

RETHINKING CORPORATE LAW DURING A FINANCIAL CRISIS

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Since the Financial Crisis of 2008, most reform measures and discussions have asked how the law of financial regulation could be improved to prevent or mitigate future crises. These discussions give short shrift to the role played by corporate law during the Financial Crisis of 2008 and other financial crises. One critical regulatory tool during the crisis was “regulation by deal,” in which healthy financial firms (“acquirers”) would hastily acquire failing firms (“targets”) to mitigate the crisis. The deals were governed by corporate law, so corporate law played an outsize role in the response to the crisis. But few observers have asked how corporate law—in addition to financial regulation—should govern dealmaking in financial crises. To fill in this gap, this Article focuses on the role played by corporate law during the Financial Crisis of 2008, and asks whether corporate law should be different during a financial crisis than in ordinary times. Using an externality framework—the failure of a systemically important firm can harm the entire economy, and not just the shareholders of the failed firm—this Article identifies a key problem with the current corporate law regime as applied in financial crises: the shareholder value maximization principle as applied to failing target companies. This principle, manifested in the form of shareholder voting rights on mergers and board fiduciary duties to shareholders, is inapplicable to systemically important target firms whose failure would have enormous negative externalities on the rest of the economy. This Article contends that corporate law as applied to systemically important, failing target firms during crises should change as follows: (1) replace shareholder merger voting rights with appraisal rights, and (2) alter fiduciary duties so that directors and officers of those failing target firms consider the interests of the broader economy.

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INTRODUCTION

After each financial crisis, commentators, regulators, policymakers, and politicians intensely discuss what went wrong with the *law of financial regulation* and how the *law of financial regulation* can be improved to prevent future crises. But it is surprising to see how these debates overlook what role *corporate law* played during the crisis and how *corporate law* can be improved to help mitigate future financial crises.

After many past financial crises, policy responses have focused on reforming the law of financial regulation, incorporating lessons from each of these crises, to prevent future crises. After the Panic of 1907, the Federal Reserve Act established the Federal Reserve as the lender of last resort to ensure the stability and liquidity of the financial system as well as to conduct monetary policy. After the stock market crash of 1929 and the subsequent banking panic that led to the Great Depression, the Banking Act of 1933 created the Federal Deposit Insurance Corporation (“FDIC”) to curb inherent instability in the banking system by guaranteeing consumer deposits and limiting affiliations between commercial banks and investment banks.

The two main regulatory responses to the recent Financial Crisis of 2008, the Dodd-Frank Act and the Basel III accords, also focus on reforming the law of financial regulation to prevent the next crisis. Among many key provisions, Dodd-Frank created the Financial Stability Oversight Council

(“FSOC”) to oversee systemic risk in the financial system and monitor emerging risks; created the Consumer Financial Protection Bureau responsible for implementing industry compliance with consumer financial laws; introduced more stringent capital, liquidity, and leverage requirements through the Federal Reserve; introduced stricter regulation of over-the-counter derivative instruments; reformed regulations on corporate governance and executive compensation practices; prohibited certain proprietary trading activities by banks; and introduced various regulations affecting the securitization markets. With the exception of the Orderly Liquidation Authority (“OLA”), Dodd-Frank is designed to make the financial system safer *ex ante*.¹ In addition, the Basel III accords—a global regulatory framework that the U.S. Federal Reserve has been gradually implementing since 2011—concern bank capital adequacy, stress testing, and market liquidity risks, which are *ex ante* preventive measures.

All this is to say that the reform measures after each crisis, and especially the crisis of 2008, largely focused on changing the law of financial regulation to prevent another crisis. Paralleling these policy responses, various academics have focused on the law of financial regulation as a way to prevent future crises.²

This Article hopes to approach the topic of financial crises from a previously unexplored angle in the literature by starting from the following two premises.

First, during the Financial Crisis of 2008, not only the law of financial regulation but also many other areas of law played crucial roles. Specifically, corporate law played an important role in shaping the immediate response to the crisis. If corporate law plays such an important role in financial crises, then we must analyze how corporate law helped or hindered regulatory and private responses to financial crises. We also must consider if we need to reform corporate law to help mitigate crises.

Second, focusing on the *prevention* of financial crises alone is not enough. No matter how well designed preventive measures are and how insightful academic proposals are, financial crises are inevitable.³ While *ex*

¹ See John C. Coffee Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 797 (2011); see generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

² See, e.g., VIRAL ACHARYA & MATTHEW RICHARDSON, *RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM* (2009); ROBERT J. SHILLER, *THE SUBPRIME SOLUTION* (2012); Viral Acharya et al., *The Financial Crisis of 2007–2009: Causes and Remedies*, 18 FIN. MARKETS, INST. & INSTRUMENTS 89 (2009); Gary Gorton & Andrew Metrick, *Securitizing Banking and the Run on Repo*, 104 J. FIN. ECON. 425 (2012); Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank’s Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151 (2011); Thomas H. Jackson & David A. Skeel Jr., *Dynamic Resolution of Large Financial Institutions*, 2 HARV. BUS. L. REV. 435 (2012); Steven L. Schwarz, *Systemic Risk*, 97 GEO. L.J. 193 (2009).

³ See Iman Anabtawi & Steven L. Schwarcz, *Regulating Ex Post: How Law Can Address the Inevitability of Financial Failure*, 92 TEX. L. REV. 75, 93–96 (2013).

ante measures that regulate banks' balance sheets and risk metrics can lower the risk of financial institutions' failure, it may be impossible to prevent financial crises altogether.⁴ As various scholars have pointed out, there are irremediable weaknesses to financial regulation that make it imperfect, such as the inherent instability of financial institutions, inevitability of accidents, cognitive limitations on regulators, and the political economy favoring deregulation over time.⁵

It is highly unlikely that Dodd-Frank, or any other ex ante regulatory measures, can eliminate the risk of financial crisis; otherwise, we would have never had any financial crisis, and that has not been the case in our history.⁶ Dodd-Frank is an ambitious act designed to make the financial system safer, and we hope that Dodd-Frank reduces the likelihood of future financial crises. However, because future financial crises are inevitable, policymakers and academics need to focus on *mitigating* crises that have already broken out as much as they focus on preventing them. With the exception of the OLA in Title II (which is not adequate by itself to mitigate crises⁷), Dodd-Frank focuses less on mitigating crises.⁸ We believe this neglect is pernicious. Financial risks must be "regulated both through ex ante and ex post measures."⁹

Combining the above two points, this Article delves into how corporate law can help mitigate a financial crisis once it breaks out. Particularly, the Article focuses on one important regulatory tool used in the Financial Crisis of 2008 called "regulation by deal," by which healthy firms would acquire failing companies.¹⁰ During the crisis, the Federal Reserve and the U.S. Treasury regularly rescued failing financial firms by merging them with healthy firms or even directly taking over failing firms. If healthy firms were reluctant to acquire failing firms, government authorities often provided subsidized financing. For example, JP Morgan's takeover of imploding Bear Stearns was supported by almost \$26.3 billion of financing by the Federal Reserve.¹¹ Other prominent U.S. examples of regulation by deal include the Federal Reserve's takeover of AIG, Bank of America's acquisition of Merrill Lynch,¹² and Citigroup's (ultimately failed) acquisition of Wachovia.¹³ The

⁴ See Kwon-Yong Jin, Note, *How To Eat an Elephant: Corporate Group Structure of Systemically Important Financial Institutions, Orderly Liquidation Authority, and Single Point of Entry Resolution*, 124 YALE L.J. 1746, 1750 (2015).

⁵ See *id.*; Anabtawi & Schwarcz, *supra* note 3, at 93–101.

⁶ See *infra* notes 17–20.

⁷ See *infra* Section IV.A.

⁸ Anabtawi & Schwarcz, *supra* note 3, at 77; see also *supra* note 1.

⁹ See Anthony J. Casey & Eric A. Posner, *A Framework for Bailout Regulation*, 91 NOTRE DAME L. REV. 479, 486 (2015) (citing Anabtawi & Schwarcz, *supra* note 3).

¹⁰ Steven M. Davidoff Solomon & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 470 (2009).

¹¹ See David Goldman, *CNNMoney.com's Bailout Tracker*, CNNMONEY (last visited Jan. 23, 2017), <http://money.cnn.com/news/storysupplement/economy/bailouttracker>.

¹² No agency directly financed the Bank of America Merrill Lynch deal. However, when Bank of America explored using a contractual provision to renege on its agreement to acquire

motivation behind these government-sponsored mergers was that the failure of these firms would impose extraordinary harms—externalities—on the rest of the financial sector and on the economy as a whole.

Regulation by deal was not unique to the Financial Crisis of 2008. A signal event of the financial meltdown that triggered the Great Depression was the failure of the Bank of United States.¹⁴ This failure was preceded by futile attempts by the Federal Reserve, among others, to find a healthy merger partner to rescue the Bank.¹⁵ Similarly, the responses to the Panic of 1907, the Savings & Loans crisis of the 1980s, and the Long-Term Capital Management bankruptcy of 1999 all involved corporate mergers as a tool to mitigate financial crises.¹⁶

If merger deals are an important part of the response to financial crises, then so is corporate law. During the Financial Crisis of 2008, regulators spent a great deal of time and effort trying to bring their rescue efforts in conformity with corporate law. Because corporate law plays such an important role in financial crises, we need to evaluate if corporate law functioned effectively during the Financial Crisis and consider how corporate law should be reformed to better mitigate future financial crises.

This Article analyzes important rescue merger deals during the Financial Crisis of 2008 using an externality framework. Its central thesis is that, because the ordinary assumptions of corporate law become ineffective during a financial crisis, corporate law during a financial crisis for systemically important, failing target firms should be different from corporate law as we know in ordinary times: shareholder rights in these firms should be curtailed during a crisis. Shareholder primacy in corporate law assumes that shareholders are the residual claimants of a corporation. But the failure of a systemically important corporation does not only harm shareholders; failure also has large negative externalities on the rest of the economy. In ordinary times, it makes sense to direct directors' fiduciary duty toward shareholder wealth maximization. After all, shareholders bear the residual risks. However, during a financial crisis, the entire economy bears the residual risks, because the failure of systemically important corporations can impose large negative externalities. And unlike creditors or employees, the economy as a whole cannot negotiate for contractual protections. Corporate law built on

Merrill Lynch, regulators made it very clear to Bank of America that the regulators strongly preferred that Bank of America follow through with the acquisition of Merrill Lynch. The Financial Crisis Inquiry Commission described the completion of the deal as a “shotgun wedding.” FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT 382 (2011).

¹³ See David Enrich & Dan Fitzpatrick, *Wachovia Chooses Wells Fargo, Spurns Citi*, WALL ST. J. (Oct. 4, 2008, 11:59 PM), <http://www.wsj.com/articles/SB122303190029501925>.

¹⁴ See Edward Harrison, *News from 1930: Closing of Bank of United States*, CREDIT WRITEDOWNS (Dec. 13, 2009, 8:56 PM), <http://www.creditwritedowns.com/2009/12/news-from-1930-closing-of-bank-of-united-states.html>.

¹⁵ See Gary Richardson, *Banking Panics of 1930–31*, FED. RES. HIST. (Nov. 22, 2013), <http://www.federalreservehistory.org/Events/DetailView/20>.

¹⁶ See *infra* Part I.

the basic premise of shareholder primacy would fail to make these shareholders internalize this external harm of the failure of their firm.

For example, during the recent crisis, the failure of Bear Stearns would have caused great harm to the economy. When JP Morgan attempted to acquire (and rescue) Bear Stearns, Bear Stearns ran into a big hurdle—shareholders were not pleased with the merger offer price and were poised to vote to reject the deal. Bear Stearns shareholders knew that the failure of Bear Stearns would cause great harm to the economy, which enabled them to drive a harder bargain. Their ability to hold the entire economy as hostage, even implicitly, in an attempt to extract a higher value showcases the inadequacy of shareholder primacy during a financial crisis. The fundamental principle of corporate law—shareholder primacy—simply does not and should not apply in this context when the whole economy is at risk.

As a result, shareholder rights in a systemically important target corporation need to be reduced during a financial crisis, when the corporation's failure could wreak havoc on the economy. Specifically, first, we propose that shareholders' voting rights be suspended for such a target company. In exchange, we protect shareholders' interests with appraisal rights after a deal is completed, where the appraisal rights would value the company at its "long-term value," assuming the company would neither fail nor get a bailout. Second, we propose that, during financial crises, fiduciary duties—duties of care and loyalty—owed by directors and officers to shareholders of failing target firms should be altered so that those directors and officers could consider the interests of the broader economy.

This Article is organized as follows. Part I provides background information on regulation by deal and surveys the literature on regulation by deal, focusing on distinguishing this Article from the previous literature. Part II offers a primer on corporate law during normal times, highlighting how the principles of shareholder primacy make sense during ordinary times. Part III delves into the problem of how corporate law is not optimal in dealing with distressed companies that could impose large negative externalities on the economy. In particular, using the examples of Bear Stearns, Lehman, and AIG, Part III highlights the inadequacy of the shareholder wealth maximization principle during financial crises. And Part III shows how shareholder voting rights and traditional fiduciary duties posed problems for carrying out regulation by deal, caused hold-up problems for shareholders, and enhanced the likelihood that the large negative externalities on the economy would materialize. Based on the analysis in Part III, Part IV details our proposals as to how corporate law should change. Part V addresses some of the major counterarguments to our proposals.

Finally, we would like to stress the relevance of the topic. It is easy to think that the Financial Crisis of 2008 is something of the past, dismiss the risk of a similar crisis, and assume that we are now safe. History teaches that financial crises occur quite regularly, and one may be coming up in a near future. The United States, for example, suffered "panics" in 1819, 1837,

1857, 1873, 1893, 1907, and 1929.¹⁷ The Great Depression was instigated by a financial crisis of 1929 and persisted for over a decade.¹⁸ Although the introduction of deposit insurance and the monetary policy by the Federal Reserve helped avoid a large-scale financial meltdown in the United States from the Great Depression through 2008, we should not exaggerate the success of the post-Depression regulatory regime. The United States experienced a “small” financial meltdown in the Savings and Loan crisis of the 1980s and 1990s.¹⁹ And in the early 2000s, the U.S. economy experienced the burst of the dotcom bubble. Other developed and developing economies and regions suffered from a variety of financial crises before 2008, including Latin America in the 1980s, Japan in 1990, Sweden in the early 1990s, and East Asia in 1997.

In addition to this temporal relevance, financial crises are extraordinarily painful. They affect our jobs, livelihood, families, and other fundamental aspects of our lives. In the United States alone, the Great Recession—triggered by the Financial Crisis of 2008—cost \$6 trillion to \$30 trillion.²⁰ Multi-trillion dollar costs continue to pile up in Europe, Japan, and elsewhere. And the political aftershocks of these financial troubles have unsettled political orders in the United States, Great Britain, and the eurozone. In sum, with stakes so high and with the risk of another crisis not too far away, the discussion of financial crises deserves our attention.

I. BACKGROUND INFORMATION AND LITERATURE REVIEW ON REGULATION BY DEAL

Broadly, there are four types of ex post measures to mitigate financial crises. These are bailout, bankruptcy resolution, OLA of the Dodd-Frank Act, and regulation by deal. These measures are not mutually exclusive. Furthermore, the Bankruptcy Code is not designed to resolve large financial

¹⁷ See G.C. Selden, *The Art of Interpreting Financial Conditions*, 12 MAG. WALL ST. 1, 263–64 (1913); *infra* note 18.

¹⁸ See Jesse Colombo, *The Stock Market Crash of 1929*, BUBBLE BUBBLE (July 17, 2012), <http://www.thebubblebubble.com/1929-crash/>.

¹⁹ U.S. GEN. ACCOUNTING OFFICE, RESOLUTION TRUST CORPORATION’S 1995 AND 1994 FINANCIAL STATEMENTS 7–8 (1996).

²⁰ This is a 2013 estimate from the Dallas Federal Reserve Bank’s Research Department. See Tyler Atkison et al., *How Bad Was It?: The Costs and Consequences of the 2007–09 Financial Crisis*, DALLAS FED. STAFF PAPERS (July 2013), <https://www.dallasfed.org/~media/documents/research/staff/staff1301.pdf>. The worldwide costs are much greater. For example, the euro area’s economy was smaller in real terms in mid-2014 than it was in 2007. Given a trend growth rate of 1.5% (much lower than the euro area’s growth rate from 1996–2005), this means that the euro area’s economy is 11% smaller than its potential. See *Euro Area GDP Growth Rate*, TRADING ECON. (last visited Apr. 4, 2018), <https://tradingeconomics.com/euro-area/gdp-growth>. The euro zone, with a GDP of approximately \$13 trillion in the past ten years, incurred a cost of over \$1.4 trillion in 2014 from the Great Recession, with prospects for even greater shortfalls in output in future years. See *Euro Area GDP*, TRADING ECON. (last visited Apr. 4, 2018), <https://tradingeconomics.com/euro-area/gdp>.

institutions in an orderly manner,²¹ so the realistic options for crisis mitigation are the other three measures.

OLA grants the FDIC the power to wind down complex, large financial institutions in an orderly manner through a special resolution proceeding; pursuant to OLA, in 2012 the FDIC proposed the Single Point of Entry strategy (“SPOE”). This OLA/SPOE strategy is an ambitious project to obviate the need for other ex post approaches; Dodd-Frank made “[SPOE] receiver-ship the only way to assist a large, troubled financial firm.”²²

Yet, as we will discuss more later and as Gordon & Muller, Jin, and others point out,²³ the OLA-SPOE approach is far from perfect, and putting all eggs in one basket is dangerous. Due to the exclusive reliance on the SPOE to mitigate financial crises ex post, Gordon and Muller state that this “Dodd-Frank nuclear option” is “simply too dangerous.”²⁴ Historically, regulation by deal has been the most consistently used response to financial crises and it has often succeeded. Thus, regulation by deal has been and likely will continue to be one of the key policy tools for ex post responses to financial crises, no matter what Dodd-Frank says.²⁵

When it comes to the academic sphere, the mainstream literature on financial crises mainly focuses on ex ante reform measures, such as, for example, financial regulations, and ex post reform measures such as OLA in response to crises. In contrast, the topic of regulation by deal—by which healthy firms acquire failing firms—has received little attention by scholars with a few notable exceptions. Solomon and Zaring offer a descriptive account of governmental responses to the recent Financial Crisis and analyze how legal constraints affected those responses.²⁶ In another article, they argue for restraining the regulation by deal approach by disciplining it through administrative law and corporate law principles.²⁷ Kerr discusses whether the federal government’s regulation by deal approach violated some corporate law principles and doctrines.²⁸ Donaldson similarly highlights how corporate governance law broke down during Bank of America’s purchase of Merrill

²¹ See generally Mark J. Roe & Stephen Adams, *Restructuring Failed Financial Firms in Bankruptcy: Selling Lehman’s Derivatives Portfolio*, 32 YALE J. ON REG. 363 (2015); see also Thomas J. Fitzpatrick IV & James B. Thomson, FED. RESERVE BANK OF CLEVELAND, ECONOMIC COMMENTARY: HOW WELL DOES BANKRUPTCY WORK WHEN LARGE FINANCIAL FIRMS FAIL? SOME LESSONS FROM LEHMAN BROTHERS (2011).

²² Gordon & Muller, *supra* note 2, at 153.

²³ See *infra* Section V.A.

²⁴ Gordon & Muller, *supra* note 2, at 153.

²⁵ See *infra* Section V.A.

²⁶ Solomon & Zaring, *supra* note 10.

²⁷ Steven Davidoff Solomon & David Zaring, *After the Deal: Fannie, Freddie, and the Financial Crisis Aftermath*, 95 B.U. L. REV. 371, 372 (2015).

²⁸ Janet E. Kerr, *The Financial Meltdown of 2008 and the Government’s Intervention: Much Needed Relief or Major Erosion of American Corporate Law? The Continuing Story of Bank of America, Citigroup, and General Motors*, 85 ST. JOHN’S L. REV. 49, 54 (2011).

Lynch.²⁹ Zaring discusses why courts were not involved in the recent regulation by deal and discusses ways Congress can ensure that courts have a more substantive role in future crises to oversee regulation by deal.³⁰

The common theme among these articles is how regulation by deal fits in or violates corporate law's framework. They do not question whether the existing corporate law framework may be inadequate in dealing with financial crises. In fact, this latter topic of questioning and reforming the existing legal framework to *facilitate* regulation by deal has not received much attention except by two articles to this date, which we distinguish our Article from.

Armour and Gordon start from a first principle similar to ours: the norm that managers should maximize shareholder value is misguided for systemically important firms. Unlike us, however, they argue that the key problem is the spillover effects of financial crises on *shareholders* and not those on other economic agents.³¹ Armour and Gordon argue that that most shareholders have diversified portfolios and hold shares of other companies as well. As a result, the interests of those diversified shareholders and the managers of a systemically important firm diverge because the failure of a systemically important firm will hurt the shareholders' interests in the other companies in their portfolio.³² This leads to directors and officers taking more risks than they should, and Armour and Gordon suggest that shareholders should be allowed to sue officers and directors more easily to counter this excessive risk.³³

Although we start from a similar principle as Armour and Gordon did, we think that their focus on spillover effects on *shareholders* is misguided for three reasons. First, the diversified shareholders problem is not unique to financial crises. In many cases, diversified shareholders want their directors to take an action that maximizes portfolio value rather than share value, such as colluding with competitors whose shares those shareholders hold. Reforming corporate law to recognize that diversified shareholders' interests differ from those of managers would be a far-reaching reform indeed.

Second, and more importantly, the divergence of diversified shareholders and managers' interests is not the core problem of corporate law during financial crises. In financial crises, as we discuss in Part III, the problem with the shareholder value maximization principle is not that shareholder interests are not properly promoted (that is, their diversified portfolios are hurt) but rather that shareholder interests are excessively promoted at the

²⁹ James K. Donaldson, *You Can Come Under the TARP, But First . . . The Bank of America-Merrill Lynch Merger Was a Failure of Corporate Governance*, 9 FLA. ST. U. BUS. REV. 21, 22–23 (2010).

³⁰ David Zaring, *Litigating the Financial Crisis*, 100 VA. L. REV. 1405, 1407 (2014).

³¹ John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J.L. ANALYSIS 35, 35 (2014).

³² *See id.*

³³ *See id.*

expense of the economy. Therefore, in contrast to Armour and Gordon's recommendation that the solution to systemic risk is to give shareholders more power, we think shareholder power is part of the problem during a financial crisis and argue for reducing shareholder rights.

Third, Armour and Gordon focus too narrowly and exclusively on harms to participants in the stock market. However, the problem is broader. When a systemically important firm fails, the harm spills over to the entire economy, not just to those participating in the capital markets.

In fact, shareholder behavior in the mergers involving Bear Stearns and AIG contradicted Armour and Gordon's predictions. If their analysis were right, diversified shareholders would have approved those mergers easily, knowing that the rescue would raise the value of their other shares. But that is not what happened. We will explore this more in Section III.B.

Rhee also starts from a starting principle similar to ours, stating that the shareholder primacy norm may need to be conditionally limited during times of public necessities, such as financial crises.³⁴ Rhee focuses on a scenario in which there is an adversarial relationship between public welfare and shareholder welfare, and he questions whether the fiduciary duties that directors and officers owe to their shareholders should be upheld. He argues that there should be "an exemption from the fiduciary principle when a board pursues the public good over the private gain on a temporary basis when the firm is uniquely situated to avert or mitigate a public crisis."³⁵

Although we start from a similar diagnosis of the problem, we differ from Rhee in three important ways. First, Rhee focuses on the change in fiduciary duties of an *acquiring* firm that is in a unique position to mitigate a financial crisis. Instead, we focus on the change in fiduciary duties of a failing *target* firm, which leads to a set of very different implications. As we argue below in Section IV.B, we believe that focusing on the fiduciary duties of the directors and officers of a failing target firm is both more appropriate and more urgent than focusing on those of an acquiring firm. Second, Rhee is asking for an exemption from the fiduciary duties, such as through a federal safe harbor or through two of the less-discussed provisions in Delaware General Corporate Law ("DGCL"), §§ 122(9) and 122(12).³⁶ In contrast, we are looking for a more extensive solution, not seeking an exemption from the previous set of duties but pushing for an affirmative change in fiduciary duties during financial crises. Third, we do not limit our discussion of a change in corporate law to a change in fiduciary duties; we also address broader corporate law issues such as shareholder voting rights.

³⁴ Robert J. Rhee, *Fiduciary Exemption for Public Necessity: Shareholder Profit, Public Good, and the Hobson's Choice During a National Crisis*, 17 *Geo. Mason L. Rev.* 661, 664 (2010).

³⁵ *See id.* at 735.

³⁶ *See id.* at 728–29.

In sum, we think that Armour & Gordon and Rhee are both on the right track but stop well short of the logical solution to the problem of the inapplicability of the shareholder primacy principle during financial crises. If the problem that these important articles address is as important as they describe, then fundamental changes in corporate law are necessary during financial crises.

II. CORPORATE LAW IN ORDINARY TIMES

Regulation by deal operates in the context of corporate law. This Part reviews the basics of corporate law relevant to mergers. Part III will show how these basic principles of corporate law make no sense in the midst of financial crises for certain systemically important corporations.

A. *Shareholder Value Maximization as the Basic Premise of Corporate Law*

According to the well-accepted agency theory of firms, shareholders are principals that provide capital to an enterprise, and managers are agents that use that capital to run the enterprise.³⁷ The logical outgrowth of the agency theory is the shareholder primacy norm, which consists of two principles: (1) “maximizing long-term shareholder value is the only legitimate objective of the corporation,” and (2) “designing ways to assist shareholders in exerting control through their powers . . . will minimize the agency costs that result from the separation of ownership from control in publicly traded and diffusely held corporations.”³⁸

The underlying assumption here is that the protection of other corporate stakeholders—employees, consumers, creditors, depositors, and others—belongs to other realms of law, such as employment contracts, consumer protection law, debt contracts, banking law, and so forth; in contrast, shareholders do not get any such protection from other areas of law.³⁹ The fact that shareholders are the residual claimants of a company gives share-

³⁷ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976); J. W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283, 315 (2010).

³⁸ Verret, *supra* note 37, at 318 (citing Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 850 (2005)).

³⁹ See Franklin A. Gevurtz, *The Role of Corporate Law in Preventing a Financial Crisis: Reflections on In Re Citigroup Inc. Shareholder Derivative Litigation*, 23 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 113, 151–52, 151 n.180 (2010) (citing Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 44 (1991)). *But see* Jonathan R. Macey & Maureen O’Hara, *The Corporate Governance of Banks*, 7 ECON. POL’Y REV. 91, 102 (2003) (advocating a different governance rule for banks that assigns directors fiduciary duties to fixed claimants, including depositors).

holders (and the directors who represent them) incentives to monitor the company to maximize total value.⁴⁰

Based on the shareholder primacy principle, directors' fiduciary duties require them to make decisions that are in the best interests of shareholders.⁴¹ Directors owe their shareholders a duty of care in making business decisions based on all available and material information and in acting in an informed manner to ensure that they promote the interests of their company and shareholders.⁴² Also, directors owe shareholders a duty of loyalty to avoid conduct that puts their own interests above the interests of their company and shareholders.

In addition, the powers to elect directors,⁴³ to ratify charter amendments,⁴⁴ and to amend bylaws (with some limitations)⁴⁵ belong to shareholders. Consistent with this shareholder primacy principle are the views that corporations owe a duty to shareholders, but not to the general public, and that corporate governance is a private activity between shareholders and directors/managers.⁴⁶ Importantly for our purpose, shareholders have the final say in fundamental transactions such as mergers.⁴⁷

B. Acquisition Process

Because regulation by deal typically involves public companies and a one-step merger process, we will sketch a one-step merger process for a public company.⁴⁸ A merger process can start with directors or managers of a target looking for an acquirer through informal contacts, private auctions, or public auctions. Alternatively, directors or managers of an acquiring company can initiate a merger process by making a friendly or hostile offer to a

⁴⁰ In light of principal-agent problems between shareholders and managers, a highly developed literature in corporate law debates how much power shareholders should have relative to managers. This Article assumes that shareholders and managers' interests are perfectly aligned and sidesteps this issue.

⁴¹ See D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 278 (1998); see also *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182 (Del. 1986) (holding that the board has fiduciary duties to act in the shareholders' best interests); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) ("[C]orporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders.>").

⁴² See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); see also *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

⁴³ See DEL. CODE ANN. tit. 8, § 211(b) (West 2016).

⁴⁴ *Id.* § 242(b).

⁴⁵ *Id.* § 109(a).

⁴⁶ See Rhee, *supra* note 34, at 662.

⁴⁷ See DEL. CODE ANN. tit. 8, §§ 251(b)-(c), 271(a) (West 2016).

⁴⁸ There are two methods of acquisitions. First, the acquirer can make a tender offer followed by the acquisition of the rest of the untendered shares through a back-end merger or DGCL § 251(h). This is called a "two-step" merger. Second, the acquirer and the acquirer can directly enter into a merger agreement. This is called a "one-step" merger. Because all the examples of regulation by deal discussed in this Article involved the one-step merger process, we will focus on the one-step merger in this Section, although regulation by deal can theoretically happen through the two-step merger process.

target. In the context of regulation by deal, an initial process often involves government officials—such as the Chairman of the Federal Reserve or the Secretary of the Treasury—connecting board members or top managers of a target and an acquiring company.

When the directors of both companies negotiate merger terms, both duties of care and loyalty to shareholders govern the directors' conduct. Once the target and the acquirer agree on the final terms of the agreement, they sign a merger agreement.

Before the signed merger deal can close, various conditions must be met, depending on the terms of the agreement. Common among them are: (i) the state corporate law requirement that the target obtain shareholder approval of the merger,⁴⁹ (ii) third-party consents and financing requirements specific to each merger, (iii) the federal securities law requirement that merger proxy statements for obtaining shareholder approval be cleared by the Securities and Exchange Commission (“SEC”),⁵⁰ (iv) for non-bank mergers, the federal antitrust requirement under the Hart-Scott-Rodino Act that the Federal Trade Commission (“FTC”) or Department of Justice (“DOJ”) Antitrust Division clear the merger,⁵¹ and (v) for bank mergers, the federal banking law requirement that they should be approved by one of four banking agencies—the Federal Reserve, FDIC, OTS, or Office of the Comptroller of the Currency (“OCC”)—along with the DOJ Antitrust Division.⁵²

The time gap between signing and closing of a deal can range from less than 12 weeks to more than months, depending on regulatory and voting conditions.⁵³ During this time gap between signing and closing, the acquirer faces various risks. In addition to the risks of regulatory rejection and share-

⁴⁹ See DEL. CODE ANN. tit. 8, §§ 251(b)–(c) (West 2016).

⁵⁰ *DealThink: Doing the Two-Step (Or the One-Step): A Look at One-Step and Two-Step Mergers*, HAYNESBOONE (Aug. 17, 2012) [hereinafter HAYNESBOONE], <http://www.haynesboone.com/alerts/dealthink-doing-the-twostep-or-the-onestep—a-look-at-one-step-and-twostep-mergers>.

⁵¹ See 15 U.S.C. §§ 18a(c)(7), 18a(c)(8).

⁵² See Jonathan M. Rich & Thomas G. Scriven, *Bank Consolidation Caused by the Financial Crisis: How Should the Antitrust Division Review “Shotgun Marriages”?*, 8 ANTITRUST-SOURCE 1 n.2 (2008).

⁵³ In the absence of any antitrust regulatory issue or other closing issues, such as, for example, financing delays, or third-party consents, the merger can be completed in 12 weeks or 18 weeks, depending on whether the SEC chooses to review the proxy statements. Preliminary merger proxy statements must be filed with the SEC, and the SEC has 10 days to determine whether it will review the proxy statement or not. See HAYNESBOONE, *supra* note 50. If the SEC takes no action during those 10 days, the target may mail out the proxy statement. If the SEC decides to review the proxy materials, there will typically be an exchange between the SEC and target company regarding the revision of the proxy statement for accuracy, lasting approximately six weeks on average. The shareholder voting meeting cannot be held until 20 business days after the relevant proxy material and prospectus have been mailed. See *A Few Questions About the Bear Stearns Deal*, N.Y. TIMES (Mar. 16, 2008), <http://dealbook.nytimes.com/2008/03/16/a-few-questions-about-the-bear-stearns-deal>. Once shareholder approval is obtained, the merger can be completed within a few days, if other closing conditions are met. However, if any antitrust, regulatory, or other closing issues exist, the merger closing may take more than 12 weeks or 18 weeks.

holders voting down the merger, the target can choose to sell itself to a third party “interloper” who offers a better price to the target shareholders. To protect against these risks, an acquirer would often demand various deal protection devices in a merger agreement, such as breakup fees, a no-shop provision, an absence of fiduciary out, a force-the-vote provision, shareholder voting agreements, a matching right, and so forth.

However, *Omnicare*, a landmark Delaware case, stated that the combination of these provisions cannot be coercive upon shareholders or preclusive of other competing deals;⁵⁴ otherwise, the merger agreement is unenforceable under the *Unocal* standard.⁵⁵ The underlying presumption is that shareholders should have meaningful opportunities to vote down the merger and consider alternative deals, and the merger agreement at issue in *Omnicare* was too “coercive and preclusive” of this opportunity.⁵⁶

III. FLAWS OF THE SHAREHOLDER PRIMACY NORM DURING A CRISIS: NEGATIVE EXTERNALITIES ON THE ECONOMY

This Part shows that one of the basic principles of corporate law, shareholder primacy, needs reconsideration in the context of financial crises. The collapse of a systemically important firm during a crisis can inflict huge negative externalities on the economy.

Based on this externality framework, first, this Part analyzes the rescues of Bear Stearns and AIG. These case studies show that target shareholders’ voting rights create uncertainty and high risks to the acquirers as well as the economy. Second, using the externality framework, this Part also analyzes the Lehman Brothers’ non-rescue. This case study shows that the current version of directors’ fiduciary duties to shareholders causes the same types of problems that shareholders’ voting rights create. These two sets of analysis lead to the conclusion that the shareholder primacy norm is fundamentally untenable in a crisis context.

A. Large Negative Externalities with a Collapse of a Systemically Important Firm During a Crisis

The shareholder primacy premise needs reconsideration in the context of financial crises. Takeovers in the context of financial crises differ from how ordinary corporate law conceptualizes them. During financial crises, the failure of certain systemically important corporations entails considerable externalities. For instance, when Lehman filed for bankruptcy on September

⁵⁴ See *Omnicare v. NCS Healthcare*, 818 A.2d 914, 918 (Del. 2003).

⁵⁵ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954–56 (Del. 1985).

⁵⁶ This “coercive” and “preclusive” standard was pronounced in *Unitrin*, which clarified the second prong of the *Unocal* standard. *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387–88 (Del. 1995).

15, 2008, the S&P 500 decreased by about 5%.⁵⁷ That is not the entire picture, as the S&P 500 had previously slid many times leading up to that date, including on September 10 when the S&P dropped 7% due to Lehman announcing a loss of \$3.9 billion and the possibility of a sale of the entire company.⁵⁸ Furthermore, the day after Lehman fell, the Reserve Primary Fund that held Lehman debt “broke the buck,” which was “only the second time in history that a money-market fund’s share value had fallen below a dollar.”⁵⁹ In addition, Lehman’s fall heavily affected the credit-default swap market, because a substantial amount of credit-default swap protection was written against Lehman’s debt.⁶⁰

As another example, then-Federal Reserve Chairman Ben Bernanke described a potential Bear Stearns bankruptcy as an event that would have inflicted unpredictable, widespread, and severe damages on Bear Stearns’ counterparties, on the financial market and then on the broader economy.⁶¹ Although Bear Stearns did not collapse and counterfactuals are unknowable, there is strong evidence suggesting that its fall would have inflicted some significant harm on the economy: Bear Stearns constituted 21% of the prime brokerage industry, and thus hedge funds would have been left with no col-

⁵⁷ See Google Finance, S&P 500 (SPX) (last visited Nov. 14, 2016), <https://finance.google.com/finance?q=NASDAQ:SPX>.

⁵⁸ See Joe Bel Bruno, *Lehman Shares Slip on Plans to Auction off Unit, Consider Sale of Company*, SEATTLE TIMES (Sept. 10, 2008), <http://www.seattletimes.com/business/lehman-shares-slip-on-plans-to-auction-off-unit-consider-sale-of-company/>.

⁵⁹ See Anabtawi & Schwarcz, *supra* note 3, at 107 (citing Diana B. Henriques, *Money Market Fund Says Customers Could Lose Money*, N.Y. TIMES (Sept. 16, 2008), <http://www.nytimes.com/2008/09/17/business/17fund.html>).

⁶⁰ *Id.* (citing See Mary Williams Walsh, *Insurance on Lehman Debt Is the Industry’s Next Test*, N.Y. TIMES (Oct. 10, 2008), <http://www.nytimes.com/2008/10/11/business/11credit.html> (discussing the post-bankruptcy implications of the “huge value of credit-default swaps on Lehman Brothers”). *But see id.* (“On the other hand, the systemic importance of Lehman’s failure should not be overstated. Lehman’s bankruptcy occurred during a time when there were good reasons for market participants to question the solvency of a number of large financial firms, not because of their exposure to Lehman, but because they were exposed to the MBS market.”).

⁶¹ Solomon & Zaring, *supra* note 10, at 478–79 (paraphrasing Hearing Before the S. Joint Economic Comm., 110th Cong. (2008) (statement of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System), <https://www.federalreserve.gov/newsevents/testimony/bernanke20080402a.htm> (“Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets. With financial conditions fragile, the sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company’s failure could also have cast doubt on the financial positions of some of Bear Stearns’ thousands of counterparties and perhaps of companies with similar businesses. Given the current exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain. Moreover, the adverse effects would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability. To prevent a disorderly failure of Bear Stearns and the unpredictable but likely severe consequences of such a failure for market functioning and the broader economy, the Federal Reserve, in close consultation with the Treasury Department, agreed to provide funding to Bear Stearns through JPMorgan Chase.”)).

lateral and assets upon the collapse of Bear Stearns.⁶² Similarly, Secretary of the Treasury Hank Paulson noted that avoiding the bankruptcy of Merrill Lynch, which was bigger than Lehman, “surely prevented destabilization of our financial system.”⁶³

As a general matter, systemically important firms—like Lehman, Merrill Lynch, Bear Stearns, Wachovia, and other firms that were saved (or could have been saved) by regulation by deal—can inflict huge negative externalities on the financial economy through multiple contagion channels. One channel is through the connection of two companies through their balance sheets, where one’s liability is another’s asset.⁶⁴ That is, these firms can adversely affect their counterparties when they default on their contractual obligations, which in turn make those counterparties default on their contractual obligations with other third parties.⁶⁵ Ultimately, this will lead to a domino-effect collapse in the financial sector as well as other sectors linked to the financial sector. Another related channel is that, when a systemically important firm is in distress, market participants feel fear and uncertainty over which of their own counterparties have exposure to the failing firm. This uncertainty leads to a panic in the market that causes market participants to start demanding more collateral from their counterparties and selling financial assets to reduce their risk exposure to their counterparties. This panic “run” ultimately adversely affects the financial market. This is what happened to the repo market upon the news of the subprime mortgage market failure.⁶⁶ Another channel is that systemically important firms, when distressed, may be forced to sell their assets to meet their obligations, and this fire sale of assets puts a severe downward pressure on the price of those assets sold.⁶⁷ As these financial assets decline in value, the “initial distress of the [systemically important] firm can spread as it has to sell other assets to meet contractual or regulatory obligations that depend on its financial condition.”⁶⁸ And these three channels can interact with each other to magnify their effects.⁶⁹

⁶² See *id.* at 479 n.54.

⁶³ Bank of America and Merrill Lynch: How Did a Private Deal Turn Into a Federal Bailout? Part III: Hearing Before the H. Comm. on Oversight and Government Reform and Subcomm. on Domestic Policy, 111th Cong. at 3 (July 16, 2009) (prepared statement of Paulson), <http://online.wsj.com/public/resources/documents/WSJ-20090715-PaulsonTestimony.pdf>; see also Bank of America and Merrill Lynch: How Did a Private Deal Turn into a Federal Bailout? Part II: Hearing Before the H. Comm. on Oversight and Government Reform, 111th Cong. (June 25, 2009) (statement of Ben S. Bernanke, Chairman, Board of Governors for the Fed. Reserve System).

⁶⁴ See Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L. J. 193, 199 (2008).

⁶⁵ See Anabtawi & Schwarcz, *supra* note 3, at 105.

⁶⁶ See Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, BROOKINGS PAPER ON ECON. ACTIVITY, Fall 2010, at 279.

⁶⁷ See Anabtawi & Schwarcz, *supra* note 3, at 105.

⁶⁸ *Id.* (citing Charles K. Whitehead, *Destructive Coordination*, 96 Cornell L. Rev. 323, 326–27 (2011)).

⁶⁹ See generally Andrew Haldane & Robert May, *Systemic Risk in Banking Ecosystems*, 469 NATURE 351–55 (2011).

And this contagion effect within the financial sector spills over to the rest of the economy.⁷⁰ The financial sector is a backbone of the economy and serves crucial necessary functions, such as supplying capital, hedging risks, allocating resource to efficient uses, providing payment systems, facilitating business deals, and more. For that reason, financial recessions are both “deeper and longer-lasting” than non-financial recessions, highlighting how financial distresses have a huge ramification on the entire economy.⁷¹ For instance, the economic recovery that followed the Financial Crisis of 2008 was delayed and sluggish. This is typical of post-financial crisis recoveries;⁷² long periods of high unemployment and slow growth are an almost-inevitable consequence of a financial crisis that stems from the failure of a systemically important financial institution such as Lehman Brothers. And various academics have documented the negative impact of financial stress on general economic activities.⁷³ When Lehman failed, everyone in society became a residual claimant on Lehman, not just Lehman stockholders or just those who held shares in the stock markets. The gap between social loss and private loss vis-à-vis Lehman became enormous.

Note that these contagion effects are much stronger during a crisis than during ordinary times. During ordinary times, a failure of one of the major banks would cause some damage to the economy, but absent any correlated risks on other firms, it is not too serious of an issue. However, if the same firm were to fail during a financial crisis when everyone is anxious, the panic and uncertainty would skyrocket and aggravate the already unstable situation of the economy.

This is what Armour and Gordon deemphasize when they argue that the shareholder value maximization principle is misguided for systemically important firms because of the spillover effects outside of the firm on the diver-

⁷⁰ As Armour and Gordon state, one measure of measuring the scale of harm on the economy is to look at the cost of subsequent rescue efforts, which indicates “how much policymakers were willing to spend to avoid what they believed would be even greater social losses.” Armour & Gordon, *supra* note 31, at 43. In 2008 and 2009, the U.S. government committed trillions of dollars in the form of loans and guarantees; although they were not called upon in full, the United States suffered “net fiscal outlays from the various programs amounting to 3.6 percent of GDP, or \$5 trillion.” *Id.* (citing Jan Schildbach, *Direct Cost of the Financial Crisis*, DEUTSCHE BANK RES. 3–4 (2010)). And despite these rescue efforts, the U.S. economy was not doing well: its GDP “contracted by 3.5 percent in the immediately following year 2009, down from growth of 2.8 percent in 2007—a loss equivalent to approximately \$9 trillion.” Armour & Gordon, *supra* note 31, at 43. (citing INTERNATIONAL MONETARY FUND, *WORLD ECONOMIC OUTLOOK 2* (2011), <http://www.imf.org/external/pubs/ft/weo/2011/02/pdf/c1.pdf>).

⁷¹ Andrew Haldane & Vasileios Madouros, *What Is the Contribution of the Financial Sector?*, VOX (Nov. 22, 2011), <http://voxeu.org/article/what-contribution-financial-sector> (also noting, “At this stage of a normal recession, output would be about 5% above its pre-crisis level. Today, in the UK, it remains about 3.5% below. So this much is clear: Starved of the services of the financial sector, the real economy cannot recuperate quickly.”).

⁷² See generally KENNETH ROGOFF & CARMEN REINHART, *THIS TIME IS DIFFERENT* (2009).

⁷³ See generally Troy Davig & Craig Hakkio, *What Is the Effect of Financial Stress on Economic Activity?*, 95 FED. RES. BANK KANSAS CITY ECON. REV. 35 (2010); Craig Hakkio & William Keeton, *Financial Stress: What Is It, How Can It Be Measured, and Why Does It Matter?*, 94 FED. RES. BANK KANSAS CITY ECON. REV. 5 (2009).

sified portfolios of shareholders.⁷⁴ Their analysis of the spillover effects stop within the boundary of those who participate in the stock market. Yet, the problem is much broader when systemically important firms collapse during a crisis: everyone in the economy is affected, not just those participating in the capital market. And the effects on the real economy are far more important than the effects simply on the S&P 500 and Dow indices, or companies listed on NYSE and NASDAQ.

Indeed, presence of these externalities provides the only justification for interventions such as “bailouts” by financial regulators. If Bear Stearns or Lehman were poorly managed ordinary firms, there would be no debate about the impropriety of a regulatory rescue that involved public funds, and the firms would be allowed to fail.⁷⁵ Because there are no large-scale negative externalities outside of an ordinary firm and its shareholders, it makes sense to uphold a shareholder primacy as the ultimate norm during ordinary times. In contrast, shareholder primacy loses its foundational merit in light of the large negative externalities in times of crisis. And to the extent that corporate law is based on this principle, corporate law is not fundamentally designed to deal well with a financial crisis.

B. Hold-Up Problem via Target Shareholder Voting Rights and Negative Externalities

When regulators are willing to inject money into a financial firm to mitigate systemic risk externalities, corporate law’s protections to shareholders—such as their voting rights over a merger decision—allow those shareholders to inefficiently “hold-up” bailouts and rescues. By threatening to reject a merger that brings systemic benefits, shareholders of a failing firm can compel regulators and acquirers to share some of the systemic benefits of the merger with the shareholders of the failing firm.

The threat of holdup becomes particularly acute because regulation by deal must happen quickly. Consider the mergers during the Financial Crisis of 2008, many of which were consummated with remarkable haste. In the evening of Friday, March 14, 2008, Paulson and President of the Federal

⁷⁴ See *supra* notes 31-33 and accompanying texts.

⁷⁵ Chrysler and GM provide two important counterexamples. Note, however, that both firms declared bankruptcy. Shareholders of both firms were wiped out. The government bailouts of the auto firms benefited certain creditors, such as the United Auto Workers (UAW) trust. Moreover, there may even have been negative externalities associated with the bailout of GM and Chrysler. If the firms had failed, many suppliers would have been harmed, causing additional job losses. Indeed, the lobbying efforts of Ford, one of Chrysler and GM’s primary competitors, in favor of the bailouts provides strong evidence that the industry perceived a bailout as having externalities that outweighed the benefit of reduced competition if Chrysler and GM had failed. See Kendra Marr, *Carmakers Lobbying as They Get Bailout Money*, WASH. POST (Mar. 11, 2009), <http://www.washingtonpost.com/wp-dyn/content/article/2009/03/10/AR2009031003310.html>; Aaron Task, *Bailouts of GM, Chrysler Were Good for Ford Too: Alan Mulally*, YAHOO! FIN. (June 26, 2012), <http://finance.yahoo.com/blogs/daily-ticker/bailouts-gm-chrysler-were-good-ford-too-alan-113859133.html>.

Reserve of New York Timothy Geithner informed Bear Stearns that “Bear Stearns had to find a buyer before the Asian markets opened Sunday night.”⁷⁶ By Sunday night, JP Morgan agreed to acquire Bear for the price of \$2 per share.⁷⁷ Similarly, the Bank of America-Merrill Lynch merger was suggested by Merrill Lynch’s CEO—who worried that if Lehman failed, the next bank to fail would be Merrill⁷⁸—on Saturday, September 13, 2008, two days before Lehman bankruptcy. Due diligence was performed over that weekend, and by the following Monday morning, September 15, 2008, Bank of America was under contract to acquire Merrill Lynch.⁷⁹ As another example, Wells Fargo’s acquisition of Wachovia was a “relatively prolonged” courtship, but still it was incredibly fast compared to normal mergers. Wells Fargo first expressed interests in acquiring Wells Fargo on September 20, 2008, and only twelve days passed before the Wachovia board voted to accept Wells Fargo’s offer.⁸⁰ By contrast, ordinary periods of pre-contractual “due diligence” before a merger tend to be much longer, and, even after parties complete due diligence, traditional deal approval mechanisms, such as shareholder voting, take at least thirty business days.⁸¹

The rapidity of these mergers was no accident. A financial firm that has lost the market’s confidence risks a rapid demise. As a result, a firm starting to lose the market’s faith must move more quickly than other firms before the value of the weak firm collapses. Consider the rapid stock price declines that preceded these mergers. Bear Stearns stock closed at a price of \$61.58 per share on March 12, 2008.⁸² After two days of growing concerns about Bear Stearns’ solvency, the stock closed at only \$30.85 on March 14, 2008.⁸³ By the evening of March 16, 2008, Bear Stearns had agreed to be acquired for \$2 per share, a 97% decline over four days (although the offer price was raised to \$10 per share later).⁸⁴ Similarly, Wachovia closed at \$18.99 per share on September 8, 2008.⁸⁵ By September 29, 2008, Wachovia’s stock

⁷⁶ FIN. CRISIS INQUIRY COMM’N, *supra* note 12, at 289.

⁷⁷ *See id.*

⁷⁸ *See* Solomon & Zaring, *supra* note 10, at 492, 492 n.127 (citing Jonathan Keehner & Bradley Keoun, *Bank of America Said To Reach \$44 Billion Deal To Buy Merrill*, BLOOMBERG (Sept. 14, 2008), <http://www.bloomberg.com/apps/news?pid=20601110&sid=CALGoI3fTq1Us> (quoting an analyst who stated “[i]f Lehman fails, the next bank to be attacked would be Merrill. They are attempting to forestall that attack by linking with Bank of America.”)).

⁷⁹ *See* FIN. CRISIS INQUIRY COMM’N, *supra* note 12, at 335.

⁸⁰ *See id.* at 366–71.

⁸¹ *See supra* Section II.B. In the absence of any antitrust regulatory issue or other closing issues, such as financing delays or third-party consents, the merger can be complete as early as 12 weeks or 18 weeks, depending on whether the SEC chooses to review the proxy material.

⁸² *See Timeline: A Dozen Key Dates in the Demise of Bear Stearns*, REUTERS (Mar. 17, 2008), <http://www.reuters.com/article/us-bearstearns-chronology-idUSN1724031920080317>.

⁸³ *See id.*

⁸⁴ *See id.*

⁸⁵ *See Wachovia Stock Historical Price Lookup*, WELLS FARGO (last visited Nov. 14, 2016), <https://wellsfargo.mworld.com/investor-relations/wachovia-historical-stock-price>.

price had declined to \$1.84 per share, a 90% decline in three weeks.⁸⁶ Rapid mergers are important during crises as they prevent value losses in failing firms, which can inflict damage on the entire economy. In sum, this timing mismatch creates uncertainty in a context where uncertainty is pernicious, exacerbating the threat of shareholder hold-up.⁸⁷

⁸⁶ *See id.*

⁸⁷ This explains why the government strongly promoted these rapid mergers during the Financial Crisis of 2008. For instance, some of these mergers enjoyed explicit government financial support (e.g., JPMorgan/Bear Stearns). *See infra* Section III.B.1. Even the mergers that did not enjoy explicit government backing were often supported by the government in implicit ways. For instance, IRS tax rulings provided an unprecedented windfall for the Wells Fargo/Wachovia merger. *See* Rich Delmar, MEMORANDUM FOR ERIC M. THORSON, INSPECTOR GEN., INQUIRY REGARDING IRS NOTICE 2008-83 11 (Sept. 3, 2009), <http://www.treasury.gov/about/organizational-structure/ig/Documents/Inquiry%20Regarding%20IRS%20Notice%202008-83.pdf>. In addition, government officials participated in private mergers and acquisition legal decisions to a surprising degree. After the merger agreement between Bank of America and Merrill Lynch was signed, Bank of America's CEO learned that "Merrill was accruing enormous losses from its investments in toxic assets." Rhee, *supra* note 34, at 696 (citing IN RE: EXECUTIVE COMPENSATION INVESTIGATION, BANK OF AMERICA-MERRILL LYNCH: EXAMINATION BEFORE THE ATTORNEY GENERAL OF THE STATE OF NEW YORK 11-12 (Feb. 26, 2009) [hereinafter LEWIS TESTIMONY], (examination of Kenneth Lee Lewis, Chief Executive Officer, Bank of America) (identifying the period as December 5 through 14)). The Bank of America board seriously considered invoking the merger agreement's material adverse change clause ("MAC"), which would allow Bank of America to terminate the deal without being liable to the counterparty when there was "a material adverse effect on (i) the financial condition, results of operations or business of such party and its Subsidiaries taken as a whole." Bank of Am. Co., Definitive Proxy Statement (Form 14-A), at A-13 (Nov. 3, 2008). In response, Paulson and Bernanke asked Bank of America's CEO to "stand down" from invoking the MAC, arguing that invoking the MAC was not a "legally reasonable option" and would represent a "colossal loss of judgment." FIN. CRISIS INQUIRY COMM'N, *supra* note 12, at 383-84. Fearing the collapse of the deal causing large negative externalities on the rest of the economy, Paulson threatened to fire the Bank's board and management if the MAC provision was invoked to terminate or renegotiate the deal. LEWIS TESTIMONY, *supra*, at 87. The federal banking agencies, including the Federal Reserve, have the authority to remove a bank's board and management upon showing that poor management damaged the company. *See* 12 U.S.C. § 1818(e)(1) (2000).

After these conversations, Bank of America declined to invoke the MAC and acquired Merrill Lynch. Although Bank of America may have decided to follow this course even without the suggestion of government officials, it is clear that the government was not neutral on the value of the Bank of America/Merrill Lynch deal. Indeed, one congressman described the deal as a "shotgun wedding," with the government wielding the gun. *Id.* at 384.

The government's financial and regulatory support for these hasty mergers made good sense. A successful merger served the government and social interest—financial stability. The failure of Lehman demonstrated the systemic risk associated with the collapse of a large financial institution. The firms acquired above were like Lehman in experiencing a rapid fall in value and loss of investor confidence. They also were roughly comparable to Lehman in size. According to the Bloomberg Terminal, the Dow Jones Industrial Average hit an all-time high on October 9, 2007. On that date, Lehman Brothers was worth approximately \$34 billion, Bear Stearns \$15 billion, Countrywide Financial \$11 billion, Merrill Lynch \$64 billion, Wachovia \$101 billion, and Washington Mutual \$31 billion. Lehman Brothers' peak market capitalization was \$60 billion. These firms differed from Lehman in that they were acquired before they failed (Washington Mutual technically declared bankruptcy on September 26, 2008). The previous day, however, JP Morgan Chase had acquired substantially all Washington Mutual's assets and liabilities. *See Status of Washington Mutual Bank Receivership*, FEDERAL DEPOSIT INS. CORP. (last visited Nov. 14, 2016), <https://www.fdic.gov/bank/individual/failed/wamu-settlement.html>). As a result, the financial system avoided the systemic collapse in confidence that

A timing mismatch also leaves an acquiring firm highly vulnerable to hold-up. In order to prevent insolvency, an acquiring firm must offer financial guarantees to a failing firm immediately—even before the deal has been approved by the failing firm’s shareholders. This timing leaves the acquiring firm—which has already provided some value to the target firm in the form of the guarantee—vulnerable in the event of a vote by the failing firm’s shareholders to reject acquisition or a decision by the target company to exploit this “bridge guarantee” to look for better offers.⁸⁸ This vulnerability to an acquiring firm does not only lead to reluctance of healthy firms to rescue collapsing firms but also contributes to instability in an acquiring firm and the overall financial system.

1. *Bear Stearns*

Leading up to the March 2008 rescue of Bear Stearns, the Federal Reserve believed that if the company failed, the financial sector would be badly shaken and the entire economy harmed. In order to prevent this outcome, the Federal Reserve was willing to subsidize JP Morgan’s takeover of Bear Stearns, by accepting up to \$30 billion in losses in hard-to-value Bear Stearns assets.⁸⁹

The Federal Reserve and the Treasury had no interest in subsidizing Bear Stearns shareholders. Bear Stearns had been poorly run, betting more on flawed mortgage-backed securities than any other investment bank did. The Federal Reserve offered a \$30 billion guarantee to JP Morgan in order to facilitate Bear Stearns’ takeover and avoid the collateral damage to the financial sector that would have followed Bear Stearns’ failure. Indeed, the original JP Morgan takeover of Bear Stearns provided Bear shareholders only \$2 per share.⁹⁰ Bear Stearns’ board accepted and entered into an agreement on March 16, 2008.⁹¹ The price for Bear shares was so low because government regulators “would not permit a higher number. . . . The Fed and the Treasury Department would not support a transaction where [Bear Stearns] equity holders received any significant consideration because of the ‘moral hazard’

followed the Lehman bankruptcy. This stability was (correctly) very valuable to the government. Indeed, the effectiveness of these acquisitions in mitigating panics suggests that rapid-fire mergers are likely to be an important part of future efforts to contain financial crises.

⁸⁸ Gordon & Muller, *supra* note 2, at 183.

⁸⁹ See *Bear Stearns, JPMorgan Chase, And Maiden Lane LLC*, BOARD FED. RES. SYS. (last visited Nov. 14, 2016), https://www.federalreserve.gov/newsevents/reform_bearstearns.htm.

⁹⁰ See Robin Sidel et al., *J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit To Avert Crisis*, WALL ST. J. (Mar. 17, 2008), <http://www.wsj.com/articles/SB120569598608739825>.

⁹¹ See Andrew Clark, *Bear Stearns Saved by Rock-Bottom JP Morgan Bid*, GUARDIAN (Mar. 16, 2008), <https://www.theguardian.com/business/2008/mar/16/creditrunch.useconomy3>.

of the federal government using taxpayer money to ‘bail out’ the investment banks’ stockholders.”⁹²

In addition to \$2 per share, JP Morgan guaranteed the liabilities of Bear Stearns before the acquisition had been approved by Bear Stearns shareholders. Such a guarantee was necessary to allow Bear Stearns to keep operating during the interval between the announcement of the deal and its approval and consummation. Moreover, the terms of the JP Morgan guarantee applied even if Bear Stearns’ shareholders voted down the deal. These unusually strong guarantees were necessary in such a circumstance to avoid a further failure and crisis. As a result of these guarantees, JP Morgan was exposed to uncertainty risks by Bear Stearns shareholders even if Bear Stearns never became part of JP Morgan, and Bear Stearns gained a very strong bargaining position.

Under corporate law, Bear shareholders needed to approve the transaction with JP Morgan by majority vote.⁹³ This right gave Bear shareholders “hold-up” power over the Federal Reserve. Hold-up occurs when one party tries to extract value from a second party by taking actions that threaten the interests of the second party but add no value otherwise. The value of a Bear Stearns rescue to the Federal Reserve and the Treasury was considerable because of the risk of financial contagion should Bear Stearns fail. Bear Stearns shareholders could hold up this value by withholding approval of the deal. Deal rejection would have cost the economy grievously, but Bear Stearns shareholders would only have lost \$2 per share.

In order to make shareholder rejection unlikely and to minimize the “bridge-guarantee” losses, the Federal Reserve, Treasury and JP Morgan insisted on unusual “deal protections” for the JP Morgan-Bear Stearns transaction.⁹⁴ For example, a negative vote by Bear Stearns shareholders would have triggered unusually large fees for Bear Stearns to pay to JP Morgan. In addition, a variation of the force-the-vote provision stated that Bear Stearns was to “repeatedly hold its shareholder meeting for one year from the date of the agreement or until Bear shareholders approved the merger agreement.” Bear Stearns also granted JP Morgan an option to purchase up to 19.9% of Bear Stearns common stock, exercisable upon Bear Stearns agreeing to be acquired by a third party.⁹⁵ These protections limited hold-up by deterring a vote against the merger. Note that these terms were negotiated in

⁹² FIN. CRISIS INQUIRY COMM’N, *supra* note 12, at 290 (quoting the minutes of a Bear Stearns board meeting).

⁹³ See DEL. CODE ANN. tit. 8, § 251 (West 2016).

⁹⁴ See Solomon & Zaring, *supra* note 10, at 480.

⁹⁵ See *id.* at 480-81 (citing Bear Stearns Cos., Current Report (Form 8-K), exhibit 2.1 (Agreement and Plan of Merger by and Between Bear Stearns Cos. and JP Morgan Chase & Co.) (Mar. 20, 2008), https://www.sec.gov/Archives/edgar/data/777001/000091412108000252/be12335840-ex2_1.txt).

the “hurry of a forty-eight-hour period” and show how time-sensitive it was to rescue Bear Stearns.⁹⁶

But, in turn, these deal protections would have most likely been invalid under Delaware corporate law for being too coercive and preclusive against Bear shareholders’ interests, violating the *Unocal/Omnicare* standard. Indeed, Kahan and Rock argue that “under existing statutory and case law, the [JP Morgan/Bear merger agreement] was invalid and should have been enjoined.”⁹⁷ Particularly, the option granted by Bear Stearns to JP Morgan was uncapped, a feature that the Delaware courts had ruled invalid in a different context in *Paramount v. QVC Network*.⁹⁸ The requirement to hold shareholder meetings multiple times during the course of a year was more coercive than the traditional force-the-vote provision that required a meeting to be held only once; this provision could have potentially violated the *Blasius* and *Unocal* standards.⁹⁹

Bear Stearns shareholders sued in Delaware and New York courts, arguing that the merger should be stopped because of the improper deal protections and other terms that would have impugned the integrity of shareholder approval for the merger. The lawsuit placed the Delaware Chancery Court in a difficult position. As described by Kahan and Rock:

On the one hand, the [JP Morgan/Bear merger] was pretty clearly invalid under current Delaware law. On the other hand, how could Delaware even contemplate enjoining a transaction that was supported, indeed, arguably driven and financed by the Federal Reserve with the full support of the Treasury—a transaction that may have been necessary to prevent a collapse of the international financial system?¹⁰⁰

Vice Chancellor Roger Parsons of the Delaware Chancery Court produced a ruling that passed no judgment on the merits of the extraordinary deal protections.¹⁰¹ Instead of bending corporate law, the Delaware court avoided deciding the case on procedural grounds.¹⁰² Even though the case implicated important issues of Delaware law and many commentators agree that the deal was invalid under Delaware corporate law,¹⁰³ the Chancery

⁹⁶ *Id.* at 481.

⁹⁷ Marcel Kahan & Edward Rock, *How To Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity*, 58 EMORY L.J. 713, 721 (2009) (providing detailed analysis of the issues discussed here).

⁹⁸ See Solomon & Zaring, *supra* note 10, at 481 (citing *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 51 (Del. 1993)).

⁹⁹ See *id.* “Blasius requires a ‘compelling justification’ for intentional interference with shareholders’ voting franchise by a board of directors.” *Blasius Indus. v. Atlas Co.*, 564 A.2d 651, 661 (Del. Ch. 1988); see also *MM Cos. v. Liquid Audio*, 813 A.2d. 1118 (Del. 2003).

¹⁰⁰ See Kahan & Rock, *supra* note 97, at 744.

¹⁰¹ See *id.* at 756. (praising the Delaware Court for avoiding the legal issue, and arguing that a legal ruling on the merits would have produced bad law).

¹⁰² See *In re Bear Stearns Co., Inc. Shareholder Litig.*, No. CIV.A. 3643-VCP, 2008 WL 959992, at *1 (Del. Ch. Apr. 9, 2008).

¹⁰³ See Kahan & Rock, *supra* note 97, at 715; see also Matthew R. Shahabian, *The Government as Shareholder and Political Risk: Procedural Protections in the Bailout*, 86 N.Y.U. L. REV. 351, 371 (2011) (citing *Unocal, Omnicare, Unitrin, Blasius, and Condec*).

court held that an earlier Bear shareholder suit filed in New York courts superseded the Delaware suit.¹⁰⁴

This ruling was clearly different from existing Delaware procedural law, in which Delaware courts have rarely deferred to other states on matters involving Delaware corporate law.¹⁰⁵ Vice Chancellor Parsons did not want to “place itself willingly in conflict with the federal government and risk delegitimizing Delaware’s authority in corporate matters.”¹⁰⁶ His opinion even stated: “What is paramount is that this Court not contribute to a situation that might cause harm to a number of affected constituencies, including U.S. taxpayers and citizens, by creating the risk of greater uncertainty.”¹⁰⁷ Kahan and Rock think that the Delaware court’s dodging of the issue upon procedural grounds was an praiseworthy act by the court to make a decision that reflected the reality of the financial crisis without making a “bad” law that contradicted Delaware precedent. As discussed later in Part IV, our proposal differs from Kahan and Rock’s prescription: instead of courts dodging the issue of having to resolve the tension between the conventional assumption of shareholder primacy and the failure of that assumption during a financial crisis, corporate law should be explicitly different during financial crises from that in ordinary times.

Similarly, New York state courts “resisted efforts to get them to deploy basic principles of corporate governance to police the mergers encouraged by the Treasury Department, applying Delaware law and deciding that the directors’ decision to complete the deal was protected by the business judgment rule.”¹⁰⁸

Bear Stearns shareholders and employees were outraged at the \$2 per share price, which was considerably less than Bear’s share price before the merger was announced.¹⁰⁹ Some shareholders threatened to vote against the deal. “In an effort to pacify angry shareholders,” JP Morgan and Bear Stearns entered into a new agreement on March 24, 2008, raising JP Morgan’s offer to \$10 per share while eliminating the 19.9% option provision and softening other deal protection clauses.¹¹⁰ But in exchange for JP Morgan’s (and the government’s) price concession, Bear Stearns provided other forms of deal protections. These included the issuance of new common stocks to JP Morgan in the amount of a 39.5% stake;¹¹¹ combined with JP

¹⁰⁴ See *In re Bear Stearns*, No. CIV.A. 3643-VCP, 2008 WL 959992, at *59-89.

¹⁰⁵ See Kahan & Rock, *supra* note 97, at 739.

¹⁰⁶ Shahabian, *supra* note 103, at 371.

¹⁰⁷ *In re Bear Stearns*, at *6.

¹⁰⁸ Zaring, *supra* note 30, at 1470.

¹⁰⁹ See STEVEN M. DAVIDOFF, *GODS AT WAR* 139 (2009).

¹¹⁰ See Andrew Ross Sorkin, *JP Morgan Raises Its Bid Fivefold*, N.Y. TIMES (Mar. 24, 2008), <http://www.nytimes.com/2008/03/24/business/worldbusiness/24iht-deal.4.11382490.html>; Bear Stearns Cos., Current Report (Form 8-K), exhibit 99.1 (Amended and Restated Guaranty Agreement) (Mar. 24, 2008), https://www.sec.gov/Archives/edgar/data/777001/000091412108000260/be12368022-ex99_1.txt.

¹¹¹ See Bear Stearns Cos., Current Report (Form 8-K), exhibit 2.2 (Share Exchange Agreement) (Mar. 24, 2008), <https://www.sec.gov/Archives/edgar/data/777001/000091412108000260>

Morgan's subsequent additional purchase of 9.93% of Bear shares in the open market, the issuance of 39.5% of common stock to JPMorgan was a "truly novel provision which . . . stretched Delaware law to the breaking point."¹¹² Bear shareholders ultimately approved the deal at this price and these terms on May 29, 2008, and the deal closed on May 30, 2008.¹¹³

It is truly difficult to assess what Bear Stearns's true value was around March through May of 2008. But Bear shareholders' voting rights played an important role in the merger between JP Morgan and Bear Stearns. In ordinary times, that is the point of the shareholder vote. If Bear Stearns shareholders did not like the price JP Morgan was offering, then they should reject the proposal, and we could all move on. And in ordinary times, these types of innovations in lock-in provisions to increase the chance of a shareholder "yes" vote stretch Delaware law enormously and thus are undesirable. They harm a firm's residual claimants—shareholders—and thus destroy value.

But 2008 was not an ordinary year. Because of the systemic risk externalities associated with financial panics, Bear Stearns shareholders were unlike the shareholders of an ordinary corporation. For an ordinary corporation with negative net worth, rejection of a low-priced merger by its shareholders is of little consequence for other agents of the economy. If the shareholders reject the merger, then the company would declare bankruptcy, leaving the shareholders with little leverage to insist on a higher price. In contrast, when Bear Stearns' shareholders threatened rejection, there was the value of a financial crisis at stake. Bear Stearns' shareholders were not the only residual claimants of the consequences of Bear Stearns' success or failure. Instead, the entire financial system and thus the entire economy were also residual claimants of Bear Stearns' success or failure. Allowing *only* Bear Stearns shareholders to decide the fate of an important part of the entire financial system therefore provided a poor alignment of incentives. Ordinary corporate law proved inadequate for coping with a financial crisis. It allowed shareholders to extract some of the value that would be gained by avoiding a crisis, even though Bear Stearns' mismanagement had made a crisis more likely.

In light of the above Bear Stearns analysis, we would like to offer two observations relating to other commentators' remarks. First, this shareholder voting threat should not have arisen if Armour and Gordon's diversified shareholder analysis were correct. Bear Stearns was owned by diversified shareholders. Armour and Gordon's diversified shareholders would have ap-

0/be12368022-ex2_2.txt. In addition, the merger agreement allowed JP Morgan's guarantee to terminate 120 days after the first "no" vote by Bear Stearns shareholders (as opposed to the one-year duration of the merger agreement). See Bear Stearns Cos., Current Report (Form 8-K), exhibit 99.1 (Amended and Restated Guaranty Agreement) (Mar. 24, 2008).

¹¹² Solomon & Zaring, *supra* note 10, at 482.

¹¹³ See Bear Stearns Cos., Current Report, (Form 8-K) (June 2, 2008), <https://www.sec.gov/Archives/edgar/data/777001/000091412108000468/be13005142-8k.txt>.

proved the \$2 per share price, knowing that the rescue would raise the value of their other shares. However, the reality was very different. Bear Stearns had enough shareholders willing to reject the merger and risk a financial crisis that JP Morgan (in concert with the Federal Reserve and the Treasury Department) felt obliged to increase the merger price five-fold. Therefore, Armour and Gordon's diversified shareholder analysis seems misplaced, contradicted by what actually happened during the Financial Crisis.

Second, based on the case study of the JP Morgan-Bear Stearns merger, some commentators argue that the means used for the rescue merger—including deal protection terms—probably violated corporate law principles, for example those established in *Unocal*, *Unitrin*, *Omnicare*, and *Blasius*.¹¹⁴ They are right. However, we find this way of looking at the rescue a little bizarre. When corporate law is not working and is hindering social welfare, it is misguided to describe the rescue as a violation of corporate law—while letting this “violation” stand and praising courts' maneuvers to condone this “violation” to avoidance a socially bad outcome—rather than questioning corporate law itself. It is more proper to ask why the law was not working properly and fix the flaws in the law.

2. AIG

Initially in September 2008, AIG negotiated with other private firms, including JC Flowers, for a merger rescue before those negotiations failed. On September 16, 2008, AIG was bailed out by the government in the form of the Federal Reserve injecting capital in exchange for some preferred stock stake in AIG. Although not strictly regulation by “private” deals, the case study of AIG's “quasi-takeover”¹¹⁵ rescue still highlights the problem of the shareholder primacy norm during financial crises.

A unit of AIG, AIG Financial Services, had sold credit insurance (i.e., credit default swaps) to various other financial firms. Under this insurance arrangement, AIG received fees from a financial firm and, in exchange, AIG agreed to pay the financial firm if a third firm that should be paying that financial firm became insolvent. Credit insurance enabled financial firms to hedge risks. For example, when Goldman Sachs purchased credit insurance on Lehman from AIG Financial Services, Goldman's exposure to Lehman diminished. AIG, rather than Goldman, bore some of the risk of Lehman's failure because AIG had agreed to pay Goldman in the event of a Lehman default.

But AIG Financial Products sold too many credit insurance contracts on too many financial firms; it had not foreseen the risk of its overexposure when these insured companies all collapsed due to the crisis. Leading up to

¹¹⁴ See, e.g., Kahan & Rock, *supra* note 97, at 722–38; see also *supra* note 112 and accompanying text.

¹¹⁵ Gordon & Muller, *supra* note 2, at 184.

the crisis and after the crisis broke out, Standard & Poor's cut AIG's credit rating from AAA to A minus.¹¹⁶ AIG had issued \$441 billion of credit default swap contracts—the reduction in its credit rating meant that it had to put up an additional \$14.5 billion in collateral. It could not post the additional collateral immediately, technically becoming insolvent.¹¹⁷ After the failure of Lehman on September 15, 2008, things got worse. AIG could not fulfill all of its contractual credit insurance obligations. AIG's failure would have had large ripple effects. AIG had over \$1 trillion in assets and \$971 billion in liabilities as of the end of the second quarter in 2008.¹¹⁸ Every financial firm that had purchased credit insurance from AIG would no longer enjoy the insurance protection that the financial firm thought it enjoyed, and there was “every prospect of a sequence of many cross-defaults.”¹¹⁹ As a result, “AIG's failure likely would have caused a rapid and catastrophic domino effect on a worldwide scale.”¹²⁰

Initially, the federal government refused to provide bailout funds to AIG.¹²¹ As with Lehman, discussed below, AIG negotiated with private firms about a merger rescue before it failed. And as with Lehman, AIG seemed to have unwarranted confidence in its stability—perhaps because of the perceived likelihood of a bailout. As one possible acquirer of AIG observed, “it was astounding to me that given what happened, nobody [at AIG] bothered to check this [JC Flowers] deal out.”¹²²

The directors and officers of AIG were right to count on a bailout. In order to mitigate the systemic risks of AIG's failure, the Federal Reserve committed \$85 billion to AIG on September 16, 2008, just one day after the failure of Lehman.¹²³ In exchange for this financing through § 13 authority, the Federal Reserve acquired a 79.9% equity stake in AIG, in terms of voting and dividend interests, through preferred stock.¹²⁴ This transaction required approval from AIG's board but not shareholder approval, because (i) the charter provided for the board's ability to issue various series of preferred stock as long as the total amount of outstanding capital stock stayed within

¹¹⁶ See Aline van Duyn et al., *Downgrades Deepen AIG Woes*, FIN. TIMES (Sept. 15, 2008), <https://www.ft.com/content/abaf3dee-834d-11dd-907e-000077b07658>; Lorna Tan, *AIG Policyholders Get Assurance*, SGMONEYMATTERS (Sept. 16, 2008), <https://www.sgmoneymatters.com/aia-policyholders-get-assurance>. Other rating agencies similarly downgraded AIG's rating around this time. See van Duyn et al., *supra*.

¹¹⁷ See Solomon & Zaring, *supra* note 10, at 495 (citing Matthew Karnitschnig et al., *AIG Faces Cash Crisis as Stock Dives 61%*, WALL ST. J. (Sept. 16, 2008), <http://www.wsj.com/articles/SB122148503202636197>).

¹¹⁸ See Am. Int'l Group, Inc., Quarterly Report (Form 10-Q), at 1–2 (Aug. 6, 2008), <http://sec.gov/Archives/edgar/data/5272/000095012308008949/y59464e10vq.htm>.

¹¹⁹ Solomon & Zaring, *supra* note 10, at 495.

¹²⁰ *Starr Int'l Co. v. United States*, 121 Fed. Cl. 428, 430 (2015).

¹²¹ See Solomon & Zaring, *supra* note 10, at 495.

¹²² FIN. CRISIS INQUIRY COMM'N, *supra* note 12, at 349 (quoting Christopher Flowers of JC Flowers).

¹²³ See William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 963 (2009).

¹²⁴ See *id.* at 965.

the authorized amount and (ii) the charter provided for authorized preferred stock which the board was empowered to issue and structure in accordance with § 151(a) of DGCL.¹²⁵ Just like the innovative deal protection provisions for Bear Stearns, the issuance of the preferred stock was a “novel solution to meet the government’s dealmaking needs.”¹²⁶

When the AIG board approved the Federal Reserve’s acquisition, it primarily focused on the consequences for AIG shareholders. As later described by the Federal Court of Claims, “Of the twelve AIG board members, all but [one] voted in favor of the Federal Reserve loan. The AIG directors believed doing so was in the best interests of AIG and its shareholders and that it was a better alternative to bankruptcy.”¹²⁷

AIG shareholders were not happy. Just like a merger, this rescue loan may have saved creditors by fully protecting them, but shareholders’ shares were significantly diluted.¹²⁸ AIG shareholders challenged the Federal Reserve-AIG transaction that left little for them. In one suit, a group of AIG shareholders filed a lawsuit in the Delaware Chancery Court complaining that the government’s Series C preferred stock should not be converted into AIG common stock without a shareholder vote.¹²⁹ After this suit was settled, AIG’s largest shareholder, Starr International, sued on behalf of all AIG shareholders, claiming that the U.S. government had illegally exacted the AIG shareholder’s property when the Federal Reserve acquired 79.9% stake in AIG.

The U.S. Court of Federal Claims observed that one of the two main issues was “whether there could legally be a taking without just compensation of AIG’s equity under the Fifth Amendment where AIG’s Board of Directors voted on September 16, 2008 to accept the Government’s proposed terms.”¹³⁰ The court concluded that there was a taking in spite of the vote by AIG’s board of directors. Although the court did not explicitly state that the board’s vote was inadequate because of the absence of a shareholder vote, the court consistently referred to the contrived absence of an AIG shareholder vote as evidence of government misconduct. For example, although AIG’s board approved the transaction with the Federal Reserve, the court concluded that “the Government usurped control of AIG without ever al-

¹²⁵ See Solomon & Zaring, *supra* note 10, at 497 (citing Am. Int’l Group, Inc., Current Report (Form 8-K), exhibit D (Sept. 26, 2008), <http://sec.gov/Archives/edgar/data/5272/000095012308011496/y71452e8vk.htm>); Sjostrom, *supra* note 123, at 976–77 (citing Am. Int’l Group, Inc., 1996 Annual Report (Form 10-K), exhibit 3(i), at 2 (Mar. 28, 1997), <https://www.sec.gov/Archives/edgar/data/5272/0000950123-97-002720.txt> (stating that AIG had six million shares of \$5 Serial Preferred stock authorized)).

¹²⁶ See Solomon & Zaring, *supra* note 10, at 497.

¹²⁷ Starr Int’l Co. v. United States, 121 Fed. Cl. 428, 444 (2015).

¹²⁸ See Solomon & Zaring, *supra* note 10, at 497.

¹²⁹ Walker v. AIG, Inc., Case No. 4142-CC (Del. Ch., Nov. 4, 2008). To be more precise, the issue was whether the common shareholders would have to separately vote to approve the conversion, or they would vote together with the government to approve the conversion, in which case the outcome would easily be approval.

¹³⁰ Starr, 121 Fed. Cl. at 431.

lowing a vote of AIG's common stock shareholders."¹³¹ It also said, "What is clear from the evidence is that the Government carefully orchestrated its takeover of AIG in a way that would avoid any shareholder vote."¹³²

Although the Court of Federal Claims found that the government was liable, it nevertheless concluded that the government's actions caused no damages because, absent the Federal Reserve intervention, AIG would have declared bankruptcy.¹³³ In a bankruptcy filing, AIG shareholders would have had worthless equity-making the Federal Reserve intervention essentially harmless to AIG shareholders.

We find the litigation connected to the AIG takeover and the Court of Federal Claims ruling peculiar. The Federal Reserve did not bail out AIG to help or to hurt AIG shareholders. The bailout was intended to stabilize the U.S. economy. AIG shareholders were, at best, only fractional residual claimants of AIG's survival or failure. The value of AIG equity was negligible relative to the size of the Great Recession. Under these circumstances, it is unfortunate that the Federal Reserve had to spend time negotiating with a board of directors representing AIG shareholders who represented only fractional residual claimants. It is even stranger that the absence of a shareholder vote by these fractional residual claimants was a theme that the court kept referring to in finding that the U.S. government was liable. Indeed, a shareholder vote by AIG shareholders would only have raised the probability of a bad outcome for the U.S. economy. The avoidance of such a shareholder vote is a virtue, and not a bug, of the terms of the Federal Reserve's AIG rescue. There is no need to empower AIG shareholders to hold up rescue, which would allow these shareholders to extract some of the value of avoiding a crisis.

More generally, the Federal Reserve and other regulators and private actors spent considerable time and effort in carrying out the deal according to Delaware corporate law, which constrained their rescue options in a welfare-harming way. One may arguably say that the AIG rescue violated corporate law principles—at least the duty of loyalty and *Blasius* principles. However, when corporate law is not working properly and is constraining actions that try to avoid economic catastrophe, we should perhaps focus on how corporate law should change in those contexts, rather than labeling the rescue as a violation of corporate law.

C. *Hold-Up Problem via Target Directors' Duty to Shareholders and Negative Externalities*

Shareholder voting rights were not the only element of corporate law to play an important role during the Financial Crisis of 2008. The fiduciary

¹³¹ *Id.* at 431.

¹³² *Id.* at 435.

¹³³ *See id.* at 436.

duties of directors and officers of failing target firms were also misdirected. In corporate law, directors and officers have a duty to maximize shareholder value. This makes sense when shareholders are the party that is most affected by directors' and officers' decisions. But this fiduciary duty structure makes no sense when the entire economy is affected by the decisions of people who are trying to maximize the value of an individual company.

1. *Lehman Brothers*

Before declaring bankruptcy on September 15, 2008,¹³⁴ Lehman engaged in merger talks. In particular, Bank of America and Barclays were interested,¹³⁵ and, to a lesser extent, Goldman Sachs was too.¹³⁶ But Lehman wanted too high a price for the firm.¹³⁷ And Bank of America and a consortium of other possible acquirers thought Lehman's assets were "overvalued."¹³⁸ Bank of America eventually backed out when Merrill Lynch reached out to it about a potential acquisition, two days before Lehman's bankruptcy.¹³⁹ As reported in the *New York Times*, "Many Wall Street executives and pundits have called [Lehman CEO Richard Fuld] delusional, saying he waited too long to try to sell Lehman, despite strong evidence it was necessary."¹⁴⁰ Fuld also was "not . . . willing to sell at a realistic price."¹⁴¹

But what appeared to be delusional may have been rational. Indeed, it may have been Fuld's fiduciary duty to his shareholders to insist on a high price that had little to do with Lehman's underlying value. Lehman knew that Bear Stearns had been bailed out in order to avoid a financial panic. Perhaps Bear shareholders had sold their ransom too cheaply. Bear Stearns shareholders—who received \$10 per share—perhaps could have received, say, \$20 per share with a tougher bargaining stance. Certainly, the value of avoiding a financial crisis was much greater than the \$1.2 billion that Bear shareholders received.¹⁴² The maximum price per share that Lehman could fetch was not bounded by Lehman's value. Instead, the price was bounded by the value that the government would be willing to pay to have Lehman

¹³⁴ See *Lehman Brothers Files for Chapter 11 Bankruptcy Protection*, ASSOCIATED PRESS, Sept. 15, 2008; Ben White & Michael M. Grynbaum, *Life After Lehman Brothers*, N.Y. TIMES (Sept. 16, 2008), <http://www.nytimes.com/2008/09/16/business/16lehman.html>.

¹³⁵ See Jon Hilsenrath et al., *Paulson, Bernanke Strained for Consensus in Bailout*, WALL ST. J. (Nov. 10, 2018), <http://www.wsj.com/articles/SB122628169939012475>.

¹³⁶ See William D. Cohan, *Three Days That Shook the World*, FORTUNE MAG. (Dec. 16, 2008), http://archive.fortune.com/2008/12/12/magazines/fortune/3days_full.fortune/index.htm.

¹³⁷ See FIN. CRISIS INQUIRY COMM'N, *supra* note 12, at 332.

¹³⁸ *Id.*; see *infra* note 146 and accompanying text.

¹³⁹ See WILLIAM D. COHAN, *HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET* 435 (2009).

¹⁴⁰ Susanne Craig, *In Former C.E.O.'s Words, the Last Days of Lehman Brothers*, N.Y. TIMES (Feb. 14, 2011), <http://dealbook.nytimes.com/2011/02/14/a-different-side-to-dick-fuld/>.

¹⁴¹ FIN. CRISIS INQUIRY COMM'N, *supra* note 12, at 332.

¹⁴² See Landon Thomas & Eric Dash, *Seeking Fast Deal, JPMorgan Quintuples Bear Stearns Bid*, N.Y. TIMES (Mar. 25, 2008), <http://www.nytimes.com/2008/03/25/business/25bear.html>.

rescued instead of going into bankruptcy. Indeed, observers of negotiations between government officials, Lehman, and potential acquirers of Lehman felt that Lehman and the management of its potential acquirers were aware of Lehman's hold-up power and engaged in a "game of chicken" with the Federal Reserve and the Treasury in order to recover more of the value associated with rescuing Lehman.¹⁴³ From Lehman's perspective, it was worth the risk of failure to try to capture more of the surplus that the government hoped to realize from avoiding a catastrophic financial failure.¹⁴⁴

Of course, Lehman's tactics failed. The Federal Reserve and the Treasury let it fail. The game of chicken ended in disaster for both Lehman and the Federal Reserve—and for the rest of us as well.

In fact, Lehman almost was rescued. On the Saturday night before Lehman's declaration of bankruptcy, the British firm Barclays Bank PLC verbally agreed to acquire Lehman.¹⁴⁵ The Barclays acquisition was facilitated by a consortium of financial firms that agreed to purchase \$40 to \$50 billion of overvalued Lehman assets that Barclays did not want.¹⁴⁶

By Sunday morning, however, Barclays' acquisition of Lehman was undermined by an issue of corporate law. As with Bear Stearns, financially fragile Lehman needed an immediate guarantee from Barclays in order to continue operating until the transaction closed. Barclays management was willing to provide this guarantee. British corporate law, however, required that a Barclays guarantee be approved by a shareholder vote before the guarantee could take effect. This shareholder vote requirement could have been waived by the British Financial Services Authority ("FSA")—the equivalent of the SEC—but the FSA refused, asserting that such a waiver would be "unprecedented."¹⁴⁷ With U.S. authorities unwilling to provide a guarantee

¹⁴³ Eric Dash, *U.S. Gives Banks Urgent Warning To Solve Crisis*, N.Y. TIMES (Sept. 12, 2008), <http://www.nytimes.com/2008/09/13/business/13rescue.html>.

¹⁴⁴ The framework of a bilateral monopoly negotiation helps better understand this hold-up problem, which is exacerbated by the fiduciary duty. The government is the sole provider of bailout funds; and the failing firm is the sole recipient of the bailout funds in this context (i.e., the issue is not over which firm the government should rescue, it is already determined that the bailout fund, if dispensed, would go to this company). When these "seller side monopolist" and "buyer side monopolist" negotiate, there is no market price; rather, the price is whatever the parties negotiate. This leads to a situation where parties could cooperate but choose not to do so because of the concern that they can give the other side more bargaining power and more benefits. On the fund-receiving side, Lehman tried to drive a tougher bargain, increasing the chance that negotiations could fail. In this bilateral monopoly negotiation context where there is no market price, Fuld's fiduciary duty to drive a hard bargain leads to a more unstable outcome.

¹⁴⁵ FIN. CRISIS INQUIRY COMM'N, *supra* note 12, at 335.

¹⁴⁶ *See id.*

¹⁴⁷ *Id.* Additional reasons given ranged from "the overall size of the potential exposure that Barclays was taking on and whether Barclays was in good enough shape to do it" to "FSA was looking for some kind of a cap to avoid U.K. contagion, and the Fed had just said, 'No assistance for Lehman.' The FSA then concluded based on the amount of diligence, the risk profile, and the lack of any assistance from the U.S. that they were not going to let it proceed." Cohan, *supra* note 136.

and Barclays unable to provide one without a waiver of U.K. corporate law, the Barclays-Lehman transaction unraveled.

The FSA's denial of a waiver may have been pretextual—a good excuse to avoid having one of the largest British financial firms get involved in an American financial crisis. Nevertheless, the role played by the shareholder vote requirement of British corporate law represents yet another instance where an issue of corporate law played an outsize role in trying to avoid a financial firm's failure.

The failure of Lehman has been called the “watershed event of the financial crisis,”¹⁴⁸ inflicting significant harm on the economy.¹⁴⁹ But the catastrophe might well have been avoided if Lehman management had not demanded an unreasonable acquisition price—a stance that was facilitated by their fiduciary obligation to their shareholders and the vast sums at stake for the financial system and the economy.¹⁵⁰

IV. TWO PROPOSALS

Financial crises make us critically reexamine the premise of shareholder value maximization, which is manifested in the form of shareholder voting rights on mergers and board fiduciary duties. During ordinary times, shareholder primacy is “highly correlated to the principle of [social] wealth maximization, and this correlation is the basis for the normative foundation of shareholder primacy.”¹⁵¹ However, financial crises put the shareholder primacy norm at odds with social welfare: with large negative externalities at stake, shareholders may be considering decisions—that is, possibly rejecting a merger deal because they do not like the price—that inflict a severe harm on the rest of the economy. For that reason, corporate law should

¹⁴⁸ ALAN S. BLINDER, *AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD* 127 (2013); *see also, e.g.*, MEHMET ODEKON, *BOOMS AND BUSTS: AN ENCYCLOPEDIA OF ECONOMIC HISTORY FROM THE FIRST STOCK MARKET CRASH OF 1792 TO THE CURRENT GLOBAL ECONOMIC CRISIS* 470 (James Ciment ed., 3rd ed. 2015) (“Some economic analysts argue that the company’s collapse was perhaps the single most important triggering event of the financial crisis.”); Jeff Cox, *Bill Gross: Central Bank ‘Casinos’ To Run out of Luck*, CNBC (Dec. 3, 2015), <http://www.cnbc.com/2015/12/03/bill-gross-central-bank-casinos-to-run-out-of-luck.html> (“[Many consider] the collapse of investment bank Lehman Brothers on Sept. 15, 2008 . . . to be the seminal event of the financial crisis.”); *The Orderly Liquidation of Lehman Brothers Holdings Under the Dodd-Frank Act*, FED. DEPOSIT INS. CORP. (last visited Nov. 14, 2016), <https://www.fdic.gov/regulations/reform/lehman.html> (“Lehman’s bankruptcy filing on September 15, 2008, was a signal event of the financial crisis.”).

¹⁴⁹ *See supra* notes 57-60 and accompanying text.

¹⁵⁰ If they had not asked for unreasonable price and if Goldman Sachs truly looked into the deal, a deal with Goldman Sachs could have happened. *See supra* note 136 and accompanying text. Or, at least, a deal with Bank of America could have happened. Bank of America ended up purchasing Merrill, but there were Goldman Sachs and Morgan Stanley potentially “in the mix” to purchase Merrill. Cohan, *supra* note 136, at 3. This means that Bank of America could have purchased Lehman without Merrill running into an issue of finding a purchaser.

¹⁵¹ *See Rhee, supra* note 34, at 725.

change in a financial crisis in the following two ways for systemically important target corporations that are failing.

A. *Suspend Target Shareholder Voting Rights and Replace Them with Appraisal Rights*

During a financial crisis, shareholders are not the only residual claimants of the fate of a systemically important failing firm, and the shareholder hold-up problem is real as the examples of Bear Stearns and AIG demonstrate. These case studies show that target shareholders' voting rights (i) allow shareholders to hold the economy hostage to extract a higher deal price, (ii) create uncertainty and high risks for the acquirer, and (iii) cause uncertainty for the rest of the financial system. The threat of hold-up during a crisis is particularly serious because regulation by deal must happen very quickly, whereas shareholder voting takes at least thirty business days.¹⁵² This timing mismatch imposes uncertainty when uncertainty is very costly.

To avoid target shareholder hold-up, corporate law should establish different approval mechanisms for mergers involving a systemically important, failing firm during a financial crisis. Most simply, corporate law during crises should deny shareholders of a systemically important, failing target firm the right to approve or reject a rescue merger during a crisis. And the case is even stronger when government bailout funds are involved in this context of a merger pursuant to regulation by deal. Unlike Kahan and Rock—who want courts to dodge issues of corporate law during a financial crisis¹⁵³—we want corporate law to be explicitly different in a financial crisis from corporate law in ordinary times.

This waiver of the shareholder voting rights is not unprecedented. For instance, a New York Stock Exchange rule requires its listed companies to get shareholder approval when issuing equal to or greater than 20% of its common shares or preferred shares convertible to common stock.¹⁵⁴ But if a delay in vote could “seriously jeopardize the financial viability” of the company and “reliance by the company on this exception is expressly approved by the Audit Committee of the Board,” then the company can bypass this requirement.¹⁵⁵ Indeed, AIG relied on this exemption to avoid a shareholder vote on issuing preferred stock to the government.¹⁵⁶

¹⁵² See *supra* note 81 and accompanying texts.

¹⁵³ See *supra* notes 97-106 and accompanying texts.

¹⁵⁴ See NYSE LISTED COMPANY MANUAL § 312.03 (2009), <http://nysemanual.nyse.com/lcm/>.

¹⁵⁵ *Id.* § 312.05.

¹⁵⁶ See Solomon & Zaring, *supra* note 10, at 498 (citing Press Release, Am. Int'l Group, Inc., AIG Notice (Sept. 26, 2008), http://media.corporate-ir.net/media_files/irol/76/76115/releases/092608a.pdf). This provision has been rarely invoked in the past, but starting with AIG it has become more frequent and “[a]dvisors have begun to recognize the value of the increased use of the exception.” Joan MacLeod Heminway, *Federal Interventions in Private Enterprise in the United States: Their Genesis in and Effects on Corporate Finance Instru-*

Another parallel example is the waiver of creditors' ordinary property rights for troubled banks under the FDIC receivership. The United States has had a mechanism to put troubled deposit-taking institutions under the FDIC receivership—though, this model works only for small to medium sized domestic banks, which is why the Dodd-Frank OLA was created to deal with large institutions—under which creditors' property rights would be waived to transfer short term liabilities and complex assets to a potential purchaser overnight.¹⁵⁷ Given that this waiver of property rights takes place in exigent situations to quickly effectuate sales of failing banks, it is not inconceivable to waive shareholder voting rights when the stakes are much higher.

To protect shareholders from unfair takings of their property, shareholders should be given appraisal rights: courts could later determine if the price forced upon shareholders was inadequate and, if so, courts could compel the acquirer to repurchase shares at a court-determined fair price. Under § 262 of the DGCL, shareholders that did not vote in favor of a merger have this appraisal right in front of the Chancery Court, when the merger is effectuated pursuant to § 251, § 252, § 253, § 254, § 257, § 258, § 263, or § 264 and when shareholders follow specified procedures to perfect their rights and meet other criteria.¹⁵⁸ One of these contexts involves a short-form merger pursuant to § 253, where an acquirer already owning 90% or more of the target's outstanding shares typically after a tender offer can simply effectuate the merger without the remaining minority shareholders' vote.¹⁵⁹ Another context involves a § 251(h) merger, where an acquirer owning less than 90% but more than 50% of the target's outstanding shares can simply effectuate the merger without the remaining minority shareholders' vote, as long as certain conditions are met.¹⁶⁰ Appraisal rights are quite protective of shareholders. For instance, when the Chancery Court calculates the just amount that the acquirer needs to compensate the former target's shareholders, it uses a relatively high interest rate—the federal discount rate plus 5%.¹⁶¹ Because appraisal rights are profitable and protective of shareholders, some hedge funds engage in appraisal arbitrage by which they buy shares in a company about to be sold in order to vote against the merger and receive the appraisal rights.

ments and Transactions, 40 SETON HALL L. REV. 1487, 1490 (2010). The examples include MoneyGran, Bear Stearns, Thornburg Mortgage, and Abitibi Bowater. See Melissa Klein Aguilar, *Mutual Recognition; NYSE Shareholder Approval; More*, COMPLIANCE WEEK (Apr. 8, 2008), <http://www.complianceweek.com/article/4066/mutual-recognition-nyse-shareholder-approval-more>.

¹⁵⁷ See John Armour, *Making Bank Resolution Credible* 12, 34 (European Corp. Governance Inst., Working Paper No. 244, 2014). The OLA expanded this FDIC's receivership power to non-bank financial institutions that are designated as SIFI. *Id.* at 12.

¹⁵⁸ DEL. CODE ANN. tit. 8, § 262 (West 2016).

¹⁵⁹ *Id.* §§ 253(d), 262(b)(3).

¹⁶⁰ *Id.* §§ 251(h).

¹⁶¹ See *Appraisal Rights—The Next Frontier in Deal Litigation?*, KIRKLAND & ELLIS 2 (May 1, 2013), https://www.kirkland.com/siteFiles/Publications/MAUpdate_050113.pdf.

Extending the logic of appraisal rights in the context of short-form or § 251(h) mergers to financial crises, once we take away voting rights for shareholders of systemically important firms during a financial crisis, we should compensate them through appraisal rights. During this appraisal process, the Chancery Court should value a failing target company at its long-term value outside of a financial crisis minus some discount to reduce moral hazard, specifically through the following three steps,

First, as a threshold matter, the court should confirm that the troubled company is long-term solvent and illiquid as opposed to long-term insolvent, based on the Thornton-Bagehot distinction between insolvency and illiquidity.¹⁶² If a company turns out to be long-term insolvent (that is, assets minus liabilities is below zero), its enterprise value to shareholders would be zero, and shareholders should not get any appraisal value.

Otherwise, the court should proceed to the second step, where it measures the long-term value of the company (i.e., assets minus liabilities), assuming that it is not in the crisis context and that it would not get any bailout funds. Note that this is a more generous approach than the alternative of valuing the company as if it would not get any bailout funds in the crisis context, which would lead to a valuation at a fire sale price. Although this alternative approach would alleviate the moral hazard problem, it is too harsh and punitive a measure to target shareholders.

Third, after the court determines the long-term value of the company, it should discount that value with a real haircut to arrive at the final price to be given to target shareholders exercising their appraisal rights. The court can either have a bright line rule of giving only, for example, 50% of the long-term value to target shareholders exercising appraisal rights or engage in a more sophisticated “present value of the long-term value” analysis using a discount rate that is the prime rate plus a penalty premium. In the former approach, 50% is not actually a harsh number for targets, given that they could be massively failing tomorrow. In either of the approaches, the discount not only rewards firms that come to the rescue at the expense of taking high risks, but it also addresses the moral hazard issue that can arise when shareholders are fully compensated. If the appraisal rights value the company at its full value, the target company, its management, and directors can act in a reckless way thinking their shareholders could be made whole regardless via appraisal. The discount qualifier does not necessarily make shareholders worse off, because, without a bailout, shareholders would lose these share values anyway. Therefore, a discount is not necessarily too punitive for shareholders and is crucial for reducing moral hazard.

¹⁶² See Thomas M. Humphrey, *Lender of Last Resort: The Concept in History*, 75 *ECON. REV.* 8, 8 (1989) (synthesizing and summarizing Thornton’s and Bagehot’s proposals in HENRY THORNTON, *AN ENQUIRY INTO THE NATURE AND EFFECTS OF THE PAPER CREDIT OF GREAT BRITAIN* (1802) and WALTER BAGEHOT, *LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET* 30, 32 (1873)).

Compared to the current regime with shareholder voting rights, the proposed regime is superior because: (i) target shareholders will be compensated for what they are entitled and not more; (ii) because the acquirer has to pay the adequate price (or even higher, if shareholders aggressively exercise their hold-up power) under the current regime, the acquirer will not be worse off under the new regime even though they have to compensate target shareholders who made the appraisal rights claim; and (iii) most importantly, the hold-up problem will be gone. Target shareholders cannot hold the economy hostage, the merger can be effectuated faster, the acquirer can worry less about guaranteeing the precarious target's assets, and the acquirer and regulators can worry less about the uncertainty surrounding shareholders voting down the merger.

Lastly, because corporate law belongs to states, state corporate law statutes should be amended to reflect this proposal for mergers supported by government funding during financial crises. Especially important is the Delaware statute, because most of the systemically important institutions are incorporated there. Or, we could imagine these changes being created by common law development of Delaware voting statutes. Alternatively, new federal legislation could preempt state corporate law's shareholder voting and appraisal rights in those contexts.

B. Target Directors' Fiduciary Duties to Shareholders Should Change During a Crisis

When a corporation's decisions substantially affect other claimants of a firm beyond just shareholders, the corporate law presumption that the firm should be run exclusively for shareholders could be weakened. When a company is insolvent, for example, its decisions affect the value of creditors' claims more than shareholders' claims. As a result, corporate law in some jurisdictions recognized for many years that "in the zone of insolvency," director's fiduciary duties change. In the zone of insolvency, some courts—though no longer in Delaware—have said that directors should consider the interests of creditors as well as shareholders.¹⁶³

¹⁶³ See, e.g., *FDIC v. Sea Pines Co.*, 692 F.2d 973, 977 (4th Cir. 1982); *In re Hoffman Assocs., Inc.*, 194 B.R. 943, 964 (Bankr. D.S.C. 1995). Other courts have decided that in the zone of insolvency the board should consider the corporate enterprise as a whole, not just creditors and shareholders. See, e.g., *Geyer v. Ingersonn Publications Co.*, 621 A.2d, 784, 789 ("[F]iduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation."); *In re Xonics, Inc.*, 99 B.R. 870, 872 (Bankr. N.D. Ill. 1989) (holding that directors of insolvent corporation owe fiduciary duties to corporation, shareholders, and creditors). In contrast, some other courts also decided to the contrary that there should be no legal effect to entering the zone of insolvency; that is, the directors' duties do not change even in the zone of insolvency. See, e.g., *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007); *Trenwick Am. Litig. Tr. v. Ernst & Young*, 906 A.2d 168, 175 (Del. Ch. 2006).

The “zone of insolvency” for a systemically important firm in a financial crisis is even more important than the zone of insolvency for an ordinary firm. The failure of a systemically important firm, like Lehman, harms not only the creditors of that firm but also the entire economy. As a result, there is a much stronger case for a shift in fiduciary duties of directors and officers for a failing systemically important firm during a financial crisis than there is for an ordinary firm. Corporate law should change accordingly. Fiduciary duties for managers and directors in insolvent systemically important firms generally—and especially when pursuing government assisted bailouts—should lie with the economy as a whole rather than with the individual firm’s shareholders.

In particular, we would like to distinguish our proposal for changing the *target* board’s fiduciary duties from the Rhee’s proposal for changing the *acquirer* board’s fiduciary duties. While our discussion of Lehman Brothers in Section III.C.1 focused on the target board’s fiduciary duties, Rhee has provided an argument for how the acquirer board should be exempted from its traditional fiduciary duties during the financial crisis, based on the case study of the Bank of America-Merrill Lynch merger.¹⁶⁴ Indeed, our target-side analysis also applies on the acquirer side, consistent with Rhee: given that the failure of a target, systemically important firm can cause cata-

¹⁶⁴ Rhee argues that the acquirer board should have been exempted from its traditional fiduciary duties of loyalty and care, based on the case of Bank of America acquiring Merrill Lynch. In short, it took fewer than 48 hours from the initiation of the merger talk to the signing of the deal, with the due diligence happening over thirty hours. Rhee points out various reasons why this would have violated the duty of care, even under the deferential business judgment rule. See Rhee, *supra* note 34, at 684–85, 678–79, 680–81. In our view, this discussion shows the fundamental incompatibility of Delaware corporate law with the crisis reality. The deal was extremely rushed because Merrill “was at the time within days of collapse.” *Bank of America - History - 2001 to Present - Acquisition of Merrill Lynch*, LIQUISEARCH (last visited Nov. 14, 2016), http://www.liquisearch.com/bank_of_america/history/2001_to_present/acquisition_of_merrill_lynh. If Merrill failed, it would have had a huge ramification on other crucial financial institutions. See Rhee, *supra* note 34, at 670. It was imperative to quickly act, negotiate, and perform due diligence to save this failing firm and the economy. We find this breach of duty of care analysis, in light of what was at stake during the crisis, not helpful.

In addition, after signing a merger agreement with Merrill Lynch, the Bank board tried to invoke the material adverse clause (“MAC”) to back out of the deal upon finding that “Merrill was accruing enormous losses from its investments in toxic assets.” Rhee, *supra* note 34, at 696 (citing LEWIS TESTIMONY, *supra* note 87, 11–12 (examination of Kenneth Lee Lewis, Chief Executive Officer, Bank of America) (identifying the period as December 5 through 14)). Upon hearing this news, Henry Paulson, Secretary of Treasury, and Ben Bernanke, Chairman of the Federal Reserve, threatened to replace the board if they backed out of the deal. And the board went ahead with the deal, explicitly clarifying that it was not being influenced by the regulators’ threat. See *id.* at 2. The Bank of America board could have allegedly breached the duty of loyalty, because it continued its transaction with Merrill “as a result of government pressure, the fear of job loss, and self-interest.” Kerr, *supra* note 28, at 96–97; see also Rhee, *supra* note 34, at 684. However, even if we assume that the board was indeed motivated by the regulators’ pressure, Paulson and Bernanke pressured the board members to go with the merger deal in the interest of saving the economy, not to personally enrich these directors. Technically, this may be a partial breach of the duty of loyalty to shareholders, but we should question whether we should characterize board members’ action in such a way, when the board members were driven by a motivation to avoid large negative externalities on the economy.

strophic effects on the economy, a rescuing firm's board may owe a duty to the overall economy.

However, we argue that the fiduciary duties of *only* a failing target firm's directors, not those of an acquirer's directors, should change during a financial crisis to consider the overall economy's interests in addition to its shareholders' interests. This is because our proposal entails sacrificing shareholders' private property for the sake of public welfare¹⁶⁵ and thus our proposal should be as narrowly tailored as possible. The degree of pressure to consider the welfare of the economy could be the same for the target board and the acquirer board, but the costs of doing so are different. For the target board, its shareholders are already in trouble. As a result, the shareholders are playing with "house money"—they really are not the residual claimants—and this fact lessens the need for protecting their rights. In contrast, the acquirer may or may not be in a unique position to rescue a failing firm, and imposing the rescue duty on the acquirer shareholders and board—third parties having nothing to do with this failing firm—could be oppressive. The acquirer shareholders are more plausibly residual claimants on what happens with the merger than the target shareholders are. The acquirer shareholders have real value at stake, and so we should be more concerned about changing corporate law in such a way that allows the acquirer's directors and officers to ignore this real value. For that reason, we think that the proper way to change the fiduciary duties during a crisis is to apply the altered rule only to the target board and not to the acquirer board. In other words, Rhee's analysis is robust in principle, but it should be directed at target firms, not acquirer firms.

Some might argue that it is better for corporate law to change quietly in financial crises, as it did with respect to the Bear Stearns shareholder suit,¹⁶⁶ rather than explicitly as recommended here. But implicit solutions are inappropriate for systemic problems; the stakes are too high. The rights and duties owed to shareholders under ordinary corporate law are inappropriate during financial crises because the fate of the firm has systemic effects on many other parties aside from the shareholders. Shareholder rights and shareholder-rights-driven fiduciary duties during financial crises should be diminished accordingly. Implicit solutions are also ad hoc and uncertain, while our proposal will raise certainty and intelligibility. And adding public duties to bank directors' and officers' traditional fiduciary duties is not unprecedented; parallel examples exist in other contexts. Fiduciary duties for bank directors are already different from those of general corporations, due to public interest concerns. Among various state court cases, *Litwin v. Allen* noted that banks serve public interests, not just the interests of their share-

¹⁶⁵ See Rhee, *supra* note 34, at 735 (describing an affirmative duty to rescue a failing firm as "swing[ing] the pendulum too far in favor of sacrificing private property for the public welfare.").

¹⁶⁶ See *supra* Section III.B.1.

holders, and the court required a higher standard of duty of care for bank directors than for nonbank directors.¹⁶⁷ Similarly, in South Korea, banks are required to “contribute to the stability of the financial markets and to the development of the national economy.”¹⁶⁸

Lastly, the proposal for changing the target board’s fiduciary duties during a crisis can be achieved through changes in state statutes, especially that of Delaware.¹⁶⁹ Alternatively, common law judicial innovations could also change corporate law. Judicial decisions have made fiduciary duties in the zone of insolvency uncertain.¹⁷⁰ So too could a judicial decision with respect to fiduciary duties for directors and officers of systemically important failing firms, especially when negotiating for a government sponsored bailout. This will reduce the likelihood of failed negotiations stemming from management attempts to force the government to pay off shareholders in order to avoid a cataclysmic failure. Alternatively, federal law can intervene to preempt state statutory or judicial law of traditional fiduciary duties.

C. *Other Feasibility and Operationalization Issues*

For the above two proposals to work in practice, this Section aims to address some of the key practical concerns. Namely, the above changes in corporate law should not apply to all corporations in all contexts; rather, given their great deviations from our traditional corporate law, these changes should apply in the narrowest way possible.

1. *Which Corporations?*

The two proposals should apply only when the target company meets certain criteria. The theoretical guiding principle is the size of negative externalities. The more harm a firm’s failure imposes on the rest of the economy, the more inclined we should be to change corporate law to reflect the economic realities.

We propose that the list of those target companies subject to our proposal should be limited to those that have been designated by the FSOC as

¹⁶⁷ See *Litwin v. Allen*, 25 N.Y.S.2d 667, 678 (N.Y. Sup. Ct. 1940); see also Hwa-Jin Kim, *Financial Regulation and Supervision in Corporate Governance of Banks*, 41 J. CORP. L. 707, 717–18 (2016).

¹⁶⁸ Eunhangbup [Banking Act], Act No. 5499, May 5, 1950, amended by Act No. 6691, Apr. 27, 2002, art. 1 (S. Kor.), translated in International Money Laundering Information Network, http://www.imolin.org/doc/amlid/Republic_of_Korea/Banking_Act_1998.pdf.

¹⁶⁹ With respect to changing the acquirer board’s fiduciary duties through changing state statutes, we want to highlight two underappreciated provisions in Delaware’s statute that appear to be related to such an idea: §§ 122(9) and 122(12) of the DGCL. DEL. CODE ANN. tit. 8, §§ 122(9), 122(12) (West 2016). For more information on these sections, see Rhee, *supra* note 46, at 701–07; Verret, *supra* note 37, at 334–39; David G. Yosifon, *Corporate Aid of Governmental Authority: History and Analysis of an Obscure Power in Delaware Corporate Law*, 10 U. ST. THOMAS L.J. 1086, 1109–1114 (2013).

¹⁷⁰ See *supra* note 163 and accompanying text.

systemically important financial institutions (“SIFIs”) plus other non-financial firms that would otherwise meet many of the criteria used to define SIFI designations. Currently, two of the SIFI designation criteria are: (i) banks having \$50 billion or more of consolidated assets; or (ii) non-banks that are determined by no fewer than 2/3 vote of the FSOC members as posing threats to the stability of the United States based on its “nature, scope, size, scale, concentration, interconnectedness, or mix of the activities.”¹⁷¹ We can import some features of these SIFI criteria—asset size, FSOC determination, FSOC vote—to devise a criterion for designating a non-financial firm as systemically important. Or, as to non-financial firms, regulators can consult with other macro-prudential regulators to see whether the failure of a given non-financial firm would impose large negative externalities to the economy. We recommend “[p]iggybacking on regulatory designation”—rather than leaving it up to judicial determination—for clarity and predictability.¹⁷²

2. *Trigger Conditions*

Because of the large deviation from traditional corporate law doctrines, our proposal needs trigger conditions to be as clear and objective as possible, while not losing the flexibility to adjust to the unique circumstance of each crisis.

We think that the proposed changes in corporate law can be triggered in any financial crisis, as long as the failing firm can impose large negative externalities on the economy. Fortuitously, financial crises have objective, quantifiable indicia: high and rapidly increasing interbank lending rates, sudden rises in spreads between government bonds and private sector bonds, crashes in various stock market indices, and an extraordinary number of bank and other financial firm failures. Based on these features, we can usually recognize financial crises in real time. These objective criteria, whether baked into statutes or presented to judges in courts, would constrain judicial and regulatory opportunism in defining financial crises and invoking changes in corporate law.

V. COUNTERARGUMENTS

A. *OLA Is Superior to Regulation by Deal And So We Need Not Bother with Better Facilitating Regulation by Deal*

Our proposals are based on the premise that regulation by deal is desirable and we need to promote it. One counterargument to our proposals is

¹⁷¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 113(a)(1), 124 Stat. 1376, 1398 (2010).

¹⁷² See Armour & Gordon, *supra* note 31, at 70.

that, as a threshold matter, our points are moot because we have an arguably better alternative to regulation by deal: OLA.

The OLA of the Dodd-Frank Act grants the FDIC the power to wind down complex financial institutions in an orderly manner. Based on the OLA power, the FDIC proposed the Single Point of Entry strategy (“SPOE”) in 2012.¹⁷³ Under the SPOE, when a financial institution in a group of affiliates is about to fail, the FDIC would put only the parent of that group into receivership, while the subsidiaries are allowed to operate normally without being affected by this resolution process.¹⁷⁴ Dodd-Frank not only replaces bankruptcy with the FDIC’s SPOE but also made “[SPOE] receivership the only way to assist a large, troubled financial firm.”¹⁷⁵ By eliminating the bailout option—specifically, by stopping the Federal Reserve, Treasury, and FDIC from injecting capital into the financial sector or offering guarantees¹⁷⁶—Dodd-Frank envisions OLA as the only method to save a large, distressed financial firm. In contrast, regulation by deal often involves some sort of partial government bailouts. Due to the exclusive reliance on the SPOE to mitigate financial crises *ex post*, a pair of commentators stated that this “Dodd-Frank nuclear option” is “simply too dangerous.”¹⁷⁷

However, the OLA/SPOE approach has the following shortcomings *vis-à-vis* regulation by deal. First, the OLA approach has never been tested, in contrast to the regulation by deal approach that has withstood the test of time. As the SPOE was devised in 2012 and we had no opportunity to test it, we simply do not know how the SPOE would play out in practice.

In contrast, virtually every past financial crisis involved merger deals to mitigate the crisis. During the Panic of 1907, J.P. Morgan Jr. played a crucial role in various dealmaking and asset guarantees to bring the New York markets toward stability.¹⁷⁸ In 1930, when the Bank of United States was about to fail, the Federal Reserve attempted to find a healthy merger partner to rescue the Bank;¹⁷⁹ the failure of these efforts led to the failure of the Bank of United States, largely aggravating the financial economy. When the

¹⁷³ See RESOLVING GLOBALLY ACTIVE, SYSTEMICALLY IMPORTANT, FINANCIAL INSTITUTIONS, FED. DEPOSIT INS. CORP. & BANK ENG. 1, 6 (2012), www.fdic.gov/about/srac/2012/gsifi.pdf.

¹⁷⁴ See *id.* at 6.

¹⁷⁵ Gordon & Muller, *supra* note 2, at 153.

¹⁷⁶ Dodd-Frank took away the Federal Reserve’s authority to make emergency loans under its § 13(3) emergency lending power to a “single and specific” firm, making the authority available only when limited to “broadly available” facilities. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 1101(a), 124 Stat. 1376, 2113–15 (2010); see also Coffee, *supra* note 1. There are further restrictions on the remaining bailout authority by the Federal Reserve. Dodd-Frank § 1101(a)(6). These new provisions limiting the Federal Reserve’s bailout authority would have ruled out the assistance to AIG, Bear Stearns, Lehman, Citigroup, and Bank of America. See Gordon & Muller, *supra* note 2, at 196.

¹⁷⁷ Gordon & Muller, *supra* note 2, at 153.

¹⁷⁸ See generally ROBERT F. BRUNER & SEAN D. CARR, *THE PANIC OF 1907* (2007); Solomon & Zaring, *supra* note 10, at 532.

¹⁷⁹ See Harrison, *supra* note 14.

Savings and Loans crisis of the 1980s and 1990s started, the regulators “initially tried to rescue failing [Savings and Loans institutions] by persuading healthy [Savings and Loans institutions] and banks to buy them.”¹⁸⁰ When the Long-Term Capital Management (“LTCM”)—a global U.S. hedge fund who was seen as a “pivotal component of the financial system”¹⁸¹—was failing in 1998, the Federal Reserve orchestrated a 3.6 billion takeover of LTCM by a consortium of sixteen financial institutions.¹⁸² And most recently, the Financial Crisis of 2008 involved: JP Morgan’s takeover of Bear Stearns, Barclay’s (failed) acquisition of Lehman, the Fed’s takeover of AIG, Bank of America’s acquisition of Merrill Lynch, and Citigroup’s (ultimately failed) acquisition of Wachovia.

Regulation by deal was not limited to the United States during the recent crisis, either. For example, HBOS, a large and struggling British bank, was acquired by Lloyd’s TSB, another important British bank, in September 2008. The Bank of England facilitated this merger by providing a line of credit “lifeline” worth over \$40 billion.¹⁸³ Two weeks later, Lloyd’s Bank was itself nationalized. Similarly, the largest bank in the Low Countries, Fortis, was nationalized by the Belgian, Dutch, and Luxembourg governments in 2008. The Belgian part of Fortis was sold immediately thereafter to BNP Paribas, a large French bank.¹⁸⁴ In sum, the OLA method has never been used and imposes many risks, whereas the regulation by deal approach has been present in virtually every past crisis. We therefore believe that improvements to regulation by deal, such as the ones we make here, are warranted, even if the OLA claims to make such interventions unnecessary.

Second, the OLA is designed to deal with the failure of individual firms due to idiosyncratic risks, but it is not necessarily designed to deal with a financial crisis as a whole when multiple firms are failing. Neither the legislation nor the conference reports discuss a strategy to address collective failures, and they instead focus on rescuing individual firms.¹⁸⁵ For instance, assume that a financial crisis has already broken out, and various large U.S.

¹⁸⁰ Casey & Posner, *supra* note 9, at 502 (citing *United States v. Winstar Corp.*, 518 U.S. 839, 847–48 (1996)).

¹⁸¹ Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 54 (2009).

¹⁸² See ROGER LOWENSTEIN, *WHEN GENIUS FAILED 183–218* (2002). These sixteen institutions were: Bankers Trust, Barclays, Bear Stearns, Chase Manhattan Bank, Credit Agricole, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, JP Morgan, Lehman Brothers, Merrill Lynch, Morgan Stanley, Paribas, Salomon Smith Barney, Societe Generale, and UBS.

¹⁸³ Press Association, *Lloyds Shareholders Demand Release of HBOS Takeover Documents at High Court*, GUARDIAN (July 22, 2015), <http://www.theguardian.com/business/2015/jul/22/lloyds-shareholders-hbos-takeover-documents-high-court>.

¹⁸⁴ See *BNP Paribas Completes the Acquisition of Fortis Bank and Forms a Strategic Partnership in Insurance with Fortis*, BNP PARIBAS (May 12, 2009), <http://www.bnpparibas.co.uk/en/2009/05/12/bnp-paribas-completes-the-acquisition-of-fortis-bank-and-forms-a-strategic-partnership-in-insurance-with-fortis/>.

¹⁸⁵ See 156 Cong. Rec. S5869–5933 (daily ed. July 15, 2010); 156 Cong. Rec. S5797–5845 (daily ed. July 14, 2010); 156 Cong. Rec. H5212–5261 (daily ed. June 30, 2010).

financial firms are about to fail. If Dodd-Frank's vision of using solely the OLA is upheld, then there would be a "cascade of [close-in-time] receiverships imposed on large U.S. financial firms," de facto nationalizing a large part of the financial sector.¹⁸⁶ This outcome can be highly destabilizing, where the mere threat of nationalizing the financial sector could "hasten a slide from financial instability into financial emergency."¹⁸⁷ This is because (1) once a firm is placed under receivership, investors would lose their equity investment and realize significant losses on their unsecured debt investments; and (2) potential capital suppliers would see their entire investment in the financial sector at risk due to the nationalization of various financial firms.¹⁸⁸ There would be a mass exodus of capital out of the entire financial market prompted by small financial instability, as investors' diversification strategy would fail. Therefore, the nationalization threat of the Dodd-Frank strategy would "accelerate the path from instability to a full-scale crisis."¹⁸⁹

Furthermore, the nationalization of a large part of the financial sector can lead to other forms of disruptions. Dodd-Frank states that "responsible" senior officers and directors of failed firms taken into receivership would be immediately removed, all employee contracts could potentially be repudiated during receivership, and those firms' financial contracts could be repudiated. If several companies in the economy were put through receiverships, there would likely be a disruption at a large scale in these multiple firms, which some commentators called "a significant concern."¹⁹⁰ In addition, the OLA and its subsequent nationalization outcome are based on the assumption that the government's "command and control" strategies would work, an assumption that may not hold.¹⁹¹

Third, it is unclear if the OLA-SPOE approach would be successful even to deal with an individual struggling firm, as the SPOE approach is predicated on some faulty assumptions as described in more details by various commentators.¹⁹²

¹⁸⁶ Gordon & Muller, *supra* note 2, at 153–54.

¹⁸⁷ *Id.* at 153.

¹⁸⁸ *See id.* at 200.

¹⁸⁹ *Id.* 202.

¹⁹⁰ *Id.* at 200.

¹⁹¹ In contrast, the regulation by deal approach does not necessarily lead to the nationalization of a failing institution. It is a way to seek a "private" solution—although directed by some government intervention—where a private company comes to acquire another distressed private company. And the private solution can, in certain circumstances, be more efficient as the source of information is localized. *See generally* F. A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).

¹⁹² The first assumption is that the creditors of the parent are substitutable with the creditors of the subsidiary. *See* Jin, *supra* note 4, at 1752. The SPOE approach can lead to moral hazard by the creditors of the subsidiaries of a group, because those creditors—protected by the parents' creditors—may not carefully monitor the group's risk-taking activities. *See id.* The SPOE could reduce moral hazard problem for the creditors of the parent, but the creditors of the parent could not offset the moral hazard problem for the creditors of the subsidiaries. *See id.* Consequently, "both the overall level of monitoring and the cost of credit for the financial group would decrease." *Id.* Another faulty assumption behind the SPOE approach is that the

All this is to say that the exclusive reliance on the OLA is dangerous. Regulation by deal should continue to be one of the key policy tools for ex post response to financial crises, as a complement to the OLA.

B Appraisal Rights Can Deter Acquirers Ex Ante

Potential acquirers, knowing that they can be required to pay unexpectedly high prices upon the exercise of appraisal rights, may be cautious about engaging in a rescue merger. For instance, if our proposals applied to the Bear Stearns/JP Morgan example, JP Morgan would have promised \$2 per share as a merger consideration, and shareholders would not have rights to vote down the \$2 per share offer. However, if the Delaware Chancery Court later finds the fair share value to be \$10 per share, JP Morgan would be obligated to pay \$8 more per share to Bear shareholders later. Therefore, before JP Morgan enters into a merger agreement to pay \$2 per share, it would fear having to pay more per share after the merger agreement is signed. And thus, JP Morgan would be less inclined to enter into a merger agreement due to this uncertainty.

This is indeed true, but we need to be clear about what our baseline is. If our baseline scenario is getting rid of shareholder voting rights on merger decisions *without* providing appraisal rights, then our proposal does deter acquirers. However, this is not the appropriate baseline; when the baseline scenario is the current system—where there is no appraisal rights but there are shareholder voting rights over merger decisions—our proposal does not deter acquirers.¹⁹³ In the stylized Bear/JP Morgan scenario above, in the current system, JP Morgan would have had to offer \$10 per share anyway, otherwise shareholders would vote down; under our proposal, JP Morgan may agree to the price of \$2 per share initially but may end up paying \$10 eventually. That is, JP Morgan would not be worse off under our proposal than under the current proposal, so there is no *ex ante* deterrence incentive.

Also, our proposal is qualified by a condition that appraisal rights should allow for a high rate of return for the acquirer in order to compensate

FDIC can neatly divide the assets of the company among different subsidiaries. *See id.* at 1772. Corporate groups often do not carefully keep a good record of the assets among different legal entities within the group, because they need to report only the consolidated financials for tax purposes. *See* Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. CHI. L. REV. 605, 615–16 (2011). Financial institutions, as the examples of Lehman and Deutsche Bank show, also face this problem as their assets move quickly on and off their balance sheets. *See* Jin, *supra* note 4, at 1772. However, for various reasons, clear asset segregation is crucial for the SPOE to be successfully implemented. *See id.* at 1772. Jin offers three explanations for this prerequisite condition: (1) “the bail-in recapitalization approach requires that the FDIC make an accurate valuation of the assets of the parent”; (2) “a clear division of assets is important in facilitating the ex post resolution of problematic subsidiaries”; and (3) “a clear division of assets among different subsidiaries is important to reduce uncertainty in the marketplace.” *Id.* at 1772–74.

¹⁹³ Not to mention, our proposal is more protective of shareholders by providing them with appraisal rights. Given the fundamental importance of shareholder voting rights, taking it away without providing any compensatory mechanism is too harsh on shareholders.

the acquirer for taking on additional risk during a crisis, in the form of *discount* on the target firm's value. The appraisal should be a function of the firm's long-term value *minus a discount*. This discount raises ex ante incentives for acquirers to come rescue failing firms.

In fact, our proposal may deter acquirers less than it would under the current system, thanks to less risks of shareholders rejecting the merger agreement and less risks of having to make bridge guarantees to the target's assets. And furthermore, under the current system, acquirers would be at risk of shareholders rejecting a fair offer—in order to drive a harder bargain, knowing that the regulators are anxious about preventing the failure of systemically important firms like Bear Stearns. Holding the economy hostage would not happen under our proposal, and the acquirer would not be forced to pay more than what is determined by courts as just price. For these reasons, the acquirer may actually have better ex ante incentives to engage in a rescue merger under our proposal rather than under the current system.

C. Cost of Equity May Go Up in Ordinary Times and Right Before Acquisitions

If the shareholder voting rights were waived and fiduciary duties changed during a financial crisis for certain firms, then capital market participants would be more reluctant to invest in equity of those firms. Furthermore, investor confidence in capital market depends on certainty and predictability of corporate law and transactions.¹⁹⁴ Therefore, the cost of equity could go up and capital flow could slow down during ordinary times, especially as the economy is about to enter into a financial crisis.

However, this concern is mitigated by various factors. First, our proposal applies only to a select number of firms the failure of which could inflict significant harms on the economy. Thus, the cost of equity would not go up for the vast majority of firms in the economy. Second, these firms—especially the SIFIs—are already subject to various stringent capital and liquidity requirements as part of the Basel III accords implementation, and this may have already driven up their cost of equity a bit. These admittedly costly measures are necessary to reduce the likelihood of a financial crisis. Similarly, given the systemic importance of the firms subject to our proposal, a slight increase in the cost of equity is a price regulators and firms should be willing to pay to ensure a sound national financial system. Third, as long as the change in corporate law is consistently and predictably executed—only among the identified firms, only for those failing firms, and only during an objectively discernible financial crisis—a lot of the unpredictability and uncertainty in the corporate law regime can be mitigated. In sum, we think the benefits of our proposals outweigh the (real) cost of raising the price of equity.

¹⁹⁴ See Heminway, *supra* note 156, at 1518.

VI. CONCLUSION

Regulation by deal is an indispensable tool to mitigate financial crises. We argued that the shareholder primacy norm—the bedrock principle of corporate law—hinders regulation by deal and is incompatible with the reality of a financial crisis. Namely, shareholder voting rights over mergers and directors' fiduciary duties to shareholders fail to take into account the externalities that financial firm failures inflict on the rest of the economy.

Using this externality framework, we contended that corporate law should change during financial crises to reduce shareholder rights—by replacing their voting rights with appraisal rights and changing directors' fiduciary duties—for systemically important target corporations that are failing. By narrowly tailoring these proposals, most of the side effects of the proposals can be mitigated.

With the near-inevitability of future financial crises, relying entirely on prophylactic means provided by financial regulation to address the problem of crises may not be enough. This Article looked into a less explored context outside of financial regulation—corporate law—and showed how corporate law should change to be more compatible with the reality of financial crises. However, corporate law is only one example of laws that should respond to a financial crisis; tax law, contract law, etc. can also be part of the regulatory toolkit to combat financial crises. It is our wish that this Article helps start the task of analyzing financial crises—one of the most serious, devastating issues of our society—through a previously unexplored lens with more flexible thinking.