TOO IMPORTANT TO FAIL: BANKRUPTCY VERSUS BAILOUT OF SOCIALLY IMPORTANT NON-FINANCIAL INSTITUTIONS

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Systemically important financial institutions are broadly considered to impose a risk to the entire economy upon failure; thus taxpayers act upon their failure, providing them with an implied insurance policy for ongoing liquidity. Yet taxpayers frequently provide de facto liquidity insurance for non-financial institutions as well. Taxpayer money is used to rescue hospitals, utility providers, and major employers.

The Article defines a new category of socially important non-financial institutions (SINFIs) and proposes a method for their ex-ante identification. SINFIs are corporations exclusively providing an essential social function, and the Article offers guidelines for defining essential industries and essential social functions.

The case for bailouts of socially important non-financial institutions is discussed. Liquidity distress for a SINFI is unlikely to be resolved efficiently through bankruptcy, as the risk of an operating default for the socially important institution imposes an immediate crisis of confidence. The provision of service by a socially important institution imposes positive externalities on the general public. This renders two of the main features of bankruptcy, debtor-in-possession rules and the ability to sell assets free and clear of all liens, sub-optimally efficient. Private investors are unlikely to capture the full value of their investment in the socially important institution on the edge of illiquidity. Thus, in a financially distressed SINFI, both the likelihood of new investment opportunities and their potential terms are expected to be suboptimal. Public finance is likely to be required as SINFIs are too important to fail.

The Article further analyzes the structural characteristics and distorted corporate governance of socially important non-financial institutions. The elevated probability of rescue in case of failure makes the socially important non-financial institution prone to unwarranted expansion, and distorts its corporate governance well before failure occurs. The resulting moral hazard creates both enhanced incentives for excessive leverage and risk-taking, and elevated incentives for empire building due to the weaker corporate governance mechanisms available.

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INTRODUCTION

Size is the measure of the day in financial regulation.[1] Too-big-to-fail financial institutions are broadly considered to pose a risk to the entire economy upon failure.[2] Thus, taxpayers act upon failure of too-big-to-fail institutions, providing them with an implied insurance policy for ongoing liquidity.[3] Yet, taxpayers frequently provide de facto liquidity insurance for

[1] *See, e.g.*, 12 U.S.C. § 5365(a)(1) (2012) (instructing the Federal Reserve Board of Governors to subject bank holding companies with assets of $50 billion or more to enhanced prudential supervision).

[2] For some leading examples, see OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 5 (Apr. 25, 2012), http://www.sigtarp.gov/Quarterly%20Reports/April_25_2012_Report_to_Congress.pdf ("A significant legacy of [the Troubled Asset Relief Program] is increased moral hazard and potentially disastrous consequences associated with institutions deemed 'too big to fail.'"); ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT 11 (2013) (discussing how governments needed to step into save too-big-to-fail banks in order to "prevent a complete meltdown of the system"); Mark J. Roe, *Structural Corporate Degradation Due to Too-Big-To-Fail Finance*, 162 U. PA. L. REV. 1419, 1438–44 (2014); Richard W. Fisher, President, Fed. Reserve Bank of Dall., Remarks Before Columbia University's School of International and Public Affairs: Comments on Monetary Policy and 'Too Big To Fail' (Feb. 27, 2013), http://www.dallasfed.org/news/ speeches/fisher/2013/fs130227.cfm ("[F]irms capture the financial upside of their actions but largely avoid payment—bankruptcy and closure—for actions gone wrong . . . . Such firms enjoy implicit subsidies relative to their non-[too-big-to-fail] competitors."). *See generally* DAVID A. SKEEL, JR., THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES (2010).

[3] In the United States, governmental insurance applies either through the Federal Reserve Board lending authority, as defined in 12 C.F.R. § 201 (2016), or through the orderly liquida-

non-financial institutions as well. For example, recently in the U.K., thirty-five hospital trusts were sharing £536 million in non-repayable bailouts in order to keep services running smoothly during 2013–2014.[4] A decade earlier, a federal bankruptcy judge approved California's multibillion-dollar bailout of Pacific Gas & Electric Corporation (PG&E).[5] The Russian government continuously subsidizes corporations which are the exclusive providers of employment and social amenities in Russian monotowns.[6] In an effort to stabilize and sustain air transportation after 9/11, the U.S. Congress passed the Air Transportation Safety and System Stabilization Act, which provided the airline industry with financial aid valued up to $10 billion.[7] In all of these cases, taxpayer money was used to rescue non-financial firms.

As this paper argues, size cannot justify governmental bailouts for non-financial institutions. No one would reasonably consider bailing out a corporation providing luxury designer apparel brands with a huge consolidated assets portfolio. Yet, organizational failure may impose significant risk to social stability beyond the financial sector. Our lives in the early twenty-first century are heavily influenced by, and dependent on, the ongoing provision of products and services by private organizations.[8] Banks are essential because they perform necessary monetary services and provide credit.[9] Other important non-financial organizations may fill key societal roles by supplying public utilities, providing public transportation, or running major hospi-

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tion of the failing entity by the Federal Deposit Insurance Corporation (FDIC), assuming the liabilities of the failing corporation through a bridging financial organization, under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5394 (2012), where no governmental funding is provided.

[4] Denis Campbell, *Rise in Bailouts as More Hospitals Overspent Their Budget*, GUARDIAN (July 22, 2014), http://www.theguardian.com/society/2014/jul/22/hospital-trusts-overspend-budgets-bailouts.

[5] *Judge Approves PG&E Bailout*, WALL ST. J. (Dec. 23, 2003, 12:01 AM), http://www.wsj.com/articles/SB107214516968910000.

[6] *See* Stephen Crowley, *Monotowns and the Political Economy of Industrial Restructuring in Russia*, 32 POST-SOVIET AFF. 397, 406–07 (2016), http://www.tandfonline.com/doi/pdf/10.1080/1060586X.2015.1054103.

[7] Air Transportation Safety and System Stabilization Act, Pub. L. No. 107–42, 115 Stat. 230 (2001) (codified at 49 U.S.C. § 40101 (2012)); *see also* Margaret Blair, *The Economics of Post–September 11 Financial Aid to Airlines*, 35 IND. L. REV. 367 (2003) (discussing the Air Transportation Safety and System Stabilization Act issuance of loan guarantees totaling up to $10 billion).

[8] *See* Shlomit Azgad-Tromer, *A Hierarchy of Markets: How Basic Needs Induce a Market Failure,* 14 DEPAUL BUS. & COM. L.J. 1 (2015) (discussing consumer purchase patterns).

[9] *See Commission Decision on a State Aid Scheme Implemented by Italy to Remunerate Poste Italiane for Distributing Postal Savings Certificates*, at 4–7, COM (2008) 5585 final (Oct. 21, 2008); *Commission Recommendation on Access to a Basic Payment Account*, at 2, SEC (2011) 906 (July 13, 2007); *Compensation to Posten AB for Providing Basic Payment and Cash Facilities Services*, at 2–3, SEC (2006) 5481 final (Nov. 22, 2006); *Credit Union Provision of Access to Basic Financial Services – Scotland*, at 1–4, COM (2005) 977 final (Apr. 6, 2005); *Modernisation of the UK Benefit Payment System and Provision of Access to Universal Banking Services through Post Offices*, at 1–2, COM (2002) 311 final (Feb. 13, 2002).

tals. Stability is the new underlying narrative of financial regulation.[10] The Dodd-Frank Wall Street Reform and Consumer Protection Act (The Dodd-Frank Act), Basel III, the Financial Stability Board, and the leaders of central banks focus extensively on promoting financial stability, not only through macroeconomic policy but also through the regulation of corporate governance for individual corporations considered systemically important financial institutions (SIFIs) and other large financial institutions.[11] However, little attention is paid in the literature to the effect on stability in the event of the financial failure of socially important non-financial institutions.

This Article proposes a framework for ex ante identification of socially important non-financial institutions (SINFIs). Governmental insurance for corporate solvency is required when the continuous operation of the SINFI is vital for the adequate functioning of society. Taxpayers should sometimes intervene to sustain the provision of essential products and services but need not intervene with public funding to reduce haircuts for institutional creditors or derivative obligations.[12] Based on the analysis of three examples of taxpayer bailouts of non-financial institutions, this Article proposes that SINFIs are corporations positioned as monopolies in providing essential social functions, typically situational monopolies of an essential industry, or major employers positioned as exclusive employers due to geographical or social circumstances. Sustaining the continued operation of SINFIs becomes a matter of public concern because it provides functions that are deemed to be part of the social contract.

This Article argues that a SINFI's failure poses a risk to social stability, creating a category of too-important-to-fail industrial firms that are faced with idiosyncratic risk of failure, which could result in broad implications on the economy as a whole. Liquidity distress for a SINFI is unlikely to be resolved efficiently through bankruptcy. Bankruptcy is an inefficient resolution mechanism not only because of the lengthy procedure for solving the operating contingency and ensuring continued service,[13] but also because sustaining the provision of service by the SINFI imposes significant positive

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[10] *See, e.g.*, 12 U.S.C. § 5323(a)(1) (2012) (instructing the Financial Stability Oversight Council to designate and supervise nonbank financial institutions that "could pose a threat to the financial stability of the United States"); *cf.* Katharina Pistor, *On the Theoretical Foundations for Regulating Financial Markets* (Columbia Law Sch. Working Paper No. 12-304, 2012) (positing that market actors do not behave rationally, but instead are beset by herd behavior).

[11] *See, e.g.*, 12 U.S.C. §§ 5323(a)(1), 5365(a)(1) (2012) (the Dodd-Frank Act's instruction that the Financial Stability Oversight Council designate and provide enhanced prudential supervision for banks exceeding $50 billion in assets and nonbank financial institutions that "could pose a threat to the financial stability of the United States"); BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS 1 (rev. ed. 2011) (noting that Basel III's reform package is aimed at addressing the lessons of the financial crisis, including improving governance risk management at banks).

[12] *See* Lucian A. Bebchuk, *AIG Still Isn't Too Big to Fail*, WALL ST. J. (Mar. 20, 2009), http://www.wsj.com/articles/SB123751263240591203.

[13] *See* Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?*, 82 TEMP. L. REV. 449, 451 (2009)

externalities on the general public. This renders the main features of bankruptcy—namely, debtor-in-possession rules and the ability to sell assets free and clear of all liens[14]—sub-optimally efficient, as the potential private investor is unlikely to capture the full value of investment in the socially important firm. Thus, in a distressed SINFI, both the likelihood of new investment opportunities and their potential terms are expected to be sub-optimally valued, and public finance is likely to be required.

Finally, this Article offers an analysis of the unique structural characteristics and distorted corporate governance of the socially important non-financial institution. SINFIs induce a behavioral market failure and are prone to unwarranted expansion. At the corporate level, society's implied subsidy induces excessive leverage and enhanced risk taking. As the corporate governance pressures that typically mitigate agency costs are weaker in these too-important-to-fail SINFIs, the incentives for empire building and the accompanying moral hazard are expected to be elevated.

Part I discusses three examples of non-financial bailouts by taxpayers and offers a framework for the ex ante identification of socially important non-financial institutions as monopolies providing essential social functions.

Part II discusses the prospects of bankruptcy versus bailouts for socially important non-financial firms. It argues that rescue funding may be required to sustain continued operation by the SINFI due to the risk to social stability rooted in the immediate crisis of confidence caused by its financial distress. Furthermore, the likelihood of a need for public rescue funding is bigger for socially important firms due to positive externalities unlikely to be captured by any private investor acquiring the distressed firm or lending to it under the debtor-in-possession rules. However, the infusion of public capital need not be limited to a taxpayer bailout, as the bankruptcy process is another possible solution to SINFI failure with the Treasury assuming the role of debtor-in-possession financier.[15]

Part III offers an analysis of the structural characteristics and distorted corporate governance of SINFIs. As situational monopolies, too-important-to-fail firms are less likely to foster efficient competition. At the market level, this Article argues, SINFIs induce the risk of a behavioral market failure and are prone to unwarranted expansion. At the corporate level, this Article argues that like the too-big-to-fail SIFIs, the too-important-to-fail SINFIs impose social costs driven by the implied subsidy that also lowers their ongoing funding costs.[16] The elevated probability of rescue in case of failure distorts the organizational incentives of the SINFI's management well

(explaining the difficulty of bankruptcy in the too-big-to-fail context using Lehman Brothers as an example).

[14] *See* Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 476 (2010).

[15] *See id.* at 487–88 (arguing that the bankruptcy process provides alternative solutions to a firm's liquidity problems through an automatic stay because it serves to suspend and differentiate funding of continued operations from funding of prior losses).

[16] *See* Roe, *supra* note 2, at 1439.

before failure occurs, increasing the taste for leverage and excessive risk taking. Further, the incentives for empire building are enhanced in SINFIs, where corporate governance pressures for mitigating agency costs are weaker.[17]

Socially important non-financial institutions are the most significant corporations in our lives, the corporations upon which we depend for social stability. These firms become too important to fail because their unique position makes the public utterly dependent upon their continuous operation. An uninterrupted service by SINFIs is part of the social contract, an inherent expectation of our civil life. Yet, SINFIs are completely under the radar of current corporate law and financial regulation. The contribution of this Article is to identify the category of socially important non-financial institutions, showing why they are likely to require rescue funding upon failure, and portraying their structural degradation and distorted corporate governance. Policy questions in acting upon these criteria open many additional research directions in corporate law, corporate governance, and antitrust policy to be further explored in future works.

I. The Socially Important Non-Financial Institution—Introducing SINFIs

This Part of the Article provides three examples of socially important non-financial institutions, and follows with a framework for their ex ante identification.

A. Examples

1. A Major Hospital

The illiquidity of major hospitals often raises the bailout debate. In the United Kingdom, the government recently paid millions of non-repayable bailouts to keep services running smoothly.[18] In 2015, Clayton county of Georgia bailed out the Southern Regional Medical Center with $50 million in taxpayer money to save it from a financial cliff.[19] In 2014, the New York State Department of Health took over the Interfaith Medical Center of Brooklyn and appointed Steven Korf and the former bankruptcy judge Melanie Cyganowski to oversee a restructuring made possible by an announced

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[17] *Cf.* Lucian A. Bebchuk, *How to Fix Bankers' Pay*, 139 Daedalus 52 (2010); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 Geo. L.J. 247 (2010); Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig, & Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Socially Expensive*, 22–23 (Stanford Univ. Rock Ctr. for Corp. Governance, Working Paper No. 161, 2013).

[18] Campbell, *supra* note 4.

[19] Andy Miller, *A Hospital's Main Strategy – Survival*, Ga. Health News (Mar. 5, 2015), http://www.georgiahealthnews.com/2015/03/hospitals-main-strategy-survival/.

$20 to 30 million bailout.[20] Some of the bailed-out hospitals are sponsored by governments. Others are private institutions, for-profit corporations, or non-profit charities. Notably, the bailout debate is triggered for major hospitals regardless of the hospitals' funding structure or choice of organizational form. Instead, it is the risk to the major hospitals' life-saving function that makes the funding an immediate public concern.

Not every corporate failure of a medical provider imposes a risk to social stability. When a pediatric clinic goes out of service, there are typically many other healthcare providers around to offer patients an adequate substitute. But, when a major hospital shuts down due to illiquidity, runs out of medical supplies, or cannot pay salaries to its medical personnel, there is likely to be a cost in human lives, which may also be reflected in a loss of public trust and degraded social stability. Proximity to hospital services has been found to be correlated with patient mortality.[21]

For a patient suffering a heart attack, the closest major hospital is a monopoly providing the essential health services. We rarely choose to become sick—the patient status is most often imposed upon individuals involuntarily. We need the hospital when and where we become sick and we frequently need it immediately. We cannot decline the purchase of health services and are rarely in a position to safely defer their purchase. A major hospital is a situational monopoly providing the public's right to health, which is considered by many to be a human right,[22] a derivative of the right to life.

2. *Utility Provider*

In April 2001, the Pacific Gas & Electric Company (PG&E), a retail electricity supplier for most of northern and central California, serving back then a population of 15 million, filed for Chapter 11 bankruptcy.[23] PG&E asserted that, as a result of the energy crisis in California starting May 2000,[24] and because its retail rates were frozen, it was unable to recover approximately $9 billion of electricity procurement from its customers, re-

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[20] *See* Danielle Furfaro, *State Takes Over Interfaith, Promises Bailout*, Brook. Paper (Mar. 27, 2014), http://www.brooklynpaper.com/stories/37/13/all-interfaith-hospital-state-takeover-2014-04-04-bk_37_13.html.

[21] Jon Nicholl, James West, Steve Goodacre, & Janette Turner, *The Relationship Between Distance to Hospital and Patient Mortality in Emergencies: An Observational Study*, 24 Emergency Med. J. 665, 665–68 (2007).

[22] *See* Aeyal Gross, *Is There a Human Right to Private Health Care?*, 41 J.L. Med. & Ethics 138, 138–39 (2013); Jennifer Prah Ruger, *Toward a Theory of a Right to Health: Capability and Incompletely Theorized Agreements*, 18 Yale J. L. & Human. 273, 275–78 (2006).

[23] *In re* Pac. Gas & Elec. Co., 304 B.R. 395, 398 (Bankr. N.D. Cal. 2004); *see* Paul W. MacAvoy, The Unsustainable Costs of Partial Deregulation 70 (Yale Univ. Press 2007) (providing a historical account).

[24] *See* MacAvoy, *supra* note 23, at 86 (providing a graph demonstrating the spike in power prices in the relevant period).

sulting in billions of dollars of defaulted debt and a downgrading of its credit by all the major credit rating agencies.[25] Others have suggested that the roots of PG&E's failure lay in a risky business strategy, an extensive acquisition policy adopted by PG&E,[26] excessive debt, and "abnormally large" dividend distributions.[27] Despite intensive borrowing, in April 2001, PG&E was out of cash, and out of ways to raise cash—it could no longer pay for wholesale power purchases made a month earlier.[28]

In January 2004, after lengthy judicially-supervised settlement negotiations between PG&E, its parent corporation, and the Official Committee of Unsecured Creditors, and the California Public Utilities Commission, Bankruptcy Judge Dennis Montali approved both a Plan of Reorganization under Chapter 11 of the Bankruptcy Code for PG&E and a Settlement Agreement among the aforementioned parties—overruling objections to confirmation of the reorganization plan.[29] The purpose of the approval and of the Settlement Agreement itself was "to enable PG&E to emerge from Chapter 11 and resume fully its traditional role of providing safe and reliable electric and gas service," acknowledging "reliable electric and gas service as being of the utmost importance to the safety, health and welfare of California's citizenry and economy."[30]

Because PG&E had not been able to pay for wholesale power, its liquidity crisis imposed a threat to its continued and uninterrupted operation, implying the risk of a statewide electricity outage.[31] Life without electricity in the twenty-first century is life in chaos: light, heat, appliances, trains, traffic lights, computers—all are subject to the electricity provider's liquidity risk. California's elected officials were not going to let this bleak scenario develop into reality.[32] The approved bankruptcy settlement provided that the California Public Utilities Commission establish a "Regulatory Asset" of $2,210,000,000 as a new, separate, and additional part of PG&E's rate

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[25] *In re* Pac. Gas & Elec. Co., 230 P.U.R.4th 101, at *15, *62 (Dec. 18, 2003) (Decision 03-12-035 of the California Public Utility Commission "Opinion Modifying The Proposed Settlement Agreement Of Pacific Gas & Electric Company, PG&E Corporation And The Commission Staff, And Approving The Modified Settlement Agreement").

[26] Tyson Slocum, *Electronic Utility Deregulation and the Myths of the Energy Crisis*, 21 BULL. OF SCI., TECH. & SOC'Y 4 (2001).

[27] *See* MACAVOY, *supra* note 23, at 83.

[28] *See id.* at 89–91.

[29] *Pac. Gas & Elec. Co.*, 304 B.R. at 398.

[30] *Id.* at 401.

[31] *See The California Energy Crisis: Impacts, Causes, and Remedies Before the House Comm. on Fin. Servs.*, 107th Cong. 15 (2001) (statement of Hon. Isaac C. Hunt Jr., Comm'r, SEC) (noting that the inability to pass wholesale price increases through to consumers has caused severe liquidity problems for PG&E); Rachel Gordon & Marianne Costantinou, *Breeze Eases Killer Heat*, S.F. CHRON. (June 15, 2000), http://www.sfgate.com/news/article/Breeze-eases-killer-heat-3056577.php (noting that California initiated rolling blackouts due to scarce power supplies in order to avoid major uncontrolled blackouts).

[32] *See A State of Gloom*, ECONOMIST (Jan. 18, 2001), http://www.economist.com/node/478833 (noting that the California Assembly passed a bill rolling back the deregulatory measures that led to the energy crisis and that Governor Gray Davis declared a state of emergency in the wake of the energy crisis).

base.[33] This Regulatory Asset, an accounting device designed to boost PG&E equity so that it regained an investment-grade rating from the credit rating firms, was approved to be amortized in PG&E's electrical retail rates over nine years.[34] In sum, PG&E was bailed out by an IOU from its retail consumers in the form of government assistance.

More than an occasional crisis, the case of PG&E raises a generic pattern of bounded bankruptcy options for SINFIs. Recently, the Texas energy company Energy Future Holdings Corp (EFH) filed for bankruptcy.[35] EFH was purchased seven years prior to the bankruptcy filing by a consortium of private equity firms and hedge funds, in what was considered the largest leveraged buyout in history: the purchasers utilized over ninety-six percent borrowed funds, totaling over $40 billion of debt.[36] Again, there is debate over the reasons for failure, with possibilities stretching from a spike of power-supply wholesale prices to excessive debt and an over-generous dividend distribution.[37] In its SEC-filed Form 10-K for the 2014 fiscal year, released on March 31, 2015, EFH describes a variety of bankruptcy-related risks, including "a decrease in the number of counterparties that are willing to engage in commodity related hedging transactions with us and a significant increase in the amount of collateral required to engage in any such transactions; a loss of, or a disruption in, the materials or services received from, suppliers, contractors or service providers."[38] Furthermore the company noted that there would be "difficulties in the retention of employees [and] management distraction," restriction of "access to capital, the cost of such capital" and "[in]ability to generate sufficient cash flow to make interest or adequate protection payments, or refinance, our debt instruments, including the DIP Facilities," all potentially leading to the ultimate risk of "limitations on our ability to operate our business."[39] Meanwhile, the Texas Public Utility Commission, which regulates public electricity in Texas, was facing a deficit in electrical power generating capacity, and was debating the

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[33] *Pac. Gas & Elec. Co.*, 304 B.R. at 402.

[34] *See id.*

[35] Energy Future Holdings Corp., Current Report (Form 8-K) (Apr. 29, 2014) (announcing that EFH and a substantial majority of its direct and indirect subsidiaries filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware).

[36] *See* David Carey & Sabrina Willmer, *Biggest Buyout Gone Bust in Energy Future Dims Megadeals*, BLOOMBERG BUS. (Apr. 30, 2014, 12:25 PM), http://www.bloomberg.com/news/articles/2014-04-30/biggest-buyout-gone-bust-in-energy-future-dims-megadeals; Peter Lattman, *A Record Buyout Turns Sour for Investors*, N.Y. TIMES (Feb. 28, 2012, 8:22 PM), http://dealbook.nytimes.com/2012/02/28/a-record-buyout-turns-sour-for-investors/?_r=0.

[37] *See* EILEEN APPELBAUM & ROSEMARY BATT, PRIVATE EQUITY AT WORK: WHEN WALL STREET MANAGES MAIN STREET 267 (Russell Sage Found. 2014); Eileen Appelbaum & Rosemary Batt, *The Real Lesson From EFH Bankruptcy*, HUFFINGTON POST: BUS. BLOG (May 16, 2014, 2:53 PM), http://www.huffingtonpost.com/eileen-appelbaum/efh-bankruptcy_b_5339343.html.

[38] Energy Future Holdings, Annual Report (Form 10-K) 19 (Mar. 31, 2015).

[39] *Id.*

effect on operational reliability.[40] The Texas Public Utilities Commission has already raised prices for Texas electricity consumers, requiring payment for availability of incremental generation through capacity markets,[41] in an action viewed by critics as a disguised bailout.[42]

3. Major Employer

Taxpayers often intervene in sustaining operations for corporations assuming other social functions exclusively. Major employers who are politically irreplaceable enjoy an implied illiquidity insurance by taxpayers in the U.S. as well. Automakers in the U.S. enjoyed considerable governmental subsidies aiming to sustain their employment commitments in tact on the edge of illiquidity.[43] Major employers are likely to be rescued with public funding when their employees' skills, geographical location, or competitive surrounding make them utterly dependent on the continued enterprise operation. For this reason, when major employers in a monopolistic employer position face financial distress, elected representatives are often urged to respond with financial aid. When SINFIs succeed, they succeed as corporations. But when they fail, public governance fails with them.

Consider for example the case of the Russian monotowns. Monotowns are urban settlements geographically located in inhospitable areas to the north and east of Central Russia, dominated by a single corporation, exclusively providing the population employment and all other social amenities, including childcare and health insurance.[44] According to World Bank research, there are approximately 467 cities and 332 smaller towns qualifying as monotowns in Russia, although there is no clear consensus for a definition of monotowns or an official statistics for the scope of this phenomenon.[45]

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[40] *See* Kenneth W. Anderson, Jr., Commissioner, Pub. Util. Comm'n of Tex., Presentation for Public Utility Law Conference: The Reliability Triad's Second Leg: Operational Reliability, The Texas Market Based Approach, Presentation for Pub. Util. Conf. (Aug. 8, 2014), http://www.puc.texas.gov/agency/about/commissioners/anderson/pp/Utility_Law_Conference_The_Reliability_Triad.pdf.

[41] McDermott Will & Emery, *Texas Public Utility Commission "PUCT" Approves Proposals to Raise Energy Price Offer Caps,* NAT'L L. REV. (Apr. 23, 2012), http://www.natlawreview.com/article/texas-public-utility-commission-puct-approves-proposals-to-raise-energy-price-offer-#sthash.0977AnMd.dpuf.

[42] *See, e.g.*, Weston Hicks, *Texas Electricity Bailout*, AGENDA WISE REP. (Oct. 31, 2013), https://web.archive.org/web/20131108164832/http://www.agendawise.com/2013/10/texas-electricity-bailout/.

[43] *See* Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727, 728–29, 733–34, 757, 761, 770 (2010) (detailing the critical role that the government's cash infusion played during the bankruptcy in keeping Chrysler from failing because of the government's fear of the grave consequences that the auto industry's collapse would have on the rest of the American economy).

[44] ZELJKO BOGETIC ET AL., WORLD BANK IN RUSS., RUSSIAN ECONOMIC REPORT NO. 22, 21 (2010), http://siteresources.worldbank.org/INTRUSSIANFEDERATION/Resources/305499-1245838520910/rer_22_eng.pdf.

[45] *Id.*

When monotowns face financial distress, they are frequently subsidized by the Russian government.[46]

B. Ex Ante Identification of Socially Important Non-Financial Institutions

SIFIs are identified by the Dodd-Frank Act as banking institutions that exceed a size threshold of $50 billion in assets, pose a risk to the stability of the financial system, and are thus deemed too big to fail.[47] The theory offered below suggests that SINFIs may also be identified prior to failure due to their increased social risk. Rather than size being the primary measure of systemic significance, this Article suggests the measure for SINFIs should be their societal importance. SINFIs are institutions exclusively providing an essential social function in their communities. In the following Section, this Article discusses the determining factors identifying the essential functions and industries as well as the nature of the exclusive monopolistic position assumed by the SINFI that provides this essential social function.

1. Essential Industries and Essential Social Functions

SINFIs are only those organizations that society relies on for its functional sustainability. No one would reasonably consider bailing out a corporation providing luxuries with a huge asset portfolio. The rescue funds are directed at firms operating in industries that taxpayers depend on for sustaining their social expectations, or, alternatively, at firms providing other essential social functions. It is essentiality, rather than size, that merits taxpayers' money to be used to rescue the firm upon failure.

What determines the essentiality of an industry? Defining essential industries raises both a legal and a practical challenge.[48] First, essential markets are markets in which we would expect consumers to purchase as a social moral baseline.[49] Purchases in particular markets are essential for the minimal normative life the state aims to provide its citizens. The right to live as a human being and the value of dignity evoke a minimal consumption

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[46] *See* Crowley, *supra* note 6, at 406–07.

[47] *See* 12 U.S.C. § 5365(a)(1) (2012) (instructing the Federal Reserve Board of Governors to subject bank holding companies with assets of $50 billion or more to enhanced prudential supervision); *see also id.* § 5323(a)(1) (2012) (directing the Financial Stability Oversight Council to consider size as a factor when determining whether a nonbank financial institution should be designated as a SIFI).

[48] For a thorough analysis of the determinants of market essentiality, see Azgad-Tromer, *supra* note 8, at 15–22.

[49] MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 79–80 (1997) (citing ALAN WERTHEIMER, COERCION 207 (1987)). Wertheimer identifies three kinds of expectations: the statistical, the phenomenological, and the moral. The statistical is based on calculated probabilities, the phenomenological on subjective expectations from the future. The moral, may or may not coincide with these, and is a normative judgment. *Id.*

basket that must be purchased if these rights are to be given substance.[50] Essential industries offer the content of this minimal normative basket—these are requisites for fulfilling society's promise for the protection of human rights under constitutional and international human rights. Second, essential industries tend to have insufficient substitutes for their goods—consumers are captive in markets for essentials and cannot switch to a different market for their needs-based shopping.[51] Third, purchases in these essential industries are often constrained in time and are unlikely to be deferred.[52] The hospital patient is not able to defer her purchase to another time; she needs the service promptly after an injury has occurred.

Policymakers may articulate a complete basket for a full and healthy human life, comprised of an objective list of requirements for minimum living,[53] which includes products required not only for healthy nutrition but also for fitness and recreation, housing, and social and cultural integration. For example, the European doctrine of *Services of General Interest* classifies some services as being "services of general interest" and, as such, imposes on their corporate providers specific public service obligations, as well as optional state aid for requisite finance.[54] When an industry is subsidized, we can assume that the government considers it politically or societally essential.[55] Subsidization and price regulation signal the state's interest in making the subsidized service or product accessible to consumers, suggesting that policymakers consider the industry politically essential.[56]

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[50] *Khosa v. Minister of Social Development* 2004 (6) SA 505 (CC) at 530 (S. Afr.) ("[B]asic necessities of life [must be] accessible to all if it is to be a society in which human dignity, freedom and equality are foundational."); *S v. Makwanyane* 1995 (3) SA 391 (CC) at 506 (S. Afr.) ("It is not life as a mere organic matter that the [Interim] constitution cherishes, but the right to human life: the right to live as a human being, to be part of a broader community, to share in the experience of humanity . . . more than existence—it is a right to be treated as a human being with dignity . . . .").

[51] *See* Azgad-Tromer, *supra* note 8, at 15.

[52] *Id.* at 16.

[53] *See, e.g.*, J. N. Morris et al., *A Minimum Income for Healthy Living,* 54 J EPIDEMIOL CMTY. HEALTH 885, 885–89 (2000) (using an objective public health approach to identify representative minimal costs per week in the UK, the authors use research providing "consensual evidence" defining the major personal requisites for health in nutrition, physical activity and psychological relations, estimating the minimal costs an comparing them with the statutory minimum wages).

[54] *See Green Paper on Services of General Interest*, at 14, COM (2003) 270 final (May 21, 2003); *see also* Treaty of Functioning of the European Union, European Union, art. 106(2), Dec. 13, 2007., 2012 J.O. (L 7) 3–10; 2012 J.O. (C 8) 15–22. Of particular interest in this article are the services of general economic interest (SGEI), economic activities which deliver outcomes in the overall public good that would not be supplied, or would be supplied under different conditions in terms of objective quality, safety, affordability, equal treatment or universal access, by the market without public intervention. *Id.*

[55] *See, e.g.*, Roe & Skeel, *supra* note 43, at 728, 767 (detailing the critical role that the federal government played in the Chrysler bankruptcy in order to avoid the potentially grave consequences that the auto industry's failure might have on the American economy).

[56] *See id.*; *A State of Gloom*, *supra* note 32 (noting that the California Assembly passed a bill rolling back the deregulatory measures governing the power industry that had led to the "sky-rocketed" prices which caused the energy crisis in the early 2000s).

The essentiality of an industry may also be assessed by an analysis of market data.[57] Low elasticity of demand documented at the market level signals the cultural perception of a subjective need, suggesting that many consumers feel that they need to purchase the product or service category regardless of its price.[58] For popular products, a public conception of luxuries would be reflected in higher market-level elasticity of demand, whereas a public perception of necessities would be reflected in lower market-level elasticity of demand, signaling that the product is more likely to be purchased under conditions of a behavioral market failure.[59]

2. Situational Monopolies

Providing an essential function does not by itself merit the social significance designation of the firm. We often have numerous providers of essentials to pick from. Health services are essential, but when the pediatric clinic we prefer goes bankrupt, we do not expect taxpayers' money to bail it out as people can usually rely on other local healthcare providers as adequate substitutes for these services. Groceries are essential, but we do not expect taxpayers' money to rescue a supermarket chain in distress when the community has multiple supermarkets. It is likely, however, that if the major hospital in a big city suffers liquidity distress, it becomes a public concern to sustain it, because that hospital serves as a situational monopoly providing essential services for many of its patients. Consider, for example, the patient suffering a heart attack—the closest major hospital is her only chance of survival, having both the medical equipment and the medical experts required to provide emergency assistance. In this circumstance, it is likely that the government will step in to ensure that patients' lives are not put in danger by the closing of a local hospital. Likewise, if an isolated village had only one grocery store, residents of the village and its public officials would make a public effort to sustain its continuous service. Thus, a situational monopoly is created when "the fortuitous circumstances surrounding the interaction between the particular parties to the exchange . . . create a monopoly power that [the situational monopoly] . . . opportunistically exploits in return for a quid pro quo that has no or negative social value."[60]

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[57] Azgad-Tromer, *supra* note 8, at 49–50 (explaining market data documenting low market-level elasticity of demand for highly popular product or service categories signals consumers' bounded voluntariness and suggests the industry is essential).

[58] *See id.* at 40.

[59] *See* Oren Bar-Gill, *Competition and Consumer Protection: A Behavioral Economics Account* 1 (N.Y. Univ. Law and Econ. Res. Paper, Paper No. 11-42, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1974499 (showing that higher market-level elasticity would apply to popular products only, as luxuries consumed only by the very wealthy are expected to show lower elasticity due to widening wealth gaps and the rational indifference to costs in this social segment); *see also* Oren Bar-Gill, *Seduction by Contract: Law, Economics and Psychology in Consumer Markets - Introduction* 4 (N.Y. Univ. Law and Econ. Res. Paper, Paper No. 12-33, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2153775.

[60] TREBILCOCK, *supra* note 49, at 93.

Unlike structural monopolies, which are sole providers in their respective markets, situational monopolies may have competitors, but the competition is not accessible to their stakeholders, who have no good substitutes at the particular time and place where the transaction occurs.[61] Situational monopolies are created within essential industries when the cost of substitutes for a particular provider is too high or unaffordable. In the case of the major hospital, even if the closest major hospital is only one hour away, that may be too long to enable the heart attack patient to be saved. It is the consumer's situation that grants the seller the situational monopoly status. Another example of a situational monopoly may be a major daycare chain. Even when there are several competitors, the collapse of a major daycare chain in the midst of a school year would make consumers' switching costs considerably higher, and potentially prohibitively expensive. Thus, the state may intervene to sustain the daycare service until another potential provider arrives.

Major employers are also rescued only if they have assumed a situational monopoly position and enjoy monopsony power over their employees. Consider, for example, a mass layoff by a high-technology corporation facing financial distress in a competitive environment, such as in Silicon Valley. Taxpayers are not likely to insure the corporation's liquidity because the mass layoff may simply make talent recruitment easier for smaller employers in the area. However, when a major employer has a situational monopoly, many of its employees are unable to find suitable replacements and are utterly dependent on its continued operation for employment.[62] If the corporation dominating the monotowns is closed, none of its employees are able to find another employer, due to the geographical distance.[63] A corporation may gain a situational monopoly in its capacity as an employer when the employees' skill, geographical location, or competitive surrounding make employees utterly dependent on its continued operation, thereby granting the corporation its monopoly power.

Situational monopolies providing essential products or functions may sometimes be subject to essential facility claims; however, it is important to note the distinction between the socially important non-financial institution, comprised of the situational monopoly in an essential industry, and the essential facility doctrine. The essential facility doctrine is focused on the duty to share an essential facility so as to avoid cartelization and enhance compe-

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[61] Substitutes are also a function of cost, and situational monopolies arise when costs of alternatives are high and unaffordable. For example, bank accounts are so costly to alter that consumers may keep paying increased fees simply because switching entails an overwhelming effort.

[62] *See* Crowley, *supra* note 6, at 404–07.

[63] *See id.* at 401, 408, 412 (noting that many monotowns are marked by their geographic isolation which may cause them to be vulnerable to labor problems, especially in times of economic shocks, and this isolation may give the Kremlin reasons for concern over potential social unrest if there are widespread monotowns failures and resulting unemployment).

tition.[64] As such, the essential facility doctrine is a "limitation on the general rule that a firm has no obligation to deal with its competitors."[65] By contrast, the SINFI is not necessarily running an essential facility that "cannot practicably be reasonably duplicated by would-be competitors."[66] Rather, it may be possible for a SINFI's competitor to duplicate the services or products provided by the SINFI, and thus the socially important firm may have competitors. But the retail consumers of the SINFI are unable to enjoy the fruits of competition due to high switching costs or the inability to switch at all. Rather than looking through the lens of a potential competitor, the social significance test looks through the lens of the consumer or employee. It is not the entry costs to the essential market, but rather the stakeholders' switching costs that make the situational monopoly socially significant. The question here is not whether a competitor may reasonably establish a competing firm, it is whether—as a practical matter of real life—stakeholders can use the competition and switch to a different provider. When stakeholders are unable to switch to a different a provider for an essential service or product, the provider of that service or product becomes a SINFI. As I argue below in Part II, sustaining that social function in the face of a liquidity distress becomes a matter of public concern.

II. The Socially Important Non-Financial Institution as Too Important to Fail

Can socially important non-financial institutions go bankrupt? This Part of the Article analyzes the prospects of bankruptcy versus bailout for the SINFI. It argues that a liquidity-distressed SINFI imposes an immediate threat to social stability. Due to the positive externalities of the SINFI, public funding is likely to be required upon its failure, either through a bailout or with the Treasury acting as a debtor-in-possession within the bankruptcy process. This Part of the Article argues that SINFIs are too important to fail.

A. Liquidity Versus Insolvency During a Crisis of Confidence

Too-big-to-fail institutions are widely considered beyond the boundaries of bankruptcy because their default generates a "systemic risk"[67]: a risk "pertaining to the system"[68] rather than to the stakeholders of a particular firm. It is not the firm-specific risks of corporate failure that justify rescue

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[64] Stephan M. Maurer & Suzanne Scotchmer, *The Essential Facilities Doctrine: The Lost Message of Terminal Railroad*, 5 Cal. L. Rev. Cir. 278, 303 (2014).

[65] Robert Pitofsky, Donna Patterson, & Jonathan Hooks, *The Essential Facilities Doctrine Under United States Antitrust Law*, 70 Antitrust L.J. 443, 446 (2002) (citing Caribbean Broad. Sys. Ltd. v. Cable & Wireless PLC, 148 F.3d 1080, 1088 (D.C. Cir. 1998)).

[66] *Id.*

[67] *See* Steven L. Schwarcz, *Systemic Risk,* 97 Geo. L.J. 193, 231 (2008).

[68] *Id.* at 196.

funding from the public, but rather the implications outside the firm—the risks imposed on the markets and on society as a whole—that make the public particularly vulnerable to a too-big-to-fail firm's potential failure and thereby merits rescue funding.[69] Financial literature offers several inconsistent definitions of "systemic risk," including different definitions for the trigger events and for the consequences, ranging from "successive and cumulative losses" to "substantial volatility in asset prices, significant reduction in corporate liquidity" and "repercussions on other [market] participants."[70] The common factor in systemic risk evaluations seems to be the loss of public confidence and its economic manifestation—in the illiquidity of market participants, in a rush out of credit markets, in credit spreads, in increased cost of capital, and in further liquidations.[71] Federal rescue funding is designed to remedy a crisis of confidence triggered by the default of the too-big-to-fail firm.[72]

The illiquidity of a SINFI triggers a similar crisis of confidence, spreading beyond the defaulting firm itself and affecting the society as a whole. Because SINFIs are situational monopolies of essential industries, their uninterrupted operation is an inherent expectation of our civil life. Hobbes, Locke, and others insist that the sovereign has "ultimate responsibility for maintaining order" and "overseeing" the citizens' administration—the state's authority ultimately rests in a shared understanding of the common good.[73] Rawls argues that there are certain primary social goods "a rational man wants whatever else he wants."[74] The sovereign is responsible for providing individuals with a sufficiently equal share of these necessary resources to establish a just and fair social baseline from which different individuals can pursue diverse goals.[75] It is thus a social function to provide the basket of products and services requisite for social order. Sometimes these goods are provided by private organizations, that occasionally act as situational monopolies. Governments need to intervene when an organiza-

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[69] *See* Ayotte & Skeel, Jr., *supra* note 14, at 470–71.

[70] Schwarcz, *supra* note 67, at 196–97 (summarizing interpretations of "systemic risk") (internal punctuation omitted).

[71] *See id.* at 201 (quoting *Hedge Fund Operations: Hearing Before the H. Comm. on Banking & Fin. Servs.*, 105th Cong. 18 (1998) (statement of William J. McDonough, President, Federal Reserve Bank of New York)); *see also* Ayotte & Skeel, Jr., *supra* note 14, at 490–91 (comparing data documenting changes in major indices surrounding the failure of AIG and of Lehman, and suggesting that the market did not distinguish between the distress resolution procedures of the two, but rather focused on the "implications of distress itself").

[72] *Cf.* Ayotte & Skeel, Jr., *supra* note 14, at 490 (noting the significant effects of the Lehman Brothers bankruptcy on public confidence and questioning whether an eve-of-bankruptcy bailout could have prevented this).

[73] Malcolm M. Feeley, *The Unconvincing Case Against Private Prisons*, 89 IND. L.J. 1401, 1415 (citing JEAN HAMPTON, HOBBES AND THE SOCIAL CONTRACT TRADITION (1986); C.B. MACPHERSON, THE POLITICAL THEORY OF POSSESSIVE INDIVIDUALISM: HOBBES TO LOCKE (1962); BRIAN SKYRMS, EVOLUTION OF THE SOCIAL CONTRACT (1996); Russell Hardin, *Hobbesian Political Order*, 19 POL. THEORY 156 (1991)).

[74] JOHN RAWLS, A THEORY OF JUSTICE 92 (Belknap Press 1971).

[75] *Id.* at 90–95.

tion experiences liquidity distress if that organization's failure poses an imminent threat to the continued operation of a critical social function. A SINFI's uninterrupted provision of services is a derivative of the social contract—an implied promise of the order and stability we expect the sovereign to assume and protect.[76] Returning to the examples analyzed above, there is clearly no social order without accessibility to the services of a major hospital, a public utility, and a monopolist public transportation provider. Rather than a Lockean unitary model of the state, we currently have a blurred line between "the state" and "private society," creating a "disaggregated state."[77] When the private organizations assuming public roles in this disaggregated vision turn illiquid, the state has an obligation to come to the rescue and secure the SINFI's continued operation and uninterrupted service to the public.

Recognizing the difference between illiquidity and insolvency is crucial to understanding the boundaries of bankruptcy in default events of socially important non-financial institutions. Illiquidity, or economic failure, means that a firm does not have access to enough cash to maintain its current operations, whereas insolvency, or financial failure, means that the firm's liabilities exceed the total value of its assets and it may not be able to meet its debt obligations even if there is enough cash to continue operations.[78] In theory, solvent firms should always be able to sell some of their assets to resolve illiquidity or, alternatively, to be able to secure debt backed by their assets.[79] But, in reality, selling illiquid assets is often a costly and lengthy procedure,[80] and it is thus not uncommon for an organization to file for bankruptcy when it is illiquid but solvent.[81] Even if the bankruptcy process will eventually prove that the SINFI is solvent, the liquidity distress threatens its day-to-day ability to meet its operating obligations in the normal course of busi-

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[76] For a comparison of this argument to the argument made in the context of private prisons, see Feeley, *supra* note 73, at 1416–17 (2014), who argues that private prisons may be considered too-important-to-fail, as the state is expected to delegate its powers to entities "capable of fulfilling the citizenry desires" but remains responsible for their ongoing operation and for future "redelegat[ions]" as may be required.

[77] *See id.* at 1417. *See generally* Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. Rev. 543 (2000); Barak Medina, *Institutional Limits to Privatization: The Israeli Supreme Court Decision to Invalidate Prison Privatization*, 8 Int'l J. Const. L. 690 (2010); Martha Minow, *Public and Private Partnerships: Accounting for the New Religion*, 116 Harv. L. Rev. 1229 (2003).

[78] *See* Mark J. Roe & Frederick Tung, Bankruptcy and Corporate Reorganization: Legal and Financial Materials 92–93 (4th ed. 2016).

[79] *See* Anthony J. Casey & Eric A. Posner, *A Framework for Bailout Regulation*, 91 Notre Dame L. Rev. 479, 522 (2015) (evaluating options that financial institutions can take when a solvent bank faces a liquidity crisis).

[80] *See id.* (noting in the financial institution context that solvent banks selling assets at fire-sale prices can face high costs, including potentially sending a solvent bank into insolvency due to low return on the asset sales).

[81] *See* Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 Cornell L. Rev. 1399, 1434–35, 1444–45 (2012).

ness.[82] If a SINFI runs out of cash, it cannot pay its suppliers or its employees and thus its continued operation is in jeopardy.[83]

Because consumers depend upon the SINFI for maintaining social order, a significant part of the loss during an operating failure due to liquidity distress would be absorbed by retail consumers and by society as a whole.[84] For example, when a major hospital is suffering liquidity distress, its current and potential patients bear the loss along with its shareholders and financial creditors, and arguably, bear a larger portion of the loss because of what these patients might have at stake. Likewise, if a public utility is facing an operating failure due to liquidity distress, its current and potential consumers bear the loss along with its investors. In these contexts, while investors' losses are only monetary, consumers' losses have implications for their health and their normal course of life. In these cases, government rescue funding becomes an interim measure providing temporary liquidity insurance for the SINFI to run its business.

Liquidity distress, by its very nature, requires immediate attention—even the solvent firm may be in urgent need of cash at a particular point in time.[85] In the SINFI context, time is of the essence, and the bankruptcy procedure is too lengthy and prolonged to ensure sustainability of the socially significant firm in order to prevent a crisis of confidence.[86] The operating failure of a SINFI may bring about a corporate-made, social disaster. Such a liquidity crisis may be seen as overwhelming the capacities of state and local governments, and thus merit public intervention.[87]

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[82] *See* Roe & Tung, *supra* note 78, at 93 (noting that some solvent firms, even in bankruptcy, "are economically worth continuing . . . and should be saved from closing up because their operations are viable" because "[t]hey can still make enough money to cover their operating costs and maybe more").

[83] *Cf. id.* at 92 (suggesting that firms in economic failure will close up, but only those firms in economic failure with debtors may need to go through the bankruptcy process before closing up).

[84] Often the retail consumers of the too-important-to-fail firm are the general public of taxpayers. *See* discussion *supra* Part I.A. (using the example of the PG&E bankruptcy to illustrate this point).

[85] *See* Casey & Posner, *supra* note 79, at 522 (noting in the financial institution context that solvent firms can face illiquidity crises).

[86] *See* Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?*, 82 Temp. L. Rev. 449, 449–50 (2009) (making a similar argument using too-big-to-fail financial institutions).

[87] *Cf.* Stephan D. Sugarman, *Roles of Government in Compensating Disaster Victims*, in Disaster Law 511 (Daniel A. Farber & Michael G. Faure, eds., 2010) (evaluating the government's critical role in helping victims in the face of overwhelming circumstances during a natural disaster); Daniel A. Farber, *Adapting to Climate Change: Who Should Pay?*, 23 J. Land Use & Envtl. L. 1, 19–30 (2007) (providing an analysis of applicable norms and principles for providing compensation in the climate change context and possible roles that the government can play in helping to pay for the costs of adaptations to combat climate change).

B. Positive Externalities

Bankruptcy offers a road to redemption. Clearly, new investors would be reluctant to subsidize the old claim holders of a distressed firm.[88] Debtor-in-possession (DIP) financing allows firms to issue senior secured claims that take priority over other creditors, thereby mitigating the incentive to underinvest.[89] Bankruptcy also generally renders ineffective the common negative pledge clauses that limit or prevent the incurrence of new, senior secured debt.[90] In addition, bankruptcy allows a potential acquirer to purchase the firm or the firm's assets free and clear of any claims,[91] neutralizing the risk of the buyer being held responsible for some of the accumulated liabilities of the distressed firm. Potential investors may bring fresh funds into the distressed firm and thereby offer it a new era of business.

Yet, for the SINFI, this road to redemption is less promising. To see why, consider the positive externalities imposed by socially important institutions: A positive externality is the positive effect or benefit imposed by a corporation on an unrelated third party.[92] Because SINFIs are the exclusive suppliers of products and services that are critical to social stability, they inherently impose positive externalities. In their daily operations, SINFIs benefit more than merely their own investors and managers—they provide the public with an essential service or function. Consider the examples discussed in Part I: a hospital benefits the community as a whole, including those residents who do not need its services at any one particular moment; a public utility benefits the community and provides the public with the electricity required for a civilized life; a provider of public transportation lowers the cost of production for other corporations by granting the public an optional way to commute, thereby making education and work more accessible, with the added value of national connectivity.[93] Everyone benefits from

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[88] *See* David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 687–89 (2012) (citing Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 154 (1977) for the explanation of the debt overhang problem that firms face when new creditors might refuse to lend to a firm for fear that the "new loan may be soaked up by existing obligations and thus simply subsidize other creditors").

[89] *See* George G. Triantis, *A Theory for the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 919–28 (1993) (noting that the bankruptcy priority given to DIP financiers helps alleviate some of the debt overhang and underinvestment problems faced by distressed firms in bankruptcy).

[90] *See* 11 U.S.C. § 541(c)(1)(B) (2012); Kelly v. Cent. Hanover Bank & Trust Co., 11 F. Supp. 497 (S.D.N.Y. 1935), *rev'd on other grounds* 85 F.25 61 (2d Cir. 1936).

[91] *See* 11 U.S.C. § 363(f) (2012); *see also* Douglas G. Baird, *The New Face of Chapter 11,* 12 AM. BANKR. INST. L. REV. 69, 97 (2004) (discussing proceeds from the sale distributed to creditors through the reorganization plan); Kenneth Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 528, 530, 538 (2009) (discussing empirical evidence suggests that most bankruptcies today involve a sale of the firm, rather than a traditional negotiated reorganization).

[92] *See Positive Externality*, BUSINESSDICTIONARY, http://www.businessdictionary.com/definition/positive-externality.html (last visited Oct. 1, 2016).

[93] *See* Margaret M. Blair, *The Economics of Post September 11 Financial Aid to Airlines*, 36 IND. L. REV. 367, 374, 377–78 (2002) (analyzing additional positive externalities of air-

the running operations of SINFIs. The value of the socially important institution far exceeds its value to its immediate financial stakeholders. A SINFI's consumer may pay the marginal cost of the service provided, but they are in fact always getting a far greater benefit from the SINFI's services. The hospital bill for the cost of fixing an injured leg is less than the benefit of being able to walk; the cost of electricity is below the value of civilized life; the cost of an airline ticket is below the benefit of social, national and international connectivity. By definition, SINFIs make our life better by running—their operating default would be to the public's disadvantage.

These positive externalities are nice to have in the normal course of business, but in the case of bankruptcy, they reduce the likelihood of redemption. This is because even with the features of DIP financing and a sale free and clear of all liabilities, a private investor is not likely to capture the full value from investment in the distressed SINFI. The marginal benefit expected from the investment in the socially important institution is less than the marginal social benefit that the institution creates. If the investor takes into account only her own private financial benefit from investing in a SINFI under distress, as investors typically do, the market is expected to cut the investment sum at a suboptimal equilibrium, with a lower investment commitment than is socially beneficial and desirable.

A financially distressed SINFI may require public rescue funding similar to a public good that is subject to the collective action problems of communication and coordination among all beneficiaries.[94] Notably, the decision that investors face when deciding to provide funding for the SINFI changes considerably before and after failure has occurred. Private investment in a SINFI before failure occurs is likely to be easier to obtain, due to investors' implied assumption of a taxpayer rescue upon failure.[95] An ex ante potential

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lines, rooted in the "hub system" whereby any particular airline enhances value for other airlines, merely by connecting in one single destination). Blair describes a "hub-and-spoke" system under which airlines extract value from connecting to other airlines' flights and thereby offer additional destinations. This analysis is applicable to other "too-important-to-fail" institutions. For example, electricity providers may extract value from competing providers as well as from other situational monopolies located in proximity to the provider's location and offering potential backup facilities. *See id.* at 377–78.

[94] *See generally* Roe & Skeel, *supra* note 43 (analyzing of the federal government's critical role in subsidizing the Chrysler bankruptcy and the task of coordinating with the various creditors and stakeholders in the bankruptcy process); *see also* discussion *supra* Part I.A.2 (discussing how the state of California had to take intervention measures in the wake of the PG&E energy crisis because it was acting on behalf of California residents who were reliant on PG&E as a power supplier and facing the possibility of statewide blackouts).

[95] *See* Gil Lan, *Insights from China for the United States: Shadow Banking, Economic Development, and Financial Systems*, 12 Berkeley Bus. L.J. 144, 190 (2015) ("Reliance on government bailouts promotes moral hazard and encourages investors to make suboptimal investment decisions based, not on the merits of the industry or business, but rather on the comfort that the government will ultimately rescue what would otherwise be an unwise investment."); *cf.* Kathleen C. Engel & Patricia A. McCoy, The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps 238 (2011) (discussing how the mutual fund Dodge & Cox presented an example of this type of moral hazard in the financial institution context when they held onto stock in Fannie Mae, AIG, and Wachovia based on the assump-

investor assumes that taxpayers will bail out the socially important firm in case of failure and thus becomes more willing to invest, because her risk is assumed to be insured.[96] But after failure has occurred, investors are less likely to be willing to act as a DIP lender or to purchase assets of the SINFI because at that moment in time the willingness of the government to insure the investment is put to a real test. Once failure has occurred for a SINFI, private investors can either invest with no implied insurance, because, by definition, their investment signals that there is no governmental insurance in place, or, alternatively, negotiate with the government for an explicitly insured investment plan.

The government may need to step in and finance the too-important-to-fail firm under distress to ensure that it sustains its service to the public and maintains the accompanying positive externalities. Rescue may be required but not necessarily beyond the scope of bankruptcy. The Treasury may participate in funding the too-important-to-fail institution through ad hoc bailouts or by acting as a debtor-in-possession, as it has done in other cases.[97] Assessment of the optimal process of financial intervention in corporate failure is a separate subject of debate.[98]

III: Structural Degradation of the Socially Important Non-Financial Institution

This Part of the Article provides a structural analysis of the socially important non-financial institution. It shows that socially important institutions enhance market degradation and are prone to unwarranted expansion. Corporate governance of the SINFI is also distorted. The too-important-to-fail status of the SINFI enhances incentives for excessive leverage and risk-taking and creates elevated agency costs and incentives for empire building.

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tion that if these firms became insolvent then the federal government would "bailout shareholders to avoid damage to the financial system and thus protect Dodge & Cox investors").

[96] *Cf.* Engel & McCoy, *supra* note 95, at 238 (discussing how the mutual fund company Dodge & Cox made strategic investment decisions based on the government's perceived willingness to bailout the financial institutions they had invested in).

[97] *See* Roe & Skeel, *supra* note 43, at 728, 767 (analyzing of the federal government's critical role in subsidizing the Chrysler bankruptcy in order to avoid the potentially devastating consequences to the American economy if the auto industry failed).

[98] *See* Vern McKinley & Gary Gegenheimer, *Bright Lines and Bailouts: To Bail or Not To Bail, That Is the Question*, 637 Pol'y Analysis 1, 18–19 (2009) (offering a historical survey of bailouts of financial institutions). Most reviewers, as well as policymakers, seem to stick with bailouts for systemic risks. *But see, e.g.*, Ayotte & Skeel, Jr., *supra* note 14, at 498 (suggesting that bankruptcy may be "surprisingly effective" and sometimes preferable to bailouts); Morrison, *supra* note 86, at 450 (suggesting that "a systemic risk regulator is needed because a judicially administered process cannot move with sufficient speed and expertise in response to rapidly changing economic conditions").

A. Unwarranted Expansion

Per its definition, SINFIs are situational monopolies providing essential products or services.[99] SINFIs manifest the classic costs of a monopoly—because the situational monopoly is the only relevant provider of essentials in the consumers' circumstances, the SINFI is likely to raise its selling price above its own full costs, so that the cost to consumers increases and the socially-important monopolist gets richer. Moreover, because the special status of a situational monopoly in an essential market is valuable, the SINFI is likely to defend itself from possible attackers such as potential competitors, regulators and lawmakers, and technological changes that would disrupt its special status in both market essentiality and position within the essential market.[100] The socially important firm's investment in protection of that special status is a damage to the economy "as egregious as the lost production of the monopoly triangle."[101] Consumers shop for essentials according to their exogenous needs, and not by the virtues of the market. When a monopolist provides a non-essential service, consumers can turn to other options. But when a monopolist provides an essential need, its market power is boundless.

SINFIs are too important to fail and thus enjoy an implicit public subsidy upon failure. Because of SINFIs' effect on social stability and their positive externalities, governments are more likely to intervene in the event of their failure and supply them with a de facto liquidity insurance similar to the subsidy supplied to the too-big-to-fail financial institutions.[102] This subsidy lowers the effective price of capital for the socially important firm. Because potential crediors take into account the potential for rescue upon failure,[103] they are willing to provide more credit with lower interest to reflect the lower risk of default. Like banks, SINFIs enjoy the "safety net by being able to borrow more cheaply and with fewer restrictions and covenants."[104]

Easy access to capital may be directed "toward innovative ways to obtain, expand, and use the subsidy" rather than "to better service the economy."[105] Unwarranted expansion of the SINFI may shift its business toward the segment that secures the firm its subsidy and situational monopoly status, thus maximizing the firm's private benefits rather than the interests of

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[99] *See supra* Part I.

[100] *See* Roe, *supra* note 2, at 1440.

[101] *Id.*

[102] *See supra* Part II.

[103] *Cf.* ENGEL & MCCOY, *supra* note 95, at 238 (discussing how the mutual fund company Dodge & Cox made strategic investment decisions based on the government's perceived willingness to bailout the financial institutions they had invested in).

[104] Admati et al., *supra* note 17, at 2.

[105] Roe, *supra* note 2, at 1447.

the economy. This implicit subsidy "encourage[s] . . . excessive growth and recklessness."[106]

B. Corporate Governance Distortions

1. Excessive Leverage and Risk Taking

The funding cost advantage enjoyed by SIFIs is both well-known and well-documented—financial literature offers a bounty of works measuring and quantifying the too-big-to-fail subsidy.[107] But for the SINFI, no empirical data have been systematically collected and published. Yet, it is a plausible hypothesis that counterparties to the SINFIs would be more willing to do business with them than with independent firms which do not enjoy the special status granted by the implicit governmental backup. This preference is likely to be reflected in better contracting terms and greater business volume,[108] and is particularly applicable to debt, which is implicitly insured for the socially important institution.[109]

The implicit subsidy of SINFIs and their lower cost of borrowing may lead to excessive leverage accompanied by several agency costs. First, the agency cost between creditors on the one hand and taxpayers on the other may lead to excessive lending by the SINFI, which may surpass the efficient sum and is based on the implicit assumption of rescue upon failure. Second, the agency cost between shareholders on the one hand and creditors and taxpayers on the other hand may lead to excessive risk taking. Because distributions to shareholders are residual, shareholders have an incentive to increase risk-taking by the too-important-to-fail firm and thereby increase their

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[106] Anat R. Admati, *The Compelling Case for Stronger and More Effective Leverage Regulation in Banking*, 43 J. LEGAL STUD. 35, 43 (2014).

[107] *See, e.g.*, Michel Araten & Christopher M. Turner, *Understanding the Funding Cost Differences between Global Systemically Important Banks (G-SIBs) and Non-G-SIBs in the United States*, 6 J. RISK MGMT. FIN. INSTITUTIONS 387 (2013); Bryan Kelly, Hanno Lustig & Stijn Van Nieuwerburgh, *Too-Systemic-to-Fail: What Option Markets Imply About Sector-wide Government Guarantees*, 106 AM. ECON. REV. 1278 (2016), https://www.aeaweb.org/articles?id=10.1257/aer.20120389; Viral V. Acharya, Deniz Anginer & A. Joseph Warburton, The End of Market Discipline? Investor Expectations of Implicit Government Guarantees (May 1, 2016) (unpublished article), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1961656; Zan Li, Shisheng Qu & Jing Zhang, *Quantifying the Value of Implicit Government Guarantees for Large Financial Institutions*, MOODY'S ANALYTICS (Jan. 14, 2011), http://www.moodysanalytics.com/~/media/Insight/Quantitative-Research/Credit-Valuation/2011/2011-14-01-Quantifying-the-Value-of-Implicit-Government-Guarantees-for-Large-Financial-Institutions-20110114.pdf; *see also* Roe, *supra* note 2, at 1461–63 (providing data on "Too-Big-to-Fail Capital Cost Saving Changes During the Financial Crisis, Recalibrated as a Portion of Profits" and "Measured Levels of too-big-to-fail funding cost saving recalibrated as a portion of profits").

[108] *Cf.* Roe, *supra* note 2, at 1438 (analyzing the too-big-to-fail subsidy's effects in the financial institution context).

[109] As creditors anticipate the potential bailout, they are likely to be willing to reflect it in the terms of the debt. *See* Admati & Hellwig, *supra* note 2, at 136 (stating this proposition in the banking context).

potential for profits. When the risk materializes, it is creditors or taxpayers who pay, while shareholders are protected by limited liability. The implied subsidy of government liquidity insurance distorts incentives because managers and investors of the socially important institution no longer bear the full cost of their actions.[110] For managers and shareholders, it is a win-win gamble, where the burden of loss is always carried by other people's money.[111] If the SINFI appears poised to fail, it is taxpayers that are likely to foot the bill. The appetite for risk is even more exacerbated when managers of the SINFI are compensated with options for equity—if the exercise price is set at market level, a SINFI's managers have strong incentives to increase risk as they will gain from the upside but will also be insulated from the downside.[112]

2. *Empire Building*

Empire building is the tendency of management to prefer excessive control over resources and to use free cash flow for extending the breadth of organizational activity at the shareholders' expense.[113] From the manager's perspective, more projects, employees, and activities mean a larger empire to control—these would maximize her job security, promotion and prestige, and may grant her further credit and more opportunities in her future career.[114] For the shareholders, on the other hand, cash or in-kind distributions may be preferable.[115] Because shareholders' interests are residual, the interests of taxpayers are (to a good approximation) aligned with those of share-

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[110] Louis Kaplow, *Incentives and Government Relief for Risk,* 4 J. RISK & UNCERTAINTY 167, 172 (1991).

[111] In the banking context the use of equity leads to lower ex ante bank liquidity, whereas greater use of debt leads to a higher probability of inefficient bank liquidation. The bank's privately-optimal capital structure trades off these two costs. With uncertainty about aggregate risk, bank creditors learn from other banks' liquidation decisions. Such inference can lead to contagious liquidations, some of which are inefficient; this is a negative externality that is ignored in privately optimal bank capital structures. *See* Viral V. Acharya & Anjan Thakor, *The Dark Side of Liquidity Creation: Leverage and Systemic Risk* (Eur. Corp. Governance Inst., Paper No. 445, 2015), http://ssrn.com/abstract=2539334.

[112] *See* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 252, 262–63 (2010).

[113] Michael Jensen, *Agency Costs of Free Cash Flow*, *Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986).

[114] *See* George W. Dent, Jr., *Unprofitable Mergers: Toward A Market-Based Legal Response*, 80 NW. U. L. REV. 777, 781 (1986) ("Corporate managers may seek growth of firm size rather than maximization of share price in order to justify better compensation and perquisites, to increase prestige, to expand opportunities for promotion, and, perhaps most importantly, to protect themselves from the discipline of the market." (internal citations omitted)); Miriam P. Hechler, *Towards a More Balanced Treatment of Bidder and Target Shareholders*, 1997 COLUM. BUS. L. REV. 319, 360 (1997) (explaining that under the empire building hypothesis, "corporate managers seek . . . to increase the size of the corporation and to enjoy corresponding increases in prestige and compensation[,]" and "[a] desire[ ] to improve status[.]" (internal citations omitted)).

[115] *See generally* Lucian Arye Bebchuk, *The Case for Increasing Shareholders Power*, 118 HARV. L. REV. 833 (2005).

holders for empire building at the socially important institution.[116] Taxpayers will bear the losses of empire building when rescue is required.[117]

SINFIs enhance management's incentives for empire building even further than the typical public corporation. This is because in the SINFI context there are fewer constraints on agency costs[118] and the corporate cake is initially bigger. We have seen that due to its status, the market pushes the SINFI towards an unwarranted expansion of its activities.[119] Capital market constraints on the agency costs of the socially important firm are weaker too. Debt, shareholders' demand for distributions, and the potential for takeovers and spinoffs are all weaker in mitigating empire building at SINFIs.[120]

Debt is widely considered in financial literature as a means to mitigate incentives for empire building.[121] This is because management would be obliged to make periodic payments to return the loan.[122] Due to the uncertainty with regard to the scope of expected free cash flow, debt cannot efficiently solve the problem of empire building as an agency cost.[123] For too-important-to-fail SINFIs in particular, debt is not efficient at mitigating incentives for empire building because managers are aware of the implied li-

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[116] This claim requires a disclaimer. Because shareholders are only entitled to distributions when there are residual profits, and dividend distributions are subject to the solvency test, at any particular point of time, the interests of shareholders are aligned with those of taxpayers: In theory, shareholders should not get any distributions from an illiquid firm. Yet as a matter of practice, corporations filing for bankruptcy often have a history of extensive dividend distributions (see for example PG&E). For too-important-to-fail firms, taxpayers are the ultimate residual claimants, not shareholders.

[117] *See* Sang Yop Kang, *Re-Envisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Often Embrace*, 16 U. PA. J. BUS. L. 843, 880 (2014) (explaining that one concept of empire building is the principle of the firm becoming too-big-to-fail and thus potentially requiring a taxpayer-funded bailout if the firm's failure occurs).

[118] *Cf.* Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organizatio*n, 149 U. PA. L. REV. 2063, 2079–80 (2001) (generally discussing agency costs in non-SINFI monopolies).

[119] *See supra* Part III.A.2.

[120] *See* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 55 (1986) (explaining the deterrent effect that takeovers had against empire building in the oil industry).

[121] *See* Jensen, *supra* note 113, at 324, 328–29; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure*, 3 J. FIN. ECON. 305 (1976); *see also* Oliver Hart & John Moore, *Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management*, 85 AM. ECON. REV. 567, 568 (1995) (analyzing use of debt as tool to provide managerial incentives against unprofitable empire-building investments); Martin F. Hellwig, *A Reconsideration of the Jensen-Meckling Model of Outside Finance*, 18 J. FIN. INTERMEDIATION 495 (2009).

[122] *See* Hart & Moore, *supra* note 121, at 658.

[123] Consider the example given by Bebchuk, *supra* note 115, at 905. Because corporations cannot foresee in advance exactly how much cash flow they will have available, debt cannot completely amend the problem of free cash flow. Any amount of debt would either create excessive burden (and be larger than the actual cash flow) or create excessive cash flow (when actual cash flow exceeds the expected one). Uncertainty makes debt either under-inclusive or over-inclusive for free cash flow and empire building as an agency cost. *Id.*

quidity insurance and this knowledge thus creates a moral hazard.[124] Empire building is always worthwhile when taxpayers foot the bill for potential downside, whereas upside grants the manager a larger kingdom to rule.

Granting shareholders the direct discretion to contract the firm's business and announce cash and in-kind distributions has been suggested as a means to overcome the empire-building agency cost.[125] However, SINFIs are often non-profits, lacking a class of shareholders to whom they are accountable. Funding non-profits grants the donors neither control over the organization nor a right to collect distributions as rent. Non-profit boards are thus generally self-perpetuating.[126] Managers of non-profits face no external pressure to make distributions and reserve sufficient funds for residual profits, so their incentives for empire building are not tamed.[127]

Consider for example the manager of a SINFI major hospital. The manager sees empire building—through staffing more jobs, building additional facilities and purchasing additional medical equipment—as a legitimate part of her job. Making the hospital bigger and better, and providing more services for patients is likely to be a higher priority for the manager, compared with the financial stability of the institution.[128] But if the socially important hospital faces liquidity distress, it is likely to be rescued—it is too important to fail.

Finally, capital markets offer takeovers and spinoffs as potential corporate governance pressures that may tame the incentives for empire building.[129] Takeovers are "both evidence to the conflicts of interests between managers and shareholders, and a solution to the problem" of agency costs, because mergers and acquisitions are one strategy managers may adopt to avoid distributions and base their empire.[130] Value-creating takeovers are expected to occur in response to breakdowns in internal control processes—takeovers and breakdowns mitigate empire building through the threat of the market for corporate control.[131] But, for the SINFI, takeovers are not likely to function as a corporate governance pressure that may deter agency costs.

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[124] *See* Kang, *supra* note 117, at 880 (explaining that firms might engage in empire building precisely because this could give them too-big-to-fail status and thus gain effective a government-provided safety net for its survival based on its empire building tactics).

[125] Bebchuk, *supra* note 115, at 905.

[126] EDWARD L. GLAESER, *Introduction*, *in* THE GOVERNANCE OF NON-PROFIT ORGANIZATIONS (Edward L. Glaeser ed., 2003).

[127] *See* HELMUT K. ANHEIER, NONPROFIT ORGANIZATIONS: THEORY, MANAGEMENT, POLICY 304 (2014); Marc Jegers, *Corporate Governance in Nonprofit Organizations*, 20 NONPROFIT MGMT. AND LEADERSHIP 143 (2009).

[128] *See* Burcay Erus & Burton A. Weisbrod, *Objective Functions and Compensation Structures in Nonprofit and For-Profit Organizations: Evidence from the "Mixed" Hospital Industry*, *in* THE GOVERNANCE OF NON-PROFIT ORGANIZATIONS 140 (Edward L. Glaeser ed., 2003) (analyzing compensation structures as indicators of organizational forms, hypothesizing that responses to fiscal stringency differed across organizational forms, and finding that nonprofit hospitals use weaker incentive mechanisms compared to for-profit hospitals).

[129] *See* Jensen, *supra* note 113, at 324.

[130] *Id.* at 328.

[131] *Id.*

First, many SINFIs are not public corporations, and their shares may not be publicly traded. Second, even for those SINFIs that have publicly traded securities, breakups and takeovers that may cause the firm to lose the implied subsidy are likely to be repressed by the market, enlarging even further the profits of the SINFI.[132]

Excessive leverage, the tendency for risk-taking, and elevated incentives for empire building are negative externalities imposed by the SINFI. It is significant to see whether these negative externalities are not offsetting the positive externality imposed by the socially important institution's operating function, discussed above.[133] While this theoretical challenge may need to be examined on a case-by-case basis, the likelihood that the negative externalities would offset the positive externality is meager because without sustaining the positive externality through the uninterrupted operating functionality of the SINFI, it would not be granted the initial implied governmental subsidy. Thus, while the negative externalities might be significant, socially important institutions are expected to preserve their positive externalities as a high priority, as part of their defense of the subsidy. Even when risk is excessive, it is likely to be channeled either towards other financial directions, or monitored to sustain the operating functionality of the socially important institution.

Conclusion

This Article offers an initial framework for the identification of socially important non-financial institutions, and explains their limitations in bankruptcy. SINFIs are less likely to resolve liquidity distress through the bankruptcy process without public funding, because their illiquidity may impose an immediate threat to social stability, even when they are solvent, and because positive externalities reduce the incentives of a private investor to solve their liquidity distress through debtor-in-possession or sale of assets within the bankruptcy process. Socially important institutions are thus too important to fail.

This Article further analyzes the corporate governance and structural characteristics of socially important firms. Because of their market positioning, SINFIs are structurally prone to lean towards unwarranted expansion. Their unique characteristics make socially important institutions particularly vulnerable to corporate governance distortions and a moral hazard, causing excessive leverage and risk taking and enhancing the incentives to empire building.

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[132] *Cf.* Roe, *supra* note 2, at 1421 (analyzing the too-big-to-fail subsidy of banks and arguing that it operates as a shadow poison pill, deterring unwanted takeovers and serving as a governance defense).

[133] *See supra* Part II.B.

Rather than ad hoc rescue upon a liquidity crisis, the framework suggested in this Article provides policymakers with a toolset to track socially important non-financial institutions well before failure occurs. SINFIs are the most important institutions in our lives, the institutions we rely upon for provision of essential needs, and depend upon for social stability. Yet, they are completely under the radar of current corporate law and corporate governance scholarship. There are many open questions to be addressed in future works, including their social accountability, financial stability, and regulatory design, along with an empirical assessment of their actual financial structures.