

# Bailouts: An Essay on Conflicts of Interest and Ethics When Government Pays the Tab

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## I. INTRODUCTION

In January 2009, I published a book on reform of government ethics law, lobbying regulation, and campaign finance.<sup>1</sup> Just as my book was going to press in the fall of 2008, the United States government was embarking on an enormous bailout of the financial industry. My concerns regarding inadequacies in government ethics law are even greater when government officials direct trillions of dollars toward private companies. With last minute revisions, my book suggested several ways in which the bailout was worrisome.<sup>2</sup> Having a year to observe the financial services bailout and bailouts of other industries,<sup>3</sup> I believe a stronger statement is required. Existing government ethics rules are inadequate for implementing bailouts in a manner that preserves public confidence in the most expensive decisions our government makes.

This Essay identifies specific concerns I have regarding government ethics and bailouts. This is a preliminary discussion of topics for future research and deliberation, not a definitive analysis of the subject. I will write more on this subject later,<sup>4</sup> but it is important to raise some issues now.

Many concerns I discuss in the bailout context are also relevant to government ethics generally. These concerns include the role of political favoritism and campaign money in government decisions, movement of senior personnel between government and the private sector, relatively lax ethics rules for federal contractors, abuse of inside information about government decisions, and other issues. Bailouts, however, are unique in several respects: the enormous

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

2. *Id.* at 39 (conflicts of interest from pensions and investments owned by government employees involved in bailouts), 44 (conflicts of interest from former employers of government employees), 54 (conflicts of interest involving prospective future employers), 64-65 (Treasury Department officials' use of information about investment banks and other companies receiving bailouts), 166-67 (insider trading on government information about bailouts).

3. The bailout of two of the three largest American car manufacturers is discussed further below. Regardless of what types of arrangements are defined as "bailouts," the government's economic intervention in response to the 2008-2009 financial collapse has been far reaching. Freezing of credit markets, for example, has forced the Federal Reserve to step in as a lender to fill a vacuum left by banks unwilling to lend. *See* Edmund L. Andrews, *Lender's Role for Fed Makes Some Uneasy*, N.Y. TIMES, June 13, 2009, at A1 (recounting how Fed officials "have been dragged into murky battles over the creditworthiness" of particular industries, including "motor homes, rental cars, snowmobiles, recreational boats and farm equipment"). "If the Fed cannot extract itself quickly, [a growing number of economists] warn, the crucial task of allocating credit will become more political and less subject to rigorous economic analysis." *Id.*

4. This Essay is a precursor for a book on the same topic.

magnitude of government expenditure required; the intricate financial relationships linking companies that receive bailouts with other companies; the wealth and social influence of individuals who benefit from bailouts in the financial services industry; and the dearth of procedural rules constraining government employees in bailouts compared with detailed regulations for procurement, investigations, adjudications and most other particular party matters for which government employees make decisions about the fates of particular companies.

This Essay discusses conflicts of interest and government ethics, not the economic utility or social policy of bailouts. Conflicts of interest and other ethics problems, however, affect economics. Ethics problems can cause federal bailout money to be spent inefficiently. Lack of public confidence in government decisions regarding bailouts—and lack of predictability in bailout decisions—can also undermine investor confidence in financial markets.

Not all bailouts are alike. Some bailouts, such as bailouts of depository institutions insured by the federal government, are routine and usually proceed according to a prearranged script. Although government officials exercise some discretion, statutes and regulations define parameters of government decision-making. Federal institutions such as the FDIC, staffed mostly by career officials, administer these bailouts. Ethics problems have an impact, but the impact is less because government officials have less discretion and decisions are less arbitrary.

Other bailouts are extraordinary because they involve companies that ordinarily would be allowed to fail. Policymakers sometimes decide that these companies are too big to fail or that for some other reason they should not fail. These government decisions are highly discretionary. There are no prearranged legal rules or institutions to implement rules. Political appointees make most of these decisions, and sometimes the decisions can appear arbitrary (e.g., Bear Stearns and AIG are bailed out, but Lehman Brothers is not). When conflicts of interest and other ethics problems contribute to arbitrariness in government decisions regarding extraordinary bailouts, officials may mispend public money, eroding public confidence in government. This unpredictability may also cause capital markets to react adversely.

While predictable bailouts in the first category are less challenging from an ethics perspective than extraordinary bailouts in the second category, predictability comes at a cost. Bailouts that are relatively certain and have predefined parameters create a moral hazard for persons who own and manage firms eligible to receive these bailouts. If left free to gamble with the government's money, many would do so. For this reason, firms eligible to receive predictable bailouts usually must comply with capital requirements, restrictions on use of capital, periodic inspections, and other regulatory restraints. Sometimes these risk oversight mechanisms break down. As I pointed out in earlier commentary on the savings and loan crisis of the 1990s, bank managers

and their lawyers are partially to blame.<sup>5</sup> Ethical failings of government officials who are supposed to regulate or oversee regulators are also to blame.<sup>6</sup> However, there is a system in place for the government to regulate and monitor risk incurred by firms eligible to receive predictable bailouts, and this system usually works.

For firms receiving extraordinary bailouts in the second category, mechanisms for external monitoring of risk before a bailout have been weak or nonexistent. Uncertainty about whether there will be a bailout, who will get a bailout, and the amount of a potential bailout diminishes the moral hazard somewhat if economic actors know they could get nothing. Investment banks, for example, are not legally entitled to bailouts, and persons managing, investing in, or loaning money to investment banks generally assume they are on their own. If, however, bailouts become more common and predictable for investment banks, or any other industry, moral hazard increases.<sup>7</sup> This is the worst of both worlds, because moral hazard typical of predictable bailouts is combined with lax government oversight of firms that are allowed to assess and assume their own risks but then are not allowed to fail.

This Essay does not focus on the skewed incentives inside these firms but instead on the skewed incentives inside the government agencies that make bailout decisions. The purpose of this Essay is not to propose a solution to conflicts of interest and other government ethics problems or even to assess the magnitude and economic impact of these problems, which varies according to the specifics of a particular bailout. The purpose here is to point out the types of problems likely to arise in bailouts and that government ethics law has not kept up. Another purpose is to suggest that proposed solutions to government ethics problems have a broader impact and can be costly—some more costly than the problems they purport to solve.

## II. RECURRING ETHICS PROBLEMS IN BAILOUTS

Companies frequently separate shareholder ownership and managerial control.<sup>8</sup> Corporate law provides statutory and judicial solutions for agency

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5. See Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225, 261-63 (1996) (proposing legislative provisions for lawyers resembling what eventually became section 307 of the Sarbanes-Oxley Act of 2002).

6. The prominent politicians with close ties to Lincoln Savings and Loan chief Charles Keating were the most notorious example in the late 1980s.

7. Although Morgan Stanley and Goldman Sachs avoided a bailout and gained access to federal funds by switching to a commercial bank holding company structure in 2008, many more investment banks have never made the switch and remain subject to relatively loose regulatory restraints imposed on firms that are not federally insured. President Obama has proposed a sweeping overhaul of financial services regulation that would include safety and soundness, but the final shape of the legislation that passes Congress has yet to be determined.

8. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119-25 (1932).

problems between shareholders and managers while allowing some flexibility for private ordering. By contrast, the relationship between companies and their creditors is principally contractual—in the form of loan agreements, bond indentures, etc. A good contract limits the inherent moral hazards a company may face when it takes risks with creditors' money.

Explaining what went wrong and why we need government bailouts is beyond the scope of this Essay, although I will mention a few possibilities. When banks and other firms took large positions in derivatives and other complex investments, corporate law might have given too much deference to managers under the “business judgment rule.”<sup>9</sup> Bonus-driven compensation for managers also may have contributed to excessive risk-taking. It is possible that contractual arrangements with creditors, which are usually effective in controlling traditional types of risk, may have failed to keep up with the economic reality of transactions. Lawyers who drafted those contracts may not have understood the economic underpinnings. Another culprit may have been the government's failure to regulate the complex financial instruments involved.<sup>10</sup> In the mortgage market, government sponsored enterprises (GSEs), most notably Freddie Mac and Fannie Mae, contributed significantly to the level of risk and used political clout and skilled lobbying to impede efforts to curtail their activities.<sup>11</sup>

The failure in the auto industry has different explanations, including the possibility that car companies were not managed in a manner consistent with the interests of shareholders, creditors, or customers. Unions also had a powerful role in the industry and may not always have made workplace efficiency a top priority. The political influence of and lobbying by car companies and unions discouraged the government from intervening until it was time for a bailout.

Thus, bad corporate management, sometimes combined with bad government regulation, may give rise to the need for a bailout. Bailouts, however, involve new problems of separation of ownership from control. Public money managed by government employees is injected into financial services firms, car

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9. For the latest rendition of the business judgment rule in Delaware, see *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009) (distinguishing risky business decisions from illegal conduct and imposing an extremely high burden on plaintiffs in suits alleging failure of directors to monitor for business risk). The business judgment rule is a rebuttable presumption that corporate directors making a business decision were disinterested and independent and acted on an informed basis, in good faith, and for a proper business purpose. Absent rebuttal of this presumption, a court generally will not second guess the directors' business decision.

10. Lobbying for loose regulation by trade associations such as the International Swaps and Derivatives Association is a separate government ethics issue discussed in my book, but not discussed further here. See PAINTER, *supra* note 1, at 227-28 (discussing how, among other things, the International Swaps and Derivatives Association was successful in getting its former chief lobbyist appointed and confirmed as a commissioner of the Commodities Futures Trading Commission).

11. The Bush Administration claimed that these GSEs were a significant cause of the financial collapse in 2008 and that it had warned about the risks they posed for the economy. See Office of the White House Press Secretary, *Just the Facts: The Administration's Unheeded Warnings About the Systemic Risk Posed by the GSEs*, Sept. 19, 2008, <http://georgewbush-whitehouse.archives.gov/news/releases/2008/09/20080919-15.html> (on file with the *McGeorge Law Review*).

manufacturers, and other companies. Government employees who make bailout decisions invest the public's money and also may help run companies if they get board seats, hire or fire senior corporate managers, or otherwise influence business policies in return for bailout money. Most of the government officials making these decisions are not elected, although in the executive branch they report to the president. Members of Congress also have a role in some bailout decisions.

When public money is invested in private companies, the public gets an ownership stake in debt, equity, or both. Besides the power of the ballot, however, the public has few mechanisms to control the conduct of government employees managing this trillion dollar enterprise. Shareholders in a company that does not accept government bailout funds sometimes do not have much control over managers either—an issue of concern for advocates of expanded corporate democracy—but even these shareholders probably have more options at their disposal (e.g., proxy fights, tender offers, etc.) than the public has if it is dissatisfied with the management of government bailout funds. Public owners (i.e., taxpayers) must wait for the next scheduled election to act upon their views of the government's bailout managers. In this respect, government bailouts epitomize the separation of ownership from control that until now has been viewed principally as a problem of the private sector.

Government ethics law is one of the few mechanisms that can influence the conduct of managers employed by the government. This Essay discusses whether government ethics law as currently written and administered is up to the task.

I briefly identify below some problems with bailouts that could be classified under the general heading of “government ethics.” The framework I use here, as in my book, is a “fiduciary principle”<sup>12</sup> binding government officials to the public interest that they purport to serve. Government ethics rules, financial disclosure rules, procurement rules, and other bodies of law regulating government officials should minimize departures from the fiduciary principle (whether these rules in fact do so is a subject discussed generally in my book and discussed in the bailout context below).

#### *A. Political Payback*

Politics is a persistent factor in government decision-making. Some political considerations are not necessarily inconsistent with the fiduciary principle—for example, a member of Congress favoring his or her own district in expenditure deliberations. Other political considerations, such as a member supporting expenditures in another member's district in return for an endorsement for reelection, are more questionable. A member's favoritism toward those who

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12. See PAINTER, *supra* note 1, at 1-6 (explaining that one of the main goals of a fiduciary in the public sector should be transparency and accountability).

supported his election to office may also raise suspicion, since once elected he is supposed to represent everyone in his district. An executive branch official's favoritism toward persons who supported election of the president is questionable on similar grounds, although it is also a common practice.

When government bails out the private sector, the public expects members of Congress to support companies in their own districts and expects members from states such as New York to favor a generous approach toward, for example, the financial services industry. However, the public probably neither expects nor wants "Republican" firms to do better than "Democratic" firms or vice versa depending on which party controls Congress or the executive branch. Appropriate parameters of politicized decision-making are difficult to define, but there are limits to what the public considers acceptable.

Although there are limits, the law does not necessarily define those limits. Sometimes voters identify inappropriately politicized decisions and impose their own sanctions on elected officials who go too far. Because voters have flexibly, their sanctions are sometimes more effective than sanctions for violations of written rules, which involve both procedural and standard-of-proof requirements. Flexibility, however, is also a weakness of political sanctions because it can lead to inconsistency. Sometimes a member of Congress or a president is sufficiently popular that voters refuse to impose a political penalty for excessively political decision-making. Sometimes important segments of the electorate want politicized decision-making and can prevail, even if the majority prefers a less politicized approach.

Commentators on "public choice theory" have analyzed how political factors play out when economic resources are allocated by government instead of by markets.<sup>13</sup> When markets in political influence emerge around government actors who allocate resources, departures from the fiduciary principle may occur, although, as pointed out above, some political influences may be consistent with the fiduciary principle. A legislator favoring a company or industry in his own district, for example, may be consistent with fiduciary obligations to the persons who elected him, but favoritism toward a campaign contributor may not be. Departures from the fiduciary principle are discussed here as a problem of "government ethics," but to some degree this is part of how government works. Controls on politicized decision-making imposed by procedural or substantive law, the character of public servants, and the character of the electorate are all factors that influence how much and in what way politics influence policy.

The legislative and executive branches both make government decisions on bailouts. Once funds have been appropriated for bailouts and broad parameters set by statute, executive officials make most implementation decisions under the watchful eye of Congress. Apart from the president and the vice president,

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13. See generally FRED S. MCCHESENEY, *MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION* (1997).

executive branch officials are not elected to office. They are, however, appointed by the president and his staff, who do consider politics in their decisions.

Political operatives in the president's political party and their supporters have varying degrees of influence upon, and access to, executive branch officials. There is likely to be more such influence when executive branch officials are permitted, and in fact encouraged, to participate in "personal capacity" partisan political activity. This is where the White House Office of Political Affairs (OPA) has a critical role. Karl Rove ran OPA for much of the George W. Bush Administration. Under President Obama, Patrick Gaspard, a labor union advisor from New York, runs OPA. OPA staff members moonlight in their "personal capacities" for the president's political party by, among other things, speaking at campaign events, coordinating strategy with candidates, and facilitating political work by other administration officials. OPA officials also recruit political appointees in the agencies, sometimes including cabinet members and their deputies, to speak at political events and perform other duties for the party.<sup>14</sup>

When political appointees participate in partisan political activity and then make bailout decisions, it should not be surprising that bailout decisions are politicized. However, it is difficult to determine the extent to which these decisions will be affected by partisan political activity. Appearances also can be worse than reality. It should be a matter of concern, for example, that there was a very active OPA during the George W. Bush Administration and that on October 3, 2008, one month before the presidential election, Congress authorized the Secretary of the Treasury to spend up to \$700 billion on bailing out the financial services industry. However, a Democrat-controlled Congress authorized the bailout and most of the money was not committed to specific banks until after the election. It is also unlikely that Secretary Paulson and other Treasury officials participated in significant partisan political activity in the months prior to the election, although their White House counterparts in the National Economic Council may have done so (there is simply no way of knowing for sure, because there are no publicly available records of government officials' political activity).

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14. The Hatch Act, 5 U.S.C. §§ 7321-7326 (2006), prohibits government officials from engaging in political activity using official titles or at government expense. PAINTER, *supra* note 1, at 245. Most government officials may not participate in political activity while on government property or during working hours. An exception in the Hatch Act regulations, however, allows senior political appointees to do so provided they do not use their official titles or incur additional expense for the government. This exception permits some people to do both official and political work in the same office, provided they purport to distinguish between the two. Numerous gadgets—BlackBerries, cell phones, computers—are thus provided by the Republican National Committee (RNC) or the Democratic National Committee (DNC) to OPA staff and some other administration officials. *Id.* at 250. Modern technology makes it easier than it once was for these officials to coordinate with political campaigns. Calls coming from White House officials on DNC cell phones and emails sent on DNC BlackBerries are, legally, not coming from the White House at all. They are merely "personal capacity" communications by persons who happen to be White House staff. In many respects, however, these distinctions are more theoretical than real. In most administrations, OPA staff members use the same internal reporting structure to coordinate political activity that they use for official duties. When they make phone calls or send email, everyone knows where they work. When they speak at campaign events, everyone knows who they are.

Nonetheless, even if politics had no effect on the Administration's bailout decisions, appearances would have been better if President Bush had asked OPA to stand down from its efforts to entangle the Administration's political appointees, or at least appointees involved with the bailout, in partisan politics.

The two Chrysler bailouts in 1979 and 2009 provide another illustration of the difficulties affiliated with assessing degrees and types of political influences and with distinguishing policy decisions from politics. The Carter Administration probably considered Chrysler factories in Michigan and other Midwestern states to be important in winning the 1980 presidential election. (President Reagan set up the formal structure of the White House OPA, but President Carter did have some political advisors in the White House). There were also, however, policy reasons to save Chrysler at a time when inflation and economic stagnation plagued the rest of the manufacturing sector. "But for" political factors in the bailout decision are difficult to identify.

When Chrysler failed again thirty years later and went into Chapter 11 bankruptcy, executive branch officials in the Obama Administration again injected federal money into Chrysler. Labor unions and other creditors fought over competing claims on Chrysler, and some critics have claimed that the administration favored labor.<sup>15</sup> President Obama and his staff might have been predisposed from a policy perspective to favor union creditors over other lenders in shaping the plan for Chrysler to emerge from bankruptcy. But lenders had good arguments on policy grounds, particularly if the Administration was concerned about whether other companies could borrow money in the future. Thus, the best approach to negotiations from a policy perspective may not have been clear.

Against this background of uncertainty, a factor in the outcome could be that Administration officials are reminded of where their loyalties lie when they meet with labor union officials and other interest groups, including perhaps some creditors, at political events. The impact of these events as a "but for" cause of particular decisions is difficult to measure empirically. Few, if any, government officials will admit that "political considerations" affected their decision-making. President Obama's approach to the Chrysler bailout might have been the same regardless of political connections members of his Administration had. Nonetheless, in general, communications from interested parties to government officials in the course of partisan political activity can make a difference, at least at the margins, and, perhaps, well beyond the margins.

Appearances would be better for the Obama Administration if the OPA stood down from some of its customary functions at least until most substantial decisions in the current round of bailouts are made.<sup>16</sup> Administration officials

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15. E.g., Patrice Hill, *Treasury Favors Unions in Chrysler Talks*, WASH. TIMES, Apr. 24, 2009, <http://www.washingtontimes.com/news/2009/apr/24/treasury-favors-unions-over-banks-in-chrysler-talk/> (on file with the *McGeorge Law Review*).

16. I suggest in my book that OPA in its current form be abolished and most of its work be moved to the

involved in the bailouts—other than the president and vice president—should be required to desist from personal capacity partisan political activity until their work on the bailouts is done.<sup>17</sup>

*B. Political Money*

Campaign contributions are a form of political payback. Political money has been the source of scandals over many years, including the exchange of campaign cash for peerages or knighthoods in Great Britain under Prime Minister Lloyd George in the 1920s<sup>18</sup> and again under Prime Minister Tony Blair in the early 2000s. Today, billions of dollars are spent on elections in the United States, and it would be naïve to assume that all of this money is donated simply for philosophical reasons by persons who do not expect something tangible in return. Unless and until the system of campaign finance is changed, political money will influence government decisions. These decisions could be much more costly to the public than the approach of British politicians who hand out peerages and knighthoods to their contributors. The cost could be astronomical in government bailouts, where hundreds of billions of dollars are at stake.

Political activity by executive branch officials also plays a role in providing campaign contributors with access to executive branch officials at political fundraisers. Although the Hatch Act prohibits government officials from soliciting campaign contributions, they may give “personal capacity” speeches at fundraisers, speeches which almost always discuss the government’s official business. Private discussions at these fundraisers are an ideal setting for exerting influence. Contributors who want bailouts for certain companies know how to ask. Contributors who want preferential treatment for certain constituencies—e.g., stockholders, management, labor, or creditors—in a bailout also know how to ask.

Here, empirical work could be useful. Is there a statistically significant correlation between campaign contributions and the companies that receive

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political party national committees. See PAINTER, *supra* note 1, at 245-53.

17. Empirical work on the impact of contacts made through partisan political activity is difficult because the Federal Election Commission (FEC) database does not contain searchable information on which government officials attend which political functions and which private sector persons also attend those same functions. As pointed out in my book, one can find out from the FEC web page if one’s neighbor or coworker gave \$250 to a campaign, but one cannot find out how many political trips Karl Rove took, where he went, and who else was at the same political events that he attended. *Id.* at 259. Only the dollar amount and contribution date for contributors is listed (there is no event information tied to the contributions), and information about government officials attending political events with contributors is not accessible (the information does exist because the White House or agency counsel’s office generally signs off on political travel by staff). *Id.* This is thus both too much and too little information provided by the FEC disclosure regime. *Id.*

18. For a long time, knighthoods and peerages were exchanged for political favors, but the system under Lloyd George was notable for its scale and brazenness. See generally TOM CULLEN, MAUNDY GREGORY: PURVEYOR OF HONOURS 26-31 (1974) (biography of the theatre producer and political operative who implemented the scheme).

bailout funds? When government makes decisions between various constituencies of companies that receive bailouts—for example, prioritizing creditors or allocating payments between creditors and shareholders—is there a statistically significant correlation between campaign contributions and the beneficiaries of those decisions? In some instances, such as car company bailouts, the sample size may be too small to allow for a statistically significant measurement. In other instances, such as financial services industry bailouts, many companies are involved and the data might be statistically significant. The fact that bailout decisions were made at the end of a Republican administration and at the beginning of a Democratic administration might complicate such a study. However, noticeable shifts in approach from one administration to the next might shed light on the influence of campaign contributions. Some preferences for campaign contributors will also have a policy rationale—e.g., Democrats’ policy orientation toward labor—making it harder to attribute a decision to particular campaign contributions. At other times, however, contributions could be a credible explanation for bailout decisions, such as where the Bush and the Obama Administrations treated similarly situated persons differently. For example, campaign contributions by chief executive officers who were forced out by the government in one administration or the other could be compared with contributions of those who were allowed to stay.

### *C. The Revolving Door into Government*

Government officials who previously worked in industries receiving bailouts benefit from prior private sector experience. Excessive ties to particular companies in those industries, however, make ethics problems worse.

In recent years, Goldman Sachs has been accused of having an unfair advantage in Washington. Many large banks, however, have had their turn in government. In the 1907 financial crisis, the United States did not have a national bank (the Federal Reserve Bank was established in 1914), so the Treasury Department turned to J.P. Morgan & Co., which acted as a de facto national bank in putting together a bailout deal.<sup>19</sup> The U.S. Treasury paid \$73 million (approximately \$1.6 billion in 2008 dollars) for bailouts, and J.P. Morgan, J.D. Rockefeller, and other financiers added millions more. J.P. Morgan himself led the negotiations and, at times, coerced the other lenders. Morgan made decisions that today the Federal Reserve or the Treasury Department would make, even though he had an obvious conflict of interest in this quasi-governmental role because of his economic interest in the outcome. In subsequent years, the United States has had senior government officials from other leading banks, including Treasury Secretaries from Mellon Bank (Andrew Mellon, 1921-1932), Salomon

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19. See generally RON CHERNOW, *THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE* (1990).

Brothers (William Simon, 1974-1977), Merrill Lynch (Donald Regan, 1981-1985), and Dillon Read & Co. (C. Douglas Dillon, 1961-1965, and Nicholas Brady, 1988-1993). The two most recent Treasury Secretaries from private banks came from Goldman Sachs (Robert Rubin, 1995-1999, and Henry Paulson, 2006-2009).<sup>20</sup>

Secretary Rubin was criticized over conflicts of interest in bailouts of foreign countries in the 1990s. In the 1995 bailout of Mexico, Rubin arguably had a conflict of interest because Goldman had large exposure in Mexico. Similar issues arose in the 1998 Asian currency bailout, when Goldman Sachs and other large investment banks, again, had large exposure. Rubin, however, was legally permitted to participate in these matters because he had sold all of his interest in Goldman upon entering the government. Ethics rules then, as now, did not require more.

Secretary Paulson presided over some of the most controversial bailouts in history from September 2008 to January 2009. Goldman was, of course, affected. Goldman itself, however, avoided becoming a direct party to bailouts given to some other Wall Street firms, in part by gaining access to federal funds in a different manner. In September 2008, Goldman and its rival, Morgan Stanley, put themselves under commercial bank holding companies. As such, they gained access to borrowing from the Federal Reserve in return for being subject to risk management controls and other regulations applicable to commercial banks.

Nonetheless, Goldman had a substantial interest in bailouts given, or denied, to other firms. The United States allowed Lehman Brothers, an old rival of Goldman among the top tier of underwriter firms, to fail in 2008. The government helped Merrill Lynch and Bear Stearns, two other firms that rivaled Goldman in some business areas, merge into bank holding companies, Bank of America and J.P. Morgan Chase, respectively. American International Group (AIG), which owed Goldman up to \$20 billion as a counterparty to various derivatives contracts, was bailed out with a substantial infusion of government cash (a portion of Goldman's exposure to AIG may have been insured or hedged in contracts with other counterparties that might or might not have been able to pay Goldman if AIG had failed).

Secretary Paulson was involved in many of these bailout decisions. His involvement was legal because, like Secretary Rubin, he had divested himself of any significant interest in Goldman upon entering the government in the summer of 2006 (as the chief White House ethics officer, I coordinated this process prior to his confirmation hearing). Paulson sold all of his Goldman stock at the then-prevailing price, which was significantly more than the stock would fetch

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20. See U.S. Dep't of the Treasury, History of the Treasury, <http://www.treas.gov/education/history/secretaries/> (last visited Oct. 27, 2009) (on file with the *McGeorge Law Review*).

today.<sup>21</sup> The entire point of the stock sale was to allow him to participate in matters that could affect Goldman and the rest of the financial services industry. Of course, at the time, nobody knew how monumental such matters would be by the summer of 2008.

Secretary Paulson brought several people from Goldman to fill top posts in the Treasury Department. This influx of Goldman personnel magnified the company's apparent influence in Washington. These individuals included Robert K. Steele, a former Vice Chairman of Goldman, as Undersecretary for Domestic Finance, and Neel Kashkari, who was recruited from a relatively junior position at Goldman to serve as Assistant Secretary of the Treasury and oversee the 2008 bailout plan. Others were hired as special government employees or on a contract basis to advise Treasury with the bailout, including: Kendrick Wilson, former Chairman of the Goldman Sachs Financial Institutions Group; Dan Jester, former Deputy Chief Financial Officer of Goldman; Steve Shafran, a retired principal of Goldman; and Edward Forst, former head of Global Investment Banking for Goldman.<sup>22</sup> As several newspapers observed, "Government Sachs" had firmly implanted itself in Washington.<sup>23</sup>

The apparent arbitrariness of bailout decisions in 2008 and 2009 exacerbated controversy over Goldman's influence. Uncertainty regarding government decisions during this period (e.g., why bail out Bear Stearns and AIG, but not Lehman?) increased speculation about the motives behind those decisions. The rationale behind the decisions does not appear to have been explained with sufficient clarity to let investors know how the government would respond to whatever crises came next. A factual dispute also arose later regarding contacts that Treasury Secretary Paulson had with Goldman Sachs personnel amidst the financial crisis in the fall of 2008. This conduct raised questions as to whether Secretary Paulson followed the terms of the ethics agreement<sup>24</sup> he signed upon

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21. Pursuant to government ethics regulations, Secretary Paulson was entitled to a "certificate of divestiture," allowing deferral of the capital gains tax until such time as he sells the investments bought with the proceeds of the stock sale. *See* 26 U.S.C. § 1043 (2009).

22. Special government employees are subject to federal conflict-of-interest statutes and other ethics rules, but contract employees, generally, are not subject to the same rules and can retain financial holdings that conflict with the work they do for the government.

23. *See, e.g.,* Julie Creswell & Ben White, *The Guys from 'Government Sachs,'* N.Y. TIMES, Oct. 19, 2008, at BU1.

24. The ethics agreement provides in part that, "As a prudential matter, I will not participate in any particular matter involving specific parties in which the Goldman Sachs Group, Inc. ("Goldman Sachs") is or represents a party for the duration of my tenure as Secretary of the Treasury, unless my participation is in accordance with 5 C.F.R. § 2635.502(d)." Letter from Henry M. Paulson, Jr., to John F. Schorn, Deputy Assistant Gen. Counsel & Designated Agency Ethics Official, U.S. Dep't of the Treasury, Re: Ethics Agreement of Henry M. Paulson, Jr. (June 19, 2009), *available at* <http://devel.philstockworld.com/2009/08/11/the-paulson-ethics-waiver/> (on file with the *McGeorge Law Review*). This pledge goes well beyond the requirements of 5 C.F.R. § 2635.502 (2009), which requires recusal from such party matters only for a period of one year from his severance of ties with Goldman Sachs. The ethics agreement, however, does not specifically prohibit Paulson from telephonic or other contact with persons who work for Goldman Sachs. The waiver provision, which is found in 5 C.F.R. § 2635.502(d), provides that:

entering office—which precluded him from participating in particular government matters to which Goldman Sachs was a party or represented a party<sup>25</sup>—and whether these contacts at least violated the spirit of the ethics agreement, even if not its specific language.<sup>26</sup> Paulson furthermore received two ethics waivers, one from the White House and one from Treasury Department ethics lawyers, which allowed him wider latitude to participate in matters affecting Goldman Sachs.<sup>27</sup> The fact that a Democratic administration would take over in January 2009, and Goldman Sachs had traditionally strong links with the Democratic Party as well as with outgoing Secretary Paulson’s Treasury Department, fueled yet more speculation that Goldman Sachs would get its way regardless of who was in power.

My own unsubstantiated speculation is that improper influence from Goldman or any other bank on former employees in the government was minimal or nonexistent. Nonetheless, the fact that there has been so much speculation about motives in bailout decisions illustrates that existing regulation of the revolving door does not instill public confidence that government officials will be evenhanded. Requiring Treasury officials coming in from Goldman Sachs or other investment banks to dump their stock in banks may not be enough when they retain close ties to their former employers. Also, there were probably too many senior Treasury Department officials from Goldman; perhaps there were

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Where an employee’s participation in a particular matter involving specific parties would not violate 18 U.S.C. 208(a), but would raise a question in the mind of a reasonable person about his impartiality, the agency designee may authorize the employee to participate in the matter based on a determination, made in light of all relevant circumstances, that the interest of the Government in the employee’s participation outweighs the concern that a reasonable person may question the integrity of the agency’s programs and operations.

For cabinet officials, such authorizations and waivers are generally obtained from the White House Counsel’s Office acting on behalf of the President. On September 17, 2008, Paulson received two waivers, one waiver from White House Counsel Fred Fielding, which allowed Paulson to participate in matters that could affect his relatively small vested interest in a Goldman Sachs defined benefit plan—the only interest he had retained in Goldman Sachs—and one waiver from the Treasury Department, which allowed him to participate in matters that could affect Goldman Sachs itself. Memorandum from Fred F. Fielding, Counsel to the President, to Henry M. Paulson, Jr., Sec’y, U.S. Dep’t of the Treasury (Sept. 17, 2008), *available at* <http://www.talkingpointsmemo.com/documents/2009/08/ethics-waiver-re-goldman-sachs-from-fred-fielding-to-henry-paulson---sept-17-2008.php?page=1> (on file with the *McGeorge Law Review*); see Gretchen Morgenson & Don Van Natta Jr., *Paulson’s Calls to Goldman Tested Ethics During Crisis*, N.Y. TIMES, Aug. 9, 2009, at A1 (discussing both waivers).

25. Goldman Sachs was not a party to the bailouts discussed at that time, but some of the bailouts, such as that of AIG, apparently benefited Goldman Sachs.

26. See ANDREW ROSS SORKIN, *TOO BIG TO FAIL* 176-78 (2009) (recounting a “secret” meeting in June 2008—before any ethics waivers were obtained—between Paulson and Goldman’s directors in Moscow that was permitted because it was characterized as “social,” although discussion topics allegedly included an upcoming speech by Paulson and his view that the Treasury Department needed the power to wind down troubled firms); Morgenson & Van Natta, *supra* note 24 (discussing multiple telephone calls between Paulson and senior Goldman Sachs officials in September 2008).

27. I participated as the chief White House ethics lawyer in preparing Paulson’s original ethics agreement in 2006. I mention here the controversy over the agreement and the subsequent waivers but will not interpret the agreement or opine on how it was changed by the waivers.

too many from the banking industry in general.

However, had Secretary Paulson declined to participate in bailout decisions because of an apparent conflict with his prior position at Goldman, he would have neglected his duty at a time when his involvement was most critical; the consequences could have been disastrous. He also needed people around him who were familiar with the source of the crisis—the banking industry. Overly theoretical or uninformed advice from people outside the industry could have exacerbated the crisis.

The Treasury Department General Counsel's Office, led by an experienced securities lawyer, Robert F. Hoyt, guided Paulson and other officials through the maze of statutes, regulations, contractual arrangements, and other criteria for each of many financial services bailouts. These lawyers also advised on matters of ethics. They surely considered appearances as well as the letter of the law. Still, they had limited room to maneuver and even less time. Treasury Department lawyers could not disable the Secretary or his staff simply because the Department went into the crisis with senior ranks top-heavy with former employees of Goldman and other investment banks.<sup>28</sup>

Federal ethics laws have loosely regulated the movement of officials from private employers into government. In general, federal ethics laws have only required divestment of any financial interest in the former employer to comply with the conflict-of-interest statute<sup>29</sup> and then recusal for one year from particular party matters in which the former employer is a party.<sup>30</sup> Waiver or authorization by the agency for an official to proceed, despite a conflict of interest under these rules, is permitted when it is needed for the official to perform a crucial function.

President Obama, in a January 21, 2009, Executive Order, tightened up the rules.<sup>31</sup> The Order requires incoming Administration appointees<sup>32</sup> to sign a

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28. Controversy over Goldman's influence has lasted beyond the departure of Secretary Paulson. Steve Friedman, a former chairman of Goldman, served as a senior economic adviser in the Bush White House. He then went back into the private sector and served on Goldman's board of directors while serving the Administration as a special government employee (SGE) in a variety of capacities. He has remained a director of the Federal Reserve Bank of New York during the Obama Administration. Friedman also allegedly purchased Goldman stock in December 2008 and January 2009. Friedman resigned his Fed post in May 2009, presumably because of the conflict. See Jon Hilsenrath & Kate Kelly, *Chairman of N.Y. Fed Quits Amid Questions*, WALL ST. J., May 8, 2009, at A-1.

29. See 18 U.S.C. § 208 (2006). The head of an agency is permitted to waive this prohibition after consultation with the Office of Government Ethics (OGE). *Id.* § 208(b).

30. This does not include party matters in which the former employer is not a party, even if the matter has an effect on the former employer. See 5 C.F.R. § 2635.502 (2002) (requiring recusal from particular matters involving specific parties if those parties include former employers within the past year and other persons with whom the government employee has a "covered relationship"). An agency-designated ethics official can grant an authorization for an agency employee to participate in such a matter if the need for the official to participate outweighs the appearance of impropriety. This rule does not cover matters, such as regulation of an entire industry, that do not have specific identifiable parties.

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

32. Appointee is defined in section (2)(b) of the order.

pledge that, for two years, they will not work on particular matters involving specific parties, including regulations and contracts that are “directly and substantially” related to their former clients or employers.<sup>33</sup> Presumably this includes most bailout packages that directly and substantially benefit former clients or employers. The Order imposes even stricter rules on incoming appointees who are registered lobbyists.<sup>34</sup> The Order recognizes that the revolving door into government is a serious problem and at least attempts to deal with it.<sup>35</sup>

There could, however, be problems with implementation of the Order. This is a difficult area to regulate because so many senior government officials come in from the private sector. If restrictions are too onerous, people from the private sector will not agree to serve. As President Kennedy said in calling for revision of ethics laws in 1961:

Such regulation, while setting the highest moral standards, must not impair the ability of the Government to recruit personnel of the highest quality and capacity. Today’s Government needs men and women with a broad range of experience, knowledge, and ability. It needs increasing

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

*Id.*

33. Paragraph 2 of the pledge reads:

*Revolving Door Ban—All Appointees Entering Government.* I will not for a period of 2 years from the date of my appointment participate in any particular matter involving specific parties that is directly and substantially related to my former employer or former clients, including regulations and contracts.

*Id.* Particular matters involving specific parties are usually thought to include contracts, investigations, lawsuits, and other matters with identifiable parties, but not government regulations that affect an entire industry. The specific reference to “regulation” in this Executive Order, however, implies that its reach could be considerably broader.

34. Paragraph 3 of the pledge reads:

*Revolving Door Ban—Lobbyists Entering Government.* If I was a registered lobbyist within the 2 years before the date of my appointment, in addition to abiding by the limitations of paragraph 2, I will not for a period of 2 years after the date of my appointment: (a) participate in any particular matter on which I lobbied within the 2 years before the date of my appointment; (b) participate in the specific issue area in which that particular matter falls; or (c) seek or accept employment with any executive agency that I lobbied within the 2 years before the date of my appointment.

*Id.*

35. The Order has been generally quite favorably received by commentators. Dennis Thompson, for example, has commented favorably on the objectives of the Executive Order, while recognizing that the Administration thus far still lacks a coordinated approach to the broader range of ethics problems in government that are not addressed in the Order. See Dennis F. Thompson, *Obama’s Ethics Agenda: The Challenge of Coordinated Change*, 7 THE FORUM, Art. 8 (2009), <http://www.bepress.com/forum/vol7/iss1/art8/> (on file with the *McGeorge Law Review*).

numbers of people with topflight executive talent. It needs hundreds of occasional and intermittent consultants and part-time experts to help deal with problems of increasing complexity and technical difficulty. In short, we need to draw upon America's entire reservoir of talent and skill to help conduct our generation's most important business—the public business.<sup>36</sup>

President Obama faces this problem as well. Indeed, there is already controversy over how many waivers from the Executive Order will be granted and whether agency lawyers will interpret the Order narrowly to require recusals from some matters but not others.<sup>37</sup> If too many waivers are granted or the Order is interpreted too narrowly, its purpose will be compromised; the Order will bring little or no improvement in public confidence that bailout decisions are immune from influence by the banks from which many government officials came.

#### *D. The Revolving Door out of Government*

Federal ethics laws, including criminal statutes, have regulated the movement of government officials into the private sector for a long time. These statutes, however, are narrow in scope.<sup>38</sup> Government officials who arrange bailouts for companies get to know senior executives of these companies in the process. Subsequent employment by those companies can be perceived to be, and sometimes might actually be, a “reward” for the bailout.

A criminal statute, 18 U.S.C. § 208, prohibits a government official from participating personally and substantially in a government matter that has a direct and predictable impact on an entity with which the official is negotiating for employment. These rules, like many ethics rules, however, are easy to evade. Consider the following hypothetical conversation:

Treasury Official: “You said you need some bailout money. Is \$20 billion really enough? Don't you think you need 30?”

Investment Bank CEO: “I'll take 30, although \$40 billion would be better. You really ought to work for us someday when you finish at Treasury; I know just the position we could give you.”

Treasury Official: “My ethics lawyer told me I can't talk to you about

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36. *Crandon v. United States*, 494 U.S. 152, 166-67 (1990) (citing Message from the President of the United States Relative to Ethical Conduct in the Government, H.R. DOC. NO. 145, at 2 (1961)).

37. Senator Chuck Grassley (R-IA) has demanded disclosure of waivers and recusals under the Executive Order. See Kenneth P. Vogel, *Grassley After W.H. Ethics Waivers*, POLITICO, June 10, 2009, <http://www.politico.com/news/stories/0609/23612.html> (on file with the *McGeorge Law Review*).

38. The prospect of a private sector job, for example, does not create a conflict barring an official from working on government matters affecting a prospective private sector employer unless and until there are actual employment negotiations. See generally 18 U.S.C. § 208 (2006).

that, at least if I am going to participate personally and substantially in this particular matter, which is to give you the \$50 billion, or whatever it is you need.”

Investment Bank CEO: “I understand. All I really meant to say is that we have a lot of talented people like yourself around our firm and that we want to keep them and hire some more. Speaking of keeping the people we have, I hope the money you are talking about does not come with strings attached that would affect our bonus program.”

Treasury Official: “Of course not. We will make sure the bill Congress passes has a provision that would protect our—excuse me I mean your—compensation arrangements.”

This hypothetical conversation is exaggerated, but it would still be difficult to prosecute under section 208. The Treasury official could argue—probably to the point of showing a reasonable doubt—that he had rebuffed the investment bank’s attempt to enter into employment negotiations. If there were no employment negotiations, he would be free under the statute to participate in government matters affecting the bank, even a bailout worth billions of dollars.

A different problem arises when a company anticipates a need for a bailout and hires officials away from government agencies, expecting them to use government contacts to arrange the bailout. Once again, there is a criminal conflict-of-interest statute, 18 U.S.C. § 207(a), which prohibits government officials from ever representing back to the government on the same particular *party* matters that they worked on while in government. Subsections 207(c) and (d) prohibit “senior”<sup>39</sup> government officials from representing back to their agencies for one year on any matters, regardless of whether they worked on those matters, and “very senior”<sup>40</sup> officials from doing so for two years (the ban for “very senior” officials also includes representing back to senior government officials in other agencies).

These provisions of section 207, like those in section 208, have limited reach. For example, a Treasury Department official who is not “senior” or “very senior” can, immediately after leaving Treasury, lobby back to Treasury on any matter other than a particular bailout involving identifiable parties that the official worked on while at Treasury. A bailout of a different company generally would not come under the prohibition. This would probably be so even if the bailout money comes from the same package of allocated funds, unless the bailout package for a particular industry as a whole could be characterized as a single

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39. See 18 U.S.C. § 207(c)(2) (2006) (defining “senior” government employees based on pay grade). The pay threshold is \$148,953 for 2008. Memorandum from Don W. Fox, Gen. Counsel, OGE, to Designated Agency Ethics Officials, Recent Legislative Activity Affecting the Executive Branch Ethics Program, at 3 (Nov. 6, 2008), available at [http://www.usoge.gov/ethics\\_guidance/daeograms/dgr\\_files/2008/do08037.pdf](http://www.usoge.gov/ethics_guidance/daeograms/dgr_files/2008/do08037.pdf) (on file with the *McGeorge Law Review*). Certain other employees, who may earn less than this amount, including Deputy Assistants to the President in the White House, also are considered to be “senior.”

40. See 18 U.S.C. § 207(d) (defining “very senior” government employees). This category includes, among others, agency heads and Assistants to the President in the White House.

“particular party matter” having many different parties.<sup>41</sup> Such a broad definition of a particular party matter is unlikely to withstand scrutiny in a criminal case under section 207(a); each separate firm bailout, or at least each group of bailouts implemented simultaneously, is most likely to be viewed as its own particular party matter. A former Treasury official who worked on such a matter or group of matters can represent back to the government on other matters, even those that are substantially similar. The only caveat is that, because OGE’s rules under section 207(a) are confusing, when two bailouts or other particular party matters are closely related, a former official should avoid defining too narrowly the scope of the particular party matters he worked on while in government service.<sup>42</sup>

The post-employment prohibition for “senior” officials is broader because it also includes representation to the former agency on any matter for one year. It does not, however, include representation to other agencies where bailout decisions are likely to be made; for example, a former Treasury Department senior official can lobby the White House Council of Economic Advisers and the Federal Reserve. The prohibition on former “very senior” officials lasts for two years and covers representations back to “senior” officials at these other agencies. Still, evasion is relatively easy. A former “very senior” official can propose the terms of a bailout in a public forum, and in private communications with members of Congress, without violating the statute. Others in his or her organization can handle direct negotiations with the relevant executive branch agencies that are covered by the statute. People in these agencies will know what the former official wants and, given his prior “very senior” position in an agency, may give his proposals considerable deference.

Furthermore, when section 207 is violated, the consequences may not be a sufficient deterrent. While this is a criminal statute and the Department of Justice prosecutes some violations, penalties are not always particularly severe.<sup>43</sup>

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41. Some Office of Government Ethics (OGE) interpretive letters predating the bailouts have addressed this general issue without resolving it. Two matters, such as two federal contracts that are part of a single umbrella contract or contracting program, in most circumstances are still separate “particular matters involving specific parties,” but in some circumstances they could be seen as a single matter; thus, a former employee who worked on one is barred from representing back to the government with respect to them all. Also, two previously separate matters could later converge into a single particular matter involving specific parties, as OGE suggested in a 2002 opinion involving the Yucca Mountain project. *See* Letter from Office of Gov’t Ethics, to Dep’t of Energy & Nuclear Regulatory Comm’n Ethics Officials, at 10 (July 31, 2002) (on file with the *McGeorge Law Review*).

42. OGE has sought to clarify some of these issues in new rules interpreting section 207(a) that were proposed in 2003, revised, and then issued as final rules in June 2008. Post-Employment Conflict of Interest Restrictions, 73 Fed. Reg. 36,168 (June 25, 2008) (to be codified at 5 C.F.R. pts. 2637 & 2641). The new rules, however, only respond to some concerns raised in the comment period about ambiguity. The final rules also, in some ways, create further potential for overbroad interpretation of the statute. For example, OGE distinguishes the convergence theory in the Yucca Mountain letter based on “a very unique set of circumstances” in that case, but there is little helpful guidance for identifying or distinguishing analogous circumstances in the future. *See id.* at 36,177.

43. Richard Holbrooke, for example, served the Clinton Administration in several top diplomatic posts before leaving to go into investment banking. The Department of Justice Public Integrity Division later charged

The revolving door out of government is another area where President Obama has sought to tighten up ethics rules in his January 2009 Executive Order, principally by lengthening the restriction on post-employment “representing back” from one year to two years.<sup>44</sup> Administration appointees who leave to lobby must promise not to lobby other Administration appointees for the remainder of the Administration.<sup>45</sup> The difficulty with the Order’s approach, however, is that a pledge of this sort is difficult to enforce *vis-à-vis* former Administration officials who lobby from the outside. It lacks the teeth of 18 U.S.C. § 207, which, although narrower in scope, is a criminal statute.

Concerns regarding the revolving door out of government and inadequate restrictions are particularly acute in bailouts, given the amounts of money involved and the discretion government officials have in determining how to use it. Companies sometimes want bailout money badly, particularly if there are relatively few strings attached. Many government officials who contemplate rejoining the private sector are high-ranking political appointees. The more discretion these officials have over expenditures due to a lack of predefined parameters, the more likely factors such as post-government employment will influence decisions.

Nonetheless, the corrupting influence from private employment prospects is difficult to mitigate with regulation. Post-employment restrictions that are too onerous may discourage qualified people from entering government to begin with. Current conflict-of-interest rules for government officials who negotiate for jobs with the private sector and former officials representing back to the

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that he violated post-employment conflict-of-interest rules by representing back to the State Department on behalf of an investment bank. As is often the case, the charges were settled with payment of a \$5,000 fine. See Memorandum from Stephen D. Potts, Dir., OGE, to Designated Agency Ethics Officials & Inspectors Gen., 1999 Conflict of Interest Prosecution Survey to Designated Agency Ethics Officials and Inspectors General DO-00-029 (Aug. 14, 2000), available at [http://www.cs.indiana.edu/sudoc/image\\_32000000478091/3200000478091/DAEOGRAM/00/Do00029.pdf](http://www.cs.indiana.edu/sudoc/image_32000000478091/3200000478091/DAEOGRAM/00/Do00029.pdf) (on file with the *McGeorge Law Review*).

Holbrooke continued to have an influential career in finance (he was a director of AIG from 2001 until 2008), and he most recently served as the President’s liaison to Afghanistan. Holbrooke is a talented diplomat and the violation was probably a consequence of carelessness rather than intent. The fact that he later survived the vetting process for appointment to other prominent posts, however, suggests that violations of post-employment restrictions are not viewed too seriously (failure to pay a “nanny tax” or a sex scandal perhaps would have been more problematic).

44. Paragraph 4 of the pledge required under the Order states:

*Revolving Door Ban—Appointees Leaving Government.* If, upon my departure from the Government, I am covered by the post-employment restrictions on communicating with employees of my former executive agency set forth in section 207(c) of title 18, United States Code, I agree that I will abide by those restrictions for a period of 2 years following the end of my appointment.

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

45. Paragraph 5 of the pledge reads:

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

*Id.*

government, however, permit many situations where post-employment job prospects and post-employment lobbying could unduly influence government decisions. Ethics rules that purport to accomplish a great deal but actually prohibit relatively little may be counterproductive if the press and the public are lured into complacency regarding conflicts of interest.

*E. Insider Trading*

Insider trading on government bailout information goes back to the founding of the Treasury Department in 1789. Alexander Hamilton's economic plan contemplated paying off both federal revolutionary war debt at one hundred percent of par and assuming debt obligations of the individual states also at one hundred percent of par. The assumption of state debt consisted of a bailout of states, such as Massachusetts, that had incurred large amounts of debt. The bailout had strong justification to the extent the debt had been incurred by the states to pay for a war which allowed the country to come into being, but it was a bailout nonetheless. Hamilton's plan passed Congress in part because of a deal with the Virginia delegation to move the capitol to Washington. "Hamilton eventually persuaded Congress to pay off these obligations at 100 percent of face value, even though many of them were trading at less than half of face value and had passed from original purchasers—often farmers and war veterans—into the hands of speculators."<sup>46</sup> Arguably it was the speculators, not the states, that were being bailed out.

The deal was preceded by massive insider trading in federal and state government bonds and by allegations that Hamilton's allies had financial conflicts of interest. Members of Congress and of the Washington Administration were among the speculators who were trading in federal and state bonds based on advance knowledge of the Treasury's intent to pay off the bonds (there was little evidence that Hamilton himself was profiting directly from these trades, but his friends apparently were). "According to Senator William Maclay, Democrat of Pennsylvania, speculators sent stage coaches all over the South and West buying up federal and state notes at fractions of their face value."<sup>47</sup> Maclay and his Jeffersonian allies were furious.

Democrats in Congress lacked the votes to block Hamilton from becoming Secretary of the Treasury, but Congress did enact a law that prohibited, and still

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46. PAINTER, *supra* note 1, at 164.

47. *Id.*; see JOURNAL OF WILLIAM MACLAY: UNITED STATES SENATOR FROM PENNSYLVANIA 1789-1791, at 174-75 (Edgar S. Maclay ed., D. Appleton & Co. 1890) (1789); see also Richard W. Painter, *University of Chicago Fulton Lecture, May 11, 2006: Ethics and Corruption in Business and Government: Lessons from the South Sea Bubble and the Bank of the United States* (U. Minn. Law Sch. Legal Studies Research Paper, No. 06-32), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=920912](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920912). "These crooked dealings in government bonds increased Jeffersonian Democrats' hostility to the rest of Hamilton's economic plan, hostility which culminated in Congress allowing the charter for the First Bank of the United States to lapse in 1808." PAINTER, *supra* note 1, at 164 n.241.

prohibits, the Secretary of the Treasury from being “concerned” in the purchase or sale of federal or state government bonds while in office.<sup>48</sup> A new Secretary of the Treasury must therefore decide how much money to invest in federal and state bonds before taking office. The Secretary may not increase or decrease these investments during his or her term in office.

In more recent times, government information about new regulation, enforcement actions, and contracts is often relevant to stock values for particular companies or entire industries. Exactly how often this information is used for insider trading is unclear. It is troubling, however, that some lawyers at the SEC itself may have traded on inside information about enforcement actions.<sup>49</sup> Trading also does not have to directly involve government officials themselves to be illegal; “tipping” of nonpublic information by government officials to others who trade is just as illegal and probably more frequent (because securities trades by senior government officials and their immediate family members are publicly reported on financial disclosure Form 278, there is an incentive to avoid suspicious trading in their own accounts). Government officials might “tip” information to others in return for political favors, future employment prospects, or even cash.

“An increasing number of financial services firms, including hedge funds, are [headquartered] in or around Washington”<sup>50</sup> and seek access to government officials in order to get information. Executive branch officials’ participation in campaign fundraisers and private “briefings” for campaign contributors creates an ideal venue for leaking inside information, as do the many social events in Washington. Meanwhile, government agencies have weak prophylactic measures to prevent insider trading on government information compared with the more robust restrictions implemented in law firms, investment banks, and many corporations. Apart from strict rules protecting classified information and prohibitions on disclosure of some information relevant to government contracts,

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48. 31 U.S.C. § 329(a) (2006).

(1) The Secretary of the Treasury and the Treasurer may not—(A) be involved in trade or commerce; (B) own any part of a vessel (except a pleasure vessel); (C) buy or hold as a beneficiary in trust public property; (D) be involved in buying or disposing of obligations of a State or the United States Government; and (E) personally take or use a benefit gained from conducting business of the Department of the Treasury except as authorized by law. (2) An officer violating this subsection shall be fined \$3,000, removed from office, and thereafter may not hold an office of the Government.

*Id.* This provision is derived from the Treasury Act of 1789, ch. 12, sec. 8, which provides that “no person appointed to any office instituted by this act, shall directly or indirectly be concerned or interested in carrying on the business of trade or commerce, or be owner in whole or in part of any sea-vessel, or purchase by himself, or another in trust for him, any public lands or other public property, or be concerned in the purchase or disposal of any public securities of any State, or of the United States.” *Id.*

49. See Bernie Becker, *Insider Trading Inquiry Cites Lawyers at S.E.C.*, N.Y. TIMES, May 16, 2009, at B3.

50. PAINTER, *supra* note 1, at 167.

there are few restrictions in government on dissemination of nonpublic information by government employees.

When a government decision—such as a bailout—dramatically affects the price of stock or debt securities of a particular company, and possibly its competitors, the risk of insider trading is even more pronounced. Stock in troubled companies may trade at very low prices, perhaps less than \$1 per share, and debt securities also are usually deeply discounted. An announcement of a bailout that provides any hope to equity holders could lead to a sharp increase in the stock price; an announcement of a creditor bailout could have a dramatic effect on the debt securities; an announcement of a bailout that sacrifices stockholders and creditors in favor of other constituencies, such as labor, could have the opposite effect. The specifics of a bailout package are critical to knowing which security-holders will win or lose. Government officials will be tempted to leak this information in advance to people who want it, particularly if there is something personal or political to gain in return. The practice is difficult to regulate, because it is often difficult to distinguish between illegitimate leaks of government information and legitimate communication with constituents affected by government decisions. If, for example, the government is going to help labor at the expense of bondholders in a particular bailout, should government officials be permitted to tell allies in organized labor this information before it is disclosed to securities markets? If so, labor leaders and the investment funds they control have the potential to gain a lot more than preferential treatment in the bailout.

The threat of prison sentences for insider trading will deter some potential abusers of the government's confidence.<sup>51</sup> Nonetheless, insider trading can be difficult to detect and hard to prosecute, particularly if multiple "tippers" and "tippees" are involved.

Insider trading and other abuses of inside information in bailouts are other areas that could be elucidated by an empirical study. Event studies have analyzed stock price fluctuations in the days leading up to a tender offer announcement. However, event studies that focus instead on bailout announcements could provide considerable insight into whether leaks of government information and insider trading are a serious problem.

#### *F. Abuses by Government Contractors*

Private firms are asked to help structure bailout transactions, value assets acquired by the government in bailouts, manage these assets for the government,

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51. Abuses of government information that involve trading in securities markets are generally prohibited by criminal statutes and Securities Exchange Commission rules thereunder. The law of insider trading, however, can be confusing and, in some cases, difficult to prosecute. See Richard W. Painter, Kimberly D. Krawiec & Cynthia A. Williams, *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153 (1998).

help the government dispose of these assets, and perform other needed functions. These firms often learn critical information before markets do, including which companies will get bailed out, which investors will receive how much, which assets the government will acquire, and how and when the government will dispose of those assets. Most of these firms have other businesses, such as providing money management and investment advice, and some also trade for their customers' and their own accounts.

Misappropriation of government information is only one of the many potential conflicts of interest that can arise when private contractors are involved in government bailouts of private companies. There is also the risk that contracting firms may structure government transactions, or advise the government, in ways that are more helpful to their own interests or private clients' interests than the public interest.<sup>52</sup>

As I discuss more generally in my book, outsourcing government functions to the private sector means outsourcing decisions regarding ethics to contract personnel who, unlike government employees, are not bound by government ethics rules and often are not subject to government supervision.<sup>53</sup> For bailouts, however, outsourcing is probably unavoidable, because the government is venturing into unfamiliar areas that require specialized private-sector expertise. In financial services bailouts, in particular, the government can acquire derivatives portfolios and other financial assets that are hard to manage and even harder to discard. Private firms with experience in the field may be required.

Individuals also sometimes work for the government as contractors. As pointed out above in the discussion of the revolving door into government, some of the Treasury Department's advisors on financial services bailouts have been brought in as contractors. As such, they may work in Treasury Department office space, meet frequently with Treasury officials, be entrusted with government information, and be asked for advice on particular bailouts. They are not, however, bound by conflict-of-interest and other ethics rules imposed on government employees. If they come from Goldman Sachs, they may still retain their holdings in Goldman Sachs—and consult with Goldman Sachs—while working on bailouts that affect Goldman Sachs.

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52. Much of the scrutiny thus far has focused on one firm, BlackRock, which the Federal Reserve hired to perform a range of functions, including management of assets acquired from Bear Stearns, AIG, and other troubled institutions. Senator Charles Grassley (R-IA) observed that BlackRock “[has] access to information when the Federal Reserve will try to sell securities, and what price they will accept. And [it has] intricate financial relations with people across the globe. . . . The potential for a conflict of interest is great and it is just very difficult to police.” Eric Lipton & Michael J. de la Merced, *Wall St. Firm Draws Scrutiny as U.S. Adviser*, N.Y. TIMES, May 19, 2009, at A1. Meanwhile the Treasury Department is expected to announce winning bidders for assistance with the \$1 trillion plan to buy troubled assets from banks, and BlackRock is expected to win one of the contracts. *Id.*

53. See PAINTER, *supra* note 1, at 99-120.

While the government has recently sought to assert more control over the ethics of its contractors, there is a long way to go.<sup>54</sup> Most of the government's experience in overseeing contractors has been in areas such as defense<sup>55</sup> and scientific research.<sup>56</sup> Complex financial transactions and asset management are relatively new areas for government outsourcing to private firms, thus the government has less experience dealing with the types of conflict of interest likely to arise.

### III. REMEDIES FOR CONFLICTS OF INTEREST AND ETHICS PROBLEMS IN BAILOUTS

The principal purpose of this Essay is to point out particular problems with government bailouts of private industry that generally fall under the heading of "government ethics." Detailed solutions will not be proposed here. However, below I discuss a few general approaches to these problems and the potential advantages and disadvantages of each.

One approach would be to tighten up ethics rules for government officials who are involved in bailouts. There are a number of ways this could be done, although it is unclear how much improvement can result from more stringent ethics rules.

Officials involved in bailouts could be barred under Hatch Act regulations from participating in a broad range of "personal capacity" political activity, including partisan fundraisers and campaign events. Similar restrictions currently apply to government officials working in intelligence and national-security-related fields, where independence from politics is deemed to be particularly important. Compared with the lenient rules that apply to government officials generally, these more restrictive rules make officials less directly accessible to political operatives and campaign contributors. Given the enormous magnitude of federal bailouts and the discretionary decision-making in bailouts, this is another policy area that should be separated from politics as much as possible. Although political influence can always be exerted indirectly on government decision-makers, political influence is not likely to be as potent or as blatant if additional Hatch Act restrictions are imposed.

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54. *Id.* at 111-17. The Federal Acquisition Regulation (FAR)—codified at Title 48 of the Code of Federal Regulations—contains uniform policies and procedures for government contractors, including a requirement that certain contractors have a written code of business ethics and conduct. *See* 40 C.F.R. § 3.104 (2008).

55. The General Accounting Office (GAO) audited contracting by a wide range of Department of Defense (DOD) agencies and then issued a report in March 2008 on financial conflict-of-interest problems among DOD contractors. *See* GAO, DEFENSE CONTRACTING: ADDITIONAL PERSONAL CONFLICT OF INTEREST SAFEGUARDS NEEDED FOR CERTAIN DOD CONTRACTOR EMPLOYEES (2008), available at <http://www.gao.gov/new.items/d08169.pdf>. DOD entered into more than \$151 billion in service contracts in 2006. *Id.* at 5.

56. The National Institute of Health (NIH) has a conflict-of-interest policy for grant recipients embodied in Department of Health and Human Services regulations concerning federal financial conflict of interest (FCOI) in research pertaining to NIH grants and cooperative agreements. *See* 42 C.F.R. § 50.601-.607 (2008).

The revolving door “in” could be addressed, in part, by imposing quotas on the number of senior officials entering an agency from a single private sector employer. A Treasury Secretary from a large financial institution should recruit all or most of his senior staff from elsewhere. Also, the most senior positions in the Treasury Department, including deputy secretaries and assistant secretaries, are not appointees of the Secretary, but appointees of the President who are confirmed by the Senate. The Secretary often makes recommendations and the President sometimes defers to the Secretary on these nominations. The President, however, should not agree to nominate any other person coming in from the same bank as the Secretary and should also avoid nominating more than one or perhaps two Treasury officials coming in from any other bank.

The revolving door “out” could be tightened somewhat by barring officials leaving government jobs from receiving compensation for one or two years from a private sector employer that received a bailout they worked on while in government service.<sup>57</sup> Congress could also specifically provide that bailouts that are part of a package for the same industry are all the “same particular matter” involving specific parties for purposes of 18 U.S.C. § 207(a), so a former government official who participated in one bailout could not represent back to the government with respect to any of the other bailouts in the package.

These and other new rules might help reduce conflicts of interest, but the stricter rules could also discourage government service in areas that sorely need private sector expertise. Also, like existing ethics rules, these new rules might be easy to evade.

A second approach would be to have government decision-makers who are less prone to conflicts of interest and other ethics problems. Bailout decisions could be taken from the hands of political appointees and given to career government officials who are less likely to enter the private sector in the near future.

Bailouts are common in the type of industrial policy used by some European countries, but bailouts were not prevalent in the United States until recently. American-style political appointments and the American-style “revolving door” in and out of government may be inconsistent with an industrial policy that picks

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57. Similar rules currently apply to some government procurement officials. Under the Procurement Integrity Act, 41 U.S.C. § 423 (2008), a government employee who serves in certain capacities in the conduct of a procurement action or contract in excess of \$10 million is prohibited for one year from receiving compensation as an employee or consultant for the same contractor (an exception allows the former employee to receive compensation from another division of the contracting company if that division does not produce the same or similar products or services as those provided to the government in the contract). *See* 41 U.S.C. § 423; Federal Acquisition Regulation, 48 C.F.R. § 3.104 (2008). The one-year ban applies to government employees who serve in the following capacities on a contract over \$10 million: procuring contracting officer, source selection authority, member of the source selection evaluation board, chief of a financial or technical evaluation team, program manager, deputy program manager, or administrative contracting officer. 41 U.S.C. § 423. The ban also applies to government employees who make certain key decisions, such as awarding a contract or subcontract over \$10 million, awarding a modification of the contract, placing a delivery order under the contract, and paying or settling a claim on the contract. *Id.*

winners and losers in the private sector and where the government owns portions of private companies. A civil service like that of France may be better suited—from an ethics vantage point, at least—than ours for making bailout decisions.

These and similar solutions, however, risk making improvements in ethics at the expense of expertise. Officials investing government money may know little about the private sector if they have never worked there. Conflicts of interest may exist, but bailout decisions could be ill-informed.

Yet a third approach would be to systematize the bailout process itself. Congress could set up a “bailout board” with standing to review bailouts before they are implemented. Career government officials could sit on the board, as could, perhaps, some private sector persons. If such persons were full-time government employees or part-time special government employees (SGEs), not contractors, they would be subject to government conflict-of-interest rules.<sup>58</sup> One disadvantage of such a board, however, is that the board structure can be cumbersome and may not be able to react quickly to the pressing timeline that most bailouts require. Furthermore, a bailout board that involved SGEs with private sector entanglements could make ethics problems—including the risk of insider trading—worse, not better.

A variation on this approach would be to reduce the discretionary component of bailout decisions by setting up a federal apparatus for all industrial bailouts similar to the FDIC apparatus for banks. If this system is used as a model, should all private enterprises that are “too big to fail” pay bailout insurance premiums and be monitored for safety and soundness? Should bondholders be subject to a predetermined principal loss in the event of a bailout? While such a prearranged system creates more certainty regarding bailouts and may alleviate ethics concerns, having such a “universal industrial insurance” system creates more moral hazard for corporate managers (e.g., incentive to run private enterprises in a risky manner).

Indeed, any approach that relies on making bailout decisions less arbitrary and more predictable creates a dilemma for policymakers. While government ethics problems can be mitigated by narrowing government discretion, these gains could be offset when moral hazard problems undermine business ethics. If firms can receive a government bailout according to a prearranged script, even if they are not managed according to a government-imposed risk control script, firm managers may manage risk as if a portion of the risk is borne by the government. Personal and institutional responsibility in the private sector would erode further than they already have. Government could respond to the moral hazard problem by imposing risk management regulation on firms that receive bailouts. Doing so across a wide spectrum of firms ranging from investment banks to car companies, however, would involve a fundamental alteration in

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58. Compliance with these rules would have to be carefully monitored if SGEs were to serve on a bailout board, because SGEs often have significant private sector entanglements.

government's relationship with business. In short, systematizing the bailout process to reduce arbitrariness of government decision-making may not be a practical endeavor. Improved chances of ethical behavior by government employees may be more than offset by moral hazards for managers of firms that receive bailouts.

Whichever of these approaches—or combination of approaches—is taken to address government ethics and bailouts, a crucial ingredient is transparency. The public should know how bailout money is being used and who is receiving it. In a recent Freedom of Information Act suit, a federal judge ordered the Federal Reserve to disclose to Bloomberg News the names of companies in its emergency lending programs and information about the collateral—mostly mortgage backed securities—that was used to back the loans.<sup>59</sup> The Judge rejected as speculative the Federal Reserve's argument that disclosure could create a downward spiral of financial instability for participating institutions. Such conjecture, without a showing of imminent harm, failed to meet the Federal Reserve's burden of justifying its refusal to release the information. A few weeks later, a Treasury Department Inspector General's report alleged that senior Treasury officials affirmatively misled the public in statements about the health of large banks receiving government assistance in the Troubled Asset Relief Program (TARP).<sup>60</sup>

Disclosure is a cornerstone of government ethics law, as well as of federal securities law. Federal employees earning over a certain salary or holding jobs above a certain level of seniority are required to disclose their financial assets and financial transactions on Form 278. Shareholders in public companies have access to annual reports, including audited financial statements, as well as quarterly reports. When a public company makes a substantial investment in another company, shareholders are entitled to find out about it. When government money is used for loans to troubled companies, or in buying assets from those companies, a similar rationale justifies disclosure to the public. Eventually, it is the public that will bear the profit or loss incurred from the investment.

Disclosure, however, will only go so far, particularly if disclosure is only provided after bailout decisions are already made (also, the later disclosure occurs in the decision-making process, the greater the risk of insider trading and other inappropriate uses of government information may be). Disclosure may give Bloomberg News and other journalists more to write about, but it is not

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59. *Bloomberg, L.P. v. Bd. of Governors of the Fed. Reserve System*, No. 08-CV-9595, 2009 WL 2599336 (S.D.N.Y. Aug. 24, 2009). The Federal Reserve appealed the order on September 30, 2009. See Board of Governors of the Federal Reserve System, Pending Cases Involving the Board of Governors, <http://www.federalreserve.gov/bankinforeg/legaldevelopmentscases.htm> (last visited Oct. 6, 2009) (on file with the *McGeorge Law Review*).

60. See OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 18 (Oct. 21, 2009), available at [http://www.sigtar.gov/reports/congress/2009/October2009\\_Quarterly\\_Report\\_to\\_Congress.pdf](http://www.sigtar.gov/reports/congress/2009/October2009_Quarterly_Report_to_Congress.pdf).

clear what, if anything, the public will do with that information. Disclosure of information about campaign contributions, for example, has done little to dampen enthusiasm for contributing or for implicit quid pro quo arrangements between government officials and their contributors. Also, if the public approaches disclosure about bailouts as a *fate accompli*—as a reason for being cynical but not for taking concrete action—disclosure may do little to change behavior of government officials or the companies they bail out.

For all of these reasons, the best approach to this problem is probably to have fewer government bailouts or none at all. Conflicts of interest and other ethics problems in bailouts are very difficult to solve, regardless of the type of system used to administer bailouts. Some solutions to these ethics problems could have even greater economic cost than the problems themselves. Avoiding bailouts may be the most cost effective approach from an ethics vantage point as well as from that of economic policy.

The government, perhaps, should not allow most businesses to get so large that they are “too big to fail.” “Bigness” may need to be considered as a factor in antitrust law regardless of whether it is directly tied to monopolistic pricing or other abuse of market power. Mergers resulting in financial services conglomerates as large as Citibank are questionable if taxpayers must pick up the tab when the conglomerates fail.

When businesses are allowed to get “too big to fail,” there perhaps should be some regulation for safety and soundness. Corporate law could do its part by imposing on managers a fiduciary obligation to look after the interests of debt-holders as well as shareholders, particularly when leverage reaches certain levels. Manager compensation packages could be designed to discourage rather than encourage excessive risk-taking. Executives earning extraordinary compensation, i.e., more than \$3 million per year, should perhaps, for purposes of personal liability to creditors of the company that employs them, be treated as partners or joint venturers with the company, even if that company is itself a corporation or other limited liability entity; such a liability rule would bring back some of the reduced moral hazard associated with the partnership form used by many investment banks before the 1980s.<sup>61</sup> The advantages and disadvantages of such proposals are beyond the scope of this paper, but some of these proposals may be cheaper alternatives to the prevailing practice of vacillating between a *laissez faire* approach to business risk and the more aggressive approach to using government bailouts when risks do not pan out.

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61. I am currently working on such a proposal with Professor Claire Hill, also of the Minnesota faculty.

#### IV. CONCLUSION

This Essay raises more questions than it provides answers, and it is intended to be that way. As discussion of this issue continues, commentators will hopefully develop more concrete proposals.

More general prescriptions, such as those set forth in my recent book on government ethics—many of which focus on the lobbying industry and campaign finance reform—may be insufficient to address conflicts of interest and other government ethics problems in bailouts. These problems are most salient when government officials move in and out of the private sector and also direct trillions of dollars to particular companies. The magnitude of these problems is difficult to measure, although empirical work in some areas, including insider trading, might be informative. My early assessment is that there are significant government ethics problems with bailouts. Given the amount of money involved and the potentially adverse impact on financial markets of any problem that increases the arbitrariness of government decision-making, the economic impact of ethics problems in bailouts is probably substantial.

There is also a risk that the government makes mistakes and then tries to fix the situation by throwing good money after bad. Some bailouts will not work, and the government will lose money. Conflicts of interest and other ethics problems will arise in association with some of these failed bailouts. Rather than admit errors in judgment and recover what the government can, government officials may invest yet more money in the irrational hope of turning around a bailout gone wrong. Psychological studies show that persons in a “loss frame” often make risk-preferring decisions in order to avoid a loss, even if the risks they take are irrational.<sup>62</sup> Casinos understand that gamblers down on their luck will likely take irrational risks to extract themselves from a loss. Government decision-makers, who are gambling with taxpayers’ money in bailouts, are probably also prone to the same risk-preferring behavior. If their own business judgment or ethical conduct could be questioned when a bailout goes wrong, government officials may be even more prone to cover things up with an infusion of yet more government money.<sup>63</sup>

Unfortunately, as also discussed above, my initial impression is that some, if not most, solutions to government ethics problems in bailouts may be more costly than their corresponding benefits. The best alternative may be a bailout-free economy, at least for the vast majority of industry sectors where the government does not regulate or monitor risk management.

Creating an economic system that does not need bailouts is a challenge for economic policymakers, not government ethics advisors. This challenge involves, among other things, aligning the incentives of economic actors with the

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62. See Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263 (1979).

63. See PAINTER, *supra* note 1, at 282 (discussing “The Psychology of the Cover-up”).

consequences of their actions. In some instances, better and more consistently enforced regulation may be appropriate; in other instances, the optimal solution may be less regulation and a clearer message that people must bear the consequences of their actions. An intelligent approach requires not only informed decisions about when government should intervene to address moral hazard and other problems, but also knowing when government intervention through bailouts or otherwise makes problems worse.