Banking and Finance Law Daily Wrap Up, TOP STORY—Fed. Cl.: AIG takeover wrong but caused no damages, (Jun. 15, 2015)

Banking and Finance Law Daily Wrap Up

http://prod.resource.cch.com/resource/scion/document/default/blw01fe45e50e7c2d10008253d8d385ad169402?cfu=Legal&cpid=WKUS-Legal-Cheetah&uAppCtx=cheetah

By Richard A. Roth, J.D.

Neither the Federal Reserve Board nor the Federal Reserve Bank of New York had the legal authority to demand nearly 80 percent of American International Group's ownership as a condition of providing emergency funding at the height of the financial crisis, a judge for the Court of Federal Claims has decided. However, while the government unjustifiably treated AIG much more harshly than it treated other financial institutions, no damages were owed to the company's shareholders because AIG's only alternative was bankruptcy. While the New York Fed's takeover reduced shareholders' equity to only 20 percent of what they once had, 20 percent of something is better than 100 percent of nothing, the judge said (*Starr International Co., Inc. v. U.S.*, June 15, 2015, Wheeler, T.).

The judge's extensive recitation of the genesis of the financial crisis, AIG's liquidity problems, and the government's response left no doubt that he believed the government had acted wrongly, including by both imposing unjustifiably harsh credit terms on the company and taking much of the company's equity to the profit of the government. For example, the judge's side-by-side comparison of how the government treated AIG and how it treated Morgan Stanley demonstrated that:

- AIG initially was charged a 12-percent interest rate, while Morgan-Stanley was to pay between 2.25 and 3 percent.
- AIG was to pay a 2-percent commitment fee, while Morgan Stanley was charged no commitment fee.
- The government claimed 79.9 percent of AIG's equity, while taking no equity position in Morgan Stanley.

The judge also concluded that "[t]he evidence supports a conclusion that AIG was *less* responsible for the crisis than other major institutions." Moreover, "The Government's justification for taking control of AIG's ownership and running its business operations appears to have been entirely misplaced," he said.

In the end, the U.S. Treasury received a $22.7 billion profit on the AIG stock it acquired, the judge said.

Claims raised. The suit was brought on behalf of two classes of AIG shareholders. The first was a class of shareholders who owned common stock during the week when the government took the 79.9-percent interest in exchange for $85 billion in credit that the company needed to meet its immediate liquidity needs. The second was a class of shareholders who held common stock nine months later when AIG's board of directors, now under the control of the federal government, approved a 20-for-1 reverse stock split that reduced the number of shares that were issued but not the total number of authorized shares. Eventually the government exchanged its preferred shares for many of those unissued shares without any shareholder vote.

According to the judge, there were two central issues in the case:

1. Did the New York Fed have the legal authority to acquire an interest in AIG in exchange for credit?
2. Did taking the 79.9-percent equity interest constitute taking the shareholders' property without just compensation?

Jurisdiction. The judge first had to address a challenge to Court of Federal Claims jurisdiction over the "illegal exaction" claim—the claim that the New York Fed unlawfully took the shareholders' equity in AIG. Normally, Court of Federal Claims jurisdiction is limited to claims based on a "money-mandating source of law." However,

according to the government, the illegal exaction claim was based on Federal Reserve Act Section 13(3) (12 U.S.C. §343), which was not money-mandating.

The government's jurisdictional challenge was rejected. If the argument was correct, the government "could nationalize a private corporation, as it did to AIG, without any fear of claims or reprisals," the judge wrote. The necessary implication of the FRA section was that injured shareholders could sue, and that was enough to establish jurisdiction.

The judge also was unpersuaded by the government's alternative claims that the FRA section was not money-mandating because it was discretionary and that the section was not intended to benefit anyone other than the Federal Reserve System. "The remedies for the financial system must be available to all who comprise it," including the shareholders of a company that has been nationalized, he said.

Illegal exaction. The Federal Reserve Board and the New York Fed had the legal authority to extend credit to AIG, but they did not have the legal authority to take an ownership interest, the judge determined. Noting that the AIG bailout was the first time among the hundreds of emergency loans the Fed has made that it took over a company, the judge said definitively that "there is no law permitting the Federal Reserve to take over a company and run its business in the commercial world as consideration for a loan."

As it read before it was amended by the Dodd-Frank Act, FRA Section 13(3) imposed four criteria for an emergency loan to a commercial company:

1. the existence of unusual and exigent circumstances;
2. authorization of the loan by at least five Fed governors;
3. the availability of collateral securing the loan to the satisfaction of the lending Federal Reserve Bank; and
4. the borrower's inability to borrow from other banks.

If the government exercises its discretion to provide a benefit, such as emergency credit under the FRA, it cannot condition that benefit on the surrender of rights it has no authority to demand, the judge said. Nothing in the FRA gave the Fed or the New York Fed the authority to demand any AIG equity as a condition of the credit, regardless of the existence of a national crisis.

While it is true that FRA Section 13(3) says that emergency credit is to be "subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe," this did not extend the Fed's powers beyond what were specifically delegated, the judge continued. The Fed's incidental powers to manage its loans could not be broader than the powers delegated to it by Congress, and those delegated powers did not include taking equity in a borrower.

The AIG board's vote to accept the conditions on the emergency credit could not be a defense to the illegal exaction claim, the judge also determined. A private person cannot ratify an illegal action by the government.

Equity in trust. The judge also observed that the Fed's outside counsel eventually concluded that there was no authority to hold an equity interest, and the Fed's own legal staff concurred. This required a restructuring of the transaction to put the shares into a trust of which the Fed was the beneficiary.

However, the creation of the trust did not remedy the illegal exaction, he said. The trust was created only after the New York Fed took the impermissible action, and even then the trustees were controlled by the Fed.

Taking claim. The illegal exaction claim and the taking claim were alternatives, the judge then said. The former was based on the theory that the 79.9-percent interest was taken without legal authority, while the latter was based on the theory that the taking was legal but that compensation was due. Only one could be the case and, since the decision that there had been an illegal exaction meant that the Fed and New York Fed had no legal authority, the taking claim failed.

Reverse split. The shareholders complaining about the effects of the reverse stock split had no claim, the judge said, because there was no evidence of any improper motive at the time of the shareholder vote that authorized the restructuring. The class claim was that the reverse split was orchestrated to allow the government later to

exchange the preferred shares it held for common shares without an otherwise required separate vote by the common shareholders. However, the judge rejected this claim.

The evidence actually showed that the purpose of the reverse split was to prevent the delisting of AIG shares, which then were trading at or below $1 per share, the judge pointed out. The shareholders knew when they voted that the reverse split would make nearly five billion shares available to be issued in the future, and 85 percent of the votes—including those of the class representative—were to approve the restructuring. The government's exchange of preferred shares for common shares was not under consideration at the time and did not happen until more than a year later.

Damages. The class of shareholders who owned shares at the time of the initial loan had to demonstrate an economic loss to prove damages from the illegal exaction of their AIG equity, according to the judge. What mattered was the shareholders' loss, not the $22.7 billion that the government later gained from selling the stock. By that measure, the shareholders lost nothing and were entitled to recover nothing.

Had the government not stepped in with the emergency loan, no matter how onerous the loan's terms were, the "inescapable conclusion" was that AIG would have filed for bankruptcy, the judge believed. The shareholders' shares then would have been worth nothing. The government's actions preserved for the shareholders 20 percent of their equity and, as one participant told AIG's board as it considered the offer, "[20] percent of something [is] better than [100] percent of nothing."

Waiver. Wrapping up his opinion, the judge easily rejected the government's defense that the AIG shareholders had waived their claim by not suing until after they had accepted the benefits of the bailout. The suit was filed well within the statute of limitations, he said, and the government and its advisors "carefully orchestrated the AIG takeover so that the shareholders would be excluded from the process." The government could not claim a waiver after it "intentionally kept the shareholders in the dark as much as possible."

Fed response. Responding to the decision, the Fed briefly but strongly defended its actions, calling them "legal, proper and effective." "The terms of the credit were appropriately tough to protect taxpayers from the risks the rescue loan presented when it was made," the Fed added.

The case is No. 11-779C.

Attorneys: David Boies (Boies, Schiller & Flexner LLP) and John L. Gardiner (Skadden, Arps, Slate, Meagher & Flom) for Starr International Company. Brian A. Mizoguchi (U.S. Department of Justice) for the United States.

Companies: American International Group, Inc.; Starr International Company, Inc.

MainStory: TopStory DistrictofColumbiaNews FederalReserveSystem FinancialStability