this success is attributable to the U.S. Treasury's purchases of Fannie and Freddie's securities, and securities in their portfolios.[186] Interestingly, Fannie Mae and Freddie Mac have been given big contracts to manage the TARP program, something the overseers of TARP have strongly criticized.[187] One commentator described the situation as follows:

182. *See id.*

183. *See* Jaffee, *supra* note 174, at 5.

184. *See* Zachary A. Goldfarb, *Mortgage Bailout's Ballooning Price*, WASH. POST, Oct. 22, 2010, at A20, *available at* 2010 WLNR 25808186; *see also* Isidore, *supra* note 7. A Congressional Budget Office report notes, "The operations of Fannie Mae and Freddie Mac added $291 billion to CBO's August 2009 baseline estimate of the federal deficit for fiscal year 2009 and $99 billion to the total deficit projected for the 2010–2019 period." CONG. BUDGET OFFICE, CBO'S BUDGETARY TREATMENT OF FANNIE MAE AND FREDDIE MAC 2 (2010), *available at* http://www.cbo.gov/ftpdocs/108xx/doc10878/01-13-FannieFreddie.pdf.

185. *See generally* FED. HOUS. FIN. AGENCY, CONSERVATOR'S REPORT ON THE ENTERPRISES' FINANCIAL PERFORMANCE: SECOND QUARTER 2010 (2010), *available at* http://www.fhfa.gov/webfiles/16592/ConservatorsRpt82610.pdf (discussing the financial condition of Fannie Mae and Freddie Mac during their conservatorships); *see also* Appelbaum, *supra* note 7, at B7.

186. *See* Jaffee, *supra* note 178, at 5–6.

187. *See Report Knocks TARP Ties to Fannie and Freddie*, N.Y. TIMES DEALBOOK BLOG (Oct. 14, 2010, 2:32 AM), http://dealbook.blogs.nytimes.com/2010/10/14/report-snipes-at-tarp-ties-to-fannie-and-freddie ("The Treasury Department has relied heavily on private companies and the troubled mortgage giants Fannie Mae and Freddie Mac to manage the $700 billion Wall Street bailout, a report released on Thursday said. The report by the Congressional panel overseeing the Troubled Asset Relief Program, said that the $437 million in Treasury contracts to Fannie Mae, Freddie Mac and private companies to manage critical aspects of the bailout program raised a number of concerns about public oversight and conflicts of interest . . . . 'Treasury may be less likely to expedite meaningful reforms of Fannie Mae and Freddie Mac

> Fannie and Freddie are not likely to disappear anytime soon. The combined mortgage giants, now 80% owned by the government, continue to provide approximately 75% of funding to the mortgage market. In addition, Fannie and Freddie insure or own $5.7 trillion of the outstanding total of $11 trillion in mortgages. The government has agreed to provide unlimited funding while policy makers debate how to reform the mortgage system to prevent Fannie and Freddie from again becoming a systemic risk to the financial system.[188]

A consensus is emerging that Fannie Mae and Freddie Mac should disappear or at least assume a far more limited role, but accomplishing this goal will be difficult.[189]

The picture that emerges is decidedly mixed. Clearly, pre-conservatorship, Fannie Mae and Freddie Mac had become poster children for the perils of government involvement in business. Their original mission was a laudable one. But something went awry. One commentator notes:

> In my view, the GSEs' high-risk mortgage investments reflect truly unacceptable decisions by the managers of large financial firms with a public mission to stabilize mortgage markets, with *government* in their status, and with almost unlimited access to low-cost funding based on an implicit guarantee of government support. While we might hope to receive much more responsible behavior from such managers, I fear this is the inevitable result of combining a public mission with private profit incentives.[190]

At this juncture, at least in the short term, Fannie Mae and Freddie Mac are probably necessary evils as is the prominent role government has in running them. Many difficult questions arise: Should their role in TARP be limited? How should their executives be compensated, and for what? When should the conservatorship end? Should the government cap the amount it is willing to spend in bailing them out? All of these decisions hold enormous potential for conflict, including those between government's interests and those of Fannie Mae and Freddie Mac, between individuals' interests, and those of their employers. Even assuming we eventually limit or even

when it has employed them for combined arrangements of $240.5 million and when these firms agreed to provide their services at cost, receiving no profit from the deals,' the report said.").

188. Michael Zielinkski, *FHFA Conservator's Report—Why Fannie Mae and Freddie Mac Failed*, PROBLEM BANK LIST (Aug. 30, 2010), http://problembanklist.com/fhfa-conservators-report-why-fannie-mae-and-freddie-mac-failed-0183/.

189. Murrey Jacobson, *Obama Administration Unveils Fannie, Freddie Proposals to Much Debate*, PBS NEWSHOUR, Feb. 11, 2011, *available at* http://www.pbs.org/newshour/rundown/2011/02/administration-rolls-out-proposals-for-fannie-freddie-to-much-debate.html.

190. Jaffee, *supra* note 174, at 15.

eliminate the roles Fannie Mae and Freddie Mac play, we will be faced with these problems for some time to come.

V. ADDRESSING CONFLICTS OF INTEREST IN BUSINESS AND GOVERNMENT

Many commentators argue that government ought not to become involved in business, if at all possible. We agree that many types of government involvement in business are undesirable, particularly where the result is to socialize losses while privatizing gains. Fannie Mae and Freddie Mac come immediately to mind. But it is probably unrealistic to hope government will be able to stay uninvolved in business; we therefore seek to identify the least problematic ways government could be involved in business. Government involvement in business can certainly claim some successes. After experimenting twice with establishing a for-profit Bank of the United States with private shareholders, Congress finally, in 1913, set up the Federal Reserve (Fed), which functions as a national bank but without the private shareholders and the many conflicts of interest that plagued its predecessors. The Fed controls enormous amounts of money. Sometimes both its judgment and its motives are questioned, but its reputation for integrity surpasses that of its predecessors. Government was finally able to set up a national bank that works—usually.

The examples in Part IV show how government-run businesses involve conflicts of interest on multiple levels, some of them the hard conflicts that law cannot easily address. Indeed, almost by definition, these conflicts of interest cannot be addressed by rules: any given action (or inaction) may reflect a conflict. That is precisely what makes hard cases hard. What about using a more standards-based approach? Doing so may help, but standards require fact-intensive ex-post determinations; such determinations will be expensive and unpredictable. Law simply cannot scrutinize *everything*. Thus, alternative approaches are needed. Some of these approaches would apply more directly to business actors, and some more to government actors. Some approaches would apply to both.

An approach fitting to government and business actors involves promoting personal and professional responsibility. This could be done through enhanced ethics education and through the promotion of norms of responsibility. Here, government ethics law offers a useful insight: it focuses on the ethics of the individuals who run institutions rather than on the institutions.

The Standards of Conduct for Federal Employees set forth broad principles and detailed federal regulations directed at individual actors and seek to implement these principles. It may also be desirable to have Standards of Conduct for Public Company Employees, or perhaps different standards of conduct for employees of public companies in different industry sectors. Merely regulating the companies themselves is not enough. There should be more of a focus on influencing the behavior of individual managers.

Another recipe for enhanced personal responsibility is accountability, which in the private sector in part means liability. Changes in law or in business practice should perhaps impose on the most senior (or the best compensated) business managers some measure of personal liability when their businesses act in ways that harm others. For example, the most senior or best compensated investment bankers should perhaps be personally liable if their bank takes on too much risk and thereby harms its creditors.[191] Indeed, investment banks were run more responsibly when they were general partnerships with personal liability for partners, suggesting that the change in this industry to the corporate form and unlimited liability in the 1970s and 1980s had significant negative effects.[192] Enhanced personal liability for irresponsible business decisions could influence action directly in specific instances and also might promote norms of personal and professional responsibility among business managers. In some situations, enhanced personal liability of business managers might even make detailed regulation of businesses less necessary.

In government, officials often are not held personally accountable even for the most blatant conflicts of interest. Conflict-of-interest laws are mostly contained in criminal statutes that are narrowly defined and fail to cover most conflicts.[193] Prosecution is rare. Civil liability of government officials is almost unheard of, and when liability is imposed for wrongful conduct the government usually pays rather than the wrongdoer. There is no government equivalent to a shareholder de-

191. *See* Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173, 1186–89 (2010).

192. *See id.* at 1179.

193. *See, e.g.*, 18 U.S.C. § 207 (2006) (prohibiting former government employees from representing back to the government in certain circumstances); *id.* § 208 (prohibiting certain financial conflicts of interest and conflicts of interest arising out of certain negotiations for private employment).

rivative suit that can be brought on behalf of the public. Voters are principally responsible for penalizing excessive conflicts of interest in government, with the political checks and balances of a two-party system playing a critical supporting role. There are many inefficiencies of government divided between two or more political parties, including gridlock, but from the vantage point of policing conflicts of interest, divided government may be the best alternative. Government ethics in this context will be highly politicized, but at least it will not be ignored.

Another helpful approach is the use of professional contrarians in both business and government. Regulatory contrarians would be offices within regulatory agencies whose charge is to consider ways in which all relevant viewpoints are not being considered.[194] Regulatory contrarians also can be on guard for instances in which self-interest and cronyism might be coloring regulators' decisions and actions. There is perhaps a role not just for regulatory contrarians but also contrarians in business. Shareholder activists might push for private contrarians—some version of shadow boards of directors or other similar bodies within corporations—as a best practice that would improve a corporation's governance by providing a check on difficult-to-detect conflicts of interest.[195] By contrast with courts, which defer to company management unless they have a strong reason not to, a contrarian might be able to look more critically at management, perhaps focusing particularly on ways in which self-interest and cronyism might have prompted the board to defer to management rather than fully exercising their role as monitors.

Another helpful approach is to disperse decisionmaking among different agencies. The bailouts, for example, were more credible when, in addition to the cadre of Goldman Sachs alumni at the Treasury, the Fed was involved. Congressional oversight is another answer, although this form of contrarian thinking is inherently politicized and labors under its own conflicts of interest. On the business side, increasing shareholder participation in key decisions such as executive compensation might mitigate the impact of conflicts of interest that affect di-

194. *See* Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians,* 88 N.C. L. REV. (forthcoming 2011), *available at* http://ssrn.com/abstract=1711901.

195. For a discussion of one type of contrarian that could be used in corporate governance, see Kelli A. Alces, *The Equity Trustee*, 42 ARIZ. ST. L.J. 717, 717 (2010) (recommending that an "'equity trustee'" be appointed by an equity committee "to represent equity interests as a whole, . . . [to] monitor[] management . . . and remain[] informed about corporate affairs").

rectors' decisionmaking, although expanded shareholder democracy also has costs that have to be considered along with its benefits.

Yet another consideration is that certain views are getting too much exposure to key decisionmakers. In government, it is the views of political operatives and campaign contributors that probably get too much exposure. When a powerful office in the White House—the Office of Political Affairs—spends much of its time catering to the needs of political campaigns and encouraging the rest of the executive branch to do the same, it should not be surprising that the persons who organize and pay for these campaigns get what they want from government.[196] Stricter regulation of political activity by executive branch officials—particularly their involvement in political fundraisers—would help reduce the imbalance in influence between persons who support political campaigns and those who do not.

Another part of the answer—especially for hard cases, conflicts of interest that are difficult to regulate through prohibitions on conduct—is transparency. Federal securities law seeks to bring more transparency to public companies.[197] The Sarbanes-Oxley Act in 2002[198] and the Dodd-Frank Act in 2010[199] brought a shift toward yet more regulation of transparency in large business organizations. As President Obama recently pointed out in the aftermath of the Supreme Court's *Citizen's United* decision, corporate involvement in political campaigns is an area where there is very little transparency.[200] The presi-

196. *See* Painter, *supra* note 124, at A23 (discussing the role of OPA in enhancing the influence of campaign contributors).

197. After the market crash of 1929, Congress federalized transparency requirements in the Securities Act of 1933, which requires disclosure of material information about securities sold to the public, and the Securities Exchange Act of 1934, which requires, among other things, disclosure by public companies in periodic reports, disclosure from persons soliciting shareholder votes, and candor by brokers in dealings with customers. *See* 15 U.S.C. §§ 77–78 (2006). This transparency mandate informs investors about persons to whom they have entrusted money and what those persons are doing with it. State corporate law, by contrast, seeks accountability by controlling the conduct of persons who manage corporations. Both securities and corporate law recognize that it would be naive to rely on shareholder democracy and the market alone to control behavior of disloyal or dishonest managers.

198. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

199. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 311–319, 124 Stat. 1376 (2010).

200. *See* President Barack Obama, State of the Union Address (Jan. 27, 2010), *available at* http://www.whitehouse.gov/the-press-office/remarks-president-state-union-address.

dent proposed legislation that would increase transparency in this area, but so far Congress has not acted. The members of Congress who have not acted are in many instances recipients of this corporate largess—one of the most glaring and apparently intractable conflicts of interest.

CONCLUSION

Government involvement in business—often as a regulator and sometimes as a manager—is here to stay. Conflicts of interest undermine fiduciary obligations in both government and business, and many of these conflicts are difficult to regulate. Understanding when these hard-to-regulate conflicts of interest arise and how they affect decisionmaking in business and government is a critical first step. Promoting an ethos of personal and professional responsibility of business and government decisionmakers, with an emphasis on independent judgment, is also important, although without concrete steps this goal may be easier to aspire to than to achieve. Imposing some degree of personal liability in the business sphere and commensurate measures of accountability in government may be an important step toward greater responsibility. Strengthening alternative voices in the decisionmaking process is also important, whether it be shareholders, ordinary voters, or professional contrarians who represent alternative viewpoints within an organization. Reducing decisionmakers' exposure to the most potent sources of conflicting interest—for example, funders of political campaigns—is also important. Finally, increasing transparency in both business and government should help. Louis Brandeis was correct when he observed that "[s]unlight is . . . the best of disinfectants."[201]

201. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY: AND HOW THE BANKERS USE IT 92 (1914).