

Too Important to Fail: Bankruptcy versus Bailout of Socially Important Non-Financial Institutions

Shlomit Azgad-Tromer*

Systemically important financial institutions are broadly considered to impose a risk to the entire economy upon failure; thus governments act upon their failure, providing them with an implied insurance policy for ongoing liquidity. Yet governments frequently provide de-facto liquidity insurance for non-financial institutions as well. For example, recently in the U.K., hospital trusts were sharing millions in bailouts. A decade earlier, a federal court approved California's multibillion-dollar bailout of Pacific Gas & Electric Corporation. After 9/11, the U.S. Congress passed the Air Transportation Safety and System Stabilization Act, which provided the airline industry with financial aid. In all of these cases, taxpayer money was used to rescue non-financial organizations. Social stability relies heavily on sustaining ongoing organizational services to retail consumers.

The essay defines a new category of socially important non-financial institutions (SINFIs) and proposes a method for their identification using a two-layer cumulative test, where the first layer is identification of the essential markets required for maintaining social stability; and the second layer is identification of the organizations providing these essential services as situational monopolies that cannot be substituted for by consumers or may be substituted for only with substantial switching costs.

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

The essay further analyses the structural characteristics of socially important non-financial institutions. As situational monopolies providing essential services, SINFIs are less likely to foster efficient competition. The elevated probability of rescue in case of failure makes the socially important non-financial institution prone to unwarranted expansion, and distorts its corporate governance well before failure occurs. The resulting moral hazard creates both enhanced incentives for excessive leverage and risk-taking, and elevated incentives for empire building due to the weaker corporate governance mechanisms available.

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Introduction

Size is the measure of the day in financial regulation. Too-big-to-fail financial institutions are broadly considered to pose a risk to the entire economy upon failure.¹ Thus governments act upon failure of too-big-to-fail institutions, providing them with an implied insurance policy for ongoing liquidity.² Yet governments frequently provide defacto liquidity insurance for non-financial institutions as well. For example, recently in the U.K., 35 hospital trusts were sharing £536 million in non-repayable bailouts in order to keep services running smoothly during 2013-2014.³ A decade earlier, a federal bankruptcy judge approved California's multibillion-dollar bailout of Pacific Gas & Electric Corporation.⁴ In an effort to stabilize and sustain air transportation after 9/11, the U.S. Congress passed the Air Transportation Safety and System Stabilization Act, which provided the airline industry with financial aid valued at as much as \$10 billion.⁵ In all of these cases, taxpayer money was used to rescue non-financial firms.

As this paper argues, in the failure of non-financial institutions, size cannot justify governmental bailouts. No one would consider bailing out a corporation providing luxury designer apparel

¹ For leading examples see the analysis in Mark J. Roe, *Structural Corporate Degradation Due to Too-Big-To-Fail Finance*, 162 *University of Pennsylvania Law Review* 1219 (2014); ANAT ADMATI AND MARTIN HELLWIG, *THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT* (2013); DAVID A. SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* (2010).

² In the U.S., governmental insurance applies either through the federal reserve lending authority, as defined in 12 C.F.R. § 201 (2002); or through the orderly liquidation of the failing entity by the Federal Deposit Insurance Corporation (FDIC), assuming the liabilities of the failing corporation through a bridging financial organization, under title II of the Dodd Frank Act, 12 U.S.C. § 5394, where no governmental funding is provided.

³ Denis Campbell, *Rise in Bailouts as More Hospitals Overspent Their Budget*, *The Guardian* (July 22, 2014). Retrieved online June 24, 2015:

<http://www.theguardian.com/society/2014/jul/22/hospital-trusts-overspend-budgets-bailouts>

⁴ Judge Approves PG&E Bailout, *Wall Street Journal* (December 23, 2003). Retrieved online June 24, 2015:

<http://www.wsj.com/articles/SB107214516968910000>

⁵ Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, 115 Stat. 230 (2001). See also Margaret Blair, *The Economics of Post September 11 Financial Aid to Airlines*, 35 *Indiana Law Review* 367 (2002).

brands with a huge consolidated assets portfolio. Yet organizational failure may impose significant risk to social stability beyond the financial sector. Our lives in the early 21st century are heavily influenced by and dependent on the ongoing provision of products and services by private organizations.⁶ Banks are essential for the provision of monetary services and credit.⁷ Other organizations supply the public with energy, electricity and gas; provide public transportation; run major hospitals; and much more. Social stability relies heavily on sustaining ongoing organizational services to retail consumers. Stability is the new underlying narrative of financial regulation.⁸ The Dodd-Frank Wall Street Reform and Consumer Protection Act (“The Dodd-Frank Act”), Basel III, the Financial Stability Board and the leaders of central banks focus extensively on promoting financial stability, not only through macroeconomic policy but also through the regulation of corporate governance for individual corporations considered systemically important financial institutions. However, little attention is paid in the literature to the effect on stability in the event of the financial failure of socially important non-financial institutions.

This essay proposes a framework for the identification of socially important non-financial institutions (SINFIs). Governmental insurance for corporate solvency is required when sustaining the provision of products or services by the failing corporation is vital for the adequate functioning of society. Governments should sometimes intervene to sustain the provision of essential products and services but need not intervene with public funding to reduce haircuts for

⁶ Shlomit Azgad-Tromer, *A Hierarchy of Markets: How Basic Needs Induce a Market Failure*, forthcoming Depaul Journal of Business and Commercial Law (2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2547995.

⁷ See the European Commission Recommendation on access to a basic payment account (C(2011)4977); Commission decision regarding state aid No N 514/2001- United Kingdom OJ C 186, 6.8.2003; State aid No N 244/2003 – United Kingdom – Credit Union Provision of Access to Basic Financial Services, OJ C 223, 10.9.2005; State aid No N 642/2005 – Sweden – Posten, OJ C 291, 5.12.2007; State aid No C 49/2006 – Italy – Poste Italiane – distribution of postal saving certificates, OJ L 189, 21.7.2009.

⁸ For a discussion of the theoretical foundations of stability as the underlying narrative, see Katharina Pistor, *On the Theoretical Foundations for Regulating Financial Markets* (Columbia Law Sch. Working Paper No. 12-304, 2014).

institutional creditors or derivative obligations.⁹ Based on the analysis of three examples of governmental bailouts of non-financial institutions, the essay proposes a framework for the assessment of social importance, based on a two-layer test. The first layer is identification of the essential markets required for sustaining lives and maintaining social stability; the second layer is identification of the particular organizations providing these essential services as situational monopolies, that cannot be substituted for by consumers or can be substituted for only with substantial switching costs. Sustaining the provision of services or products by the socially significant non-financial firm becomes a matter of public concern because it provides products or services that are deemed to be part of the social contract, and because its consumers are facing high or inapplicable switching costs for its essential services.

The essay argues that the failure of socially significant non-financial institution poses a risk to social stability, creating a category of too-important-to-fail industrial firms. Liquidity distress for a socially significant non-financial institution is unlikely to be resolved efficiently through bankruptcy, not only because of the lengthy procedure for solving the operating contingency and ensuring continued service,¹⁰ but also because sustaining the provision of service by the socially significant firm imposes significant positive externalities on the general public, rendering the main features of bankruptcy: namely, debtor-in-distress rules and the ability to sell assets free and clear of all liens,¹¹ sub-optimally efficient, as the potential private investor is unlikely to capture the full value of investment in the socially significant firm. Thus, in a distressed socially

⁹ Lucian A. Bebchuk, *AIG Still Isn't Too Big To Fail*, WALL ST. J., March 20, 2009.

¹⁰ Compare to the too-big-to-fail argument for bankruptcy inadequacy given at Edward Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?* 82 Temp. L. Rev. 449, 451 (2009-2010).

¹¹ Kenneth Ayotte and David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35(3) The Journal of Corporation Law, 476 (2010).

important institution, both the likelihood of new investment opportunities and their potential terms are expected to be sub-optimally valued, and public finance is likely to be required.

Finally, the essay offers an analysis of the unique structural characteristics of the socially important non-financial institution. As situational monopolies of essential markets, too-important-to-fail firms induce a behavioral market failure and are prone to unwarranted expansion. At the corporate level, the implied subsidy may translate to excessive leverage and enhanced risk taking. As the corporate governance pressures that typically mitigate agency costs are weaker in too-important-to-fail firms, the incentives for empire building and the accompanying moral hazard are expected to be elevated.

The essay is structured as follows. Part I discusses three examples of non-financial bailouts by governments and offers a framework for the identification of socially significant non-financial institutions ex-ante, based on a two-layered test: first, identifying the essential industries sustaining social stability; second, identifying the organizations acting within such essential industries that may not be substituted for by consumers. For that purpose, Part I portrays the determinants of industry essentiality, offers methods for the assessment of essential markets, and defines the characteristics of the “situational monopoly”, a position granting the socially significant firm exclusivity for providing the essential service or product to its consumers.

Part II discusses the prospects of bankruptcy versus bail-outs for socially significant non-financial firms. It argues that rescue funding may be required to sustain essential services by the socially important situational monopolist, due to the risk to social stability rooted in the immediate crisis of confidence caused by its potential operating failure. Furthermore, the likelihood of a need for public rescue funding is bigger for socially significant firms, due to positive externalities unlikely to be captured by any private investor acquiring the distressed firm

or lending to it under the debtor-in-possession rule. However, the infusion of public capital need not be limited to a governmental bailout, and using bankruptcy is possible with the Treasury assuming the role of debtor-in-possession financier.¹²

Part III offers an analysis of the structural characteristics of socially important non-financial institution, both in the industry and at the corporate level. As situational monopolies, too-important-to-fail firms are less likely to foster efficient competition. At the market level, the essay argues, SINFI's induce the risk of a behavioral market failure and are prone to unwarranted expansion. At the corporate level, the essay claims that as the too-big-to-fail, the too-important-to-fail SINFI's impose social costs driven by the implied subsidy that also lowers their ongoing funding costs.¹³ The elevated probability of rescue in case of failure distorts the organizational incentives of the SINFI's' management well before failure occurs, increasing the taste for leverage and excessive risk taking. Further, the incentives for empire building are enhanced in SINFI's, where corporate governance pressures for mitigating agency costs are weaker.¹⁴

Socially important non-financial institutions are the most important organizations in our lives, the organizations upon which we depend for social stability. These firms become too-important-to-fail because their unique position within the market makes their retail consumers utterly dependent upon their continuous service. An uninterrupted service by SINFI's is part of the social contract, an inherent expectation of our civil life. The contribution of this essay is to identify the category of socially important non-financial institutions, showing why they are likely to require

¹² Kenneth Ayotte and David A. Skeel, Jr, *supra* note 11, page 488. Using the bankruptcy process to infuse public capital may be preferable, as automatic stay may serve to suspend and differentiate funding of continued operations from funding of prior losses.

¹³ Mark J. Roe, *Structural Corporate Degradation Due to Too-Big-To-Fail Finance*, *supra* note 1 id, 1419, 1439-1440 (2014).

¹⁴ Compare: Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig, and Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Socially Expansive* 22-23 (Stanford Univ. Graduate Sch. of Business Research Paper No. 13-7,2013); Lucian Bebchuk and Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010); Lucian A. Bebchuk, *How to Fix Bankers' Pay*, 139(4) DAEDALUS (2010).

rescue funding upon failure, and portraying their structural degradation and unique corporate governance. Policy questions in acting upon these criteria open many additional research directions in corporate law, corporate governance and antitrust policy, to be further explored in future works.

Part I: The Socially Important Non-Financial Institution

This part of the essay provides three examples of socially important non-financial institutions, and then provides a framework for their identification prior to failure.

A. Examples

(1) A Major Hospital

The illiquidity of major hospitals often raises the bailout debate. In the U.K., the government recently paid millions of non-repayable bailouts to keep services running smoothly.¹⁵ In 2015, Clayton county of Georgia bailed out the Southern Regional Medical Center with \$50 million in taxpayer money to save it from a financial cliff.¹⁶ In 2014, the state Department of Health took over the Interfaith Medical Center of Brooklyn and appointed former bankruptcy judge Melanie Cyganowski and Steven Korf to oversee a restructuring made possible by an announced \$20 to 30 million bailout.¹⁷ Some of the bailed-out hospitals are sponsored by governments. Others are private institutions, for-profit corporations or non-profit charities. Notably, the bailout debate is triggered for major hospitals regardless of the hospitals' funding structure or choice of organizational form. It is the risk to the major hospital's life-saving function that makes the funding an immediate public concern.

¹⁵ See supra note 3 id.

¹⁶ Andy Miller, *A Hospital's Main Strategy – Survival*, Georgia Health News (March 5, 2015), available on line: <http://www.georgiahealthnews.com/2015/03/hospitals-main-strategy-survival/> (retrieved July 17, 2015).

¹⁷ Danielle Furfaro, *State Takes Over Interfaith, Promises Bailout*, The Brooklyn Paper (March 27, 2014), available on-line: http://www.brooklynpaper.com/stories/37/13/all-interfaith-hospital-state-takeover-2014-04-04-bk_37_13.html

Not every corporate failure of a medical provider imposes a risk to social stability. When a pediatric clinic goes out of service, there are typically many others around to offer patients an adequate substitute. But when a major hospital shuts down due to illiquidity, runs out of medical supplies, or cannot pay salaries to its medical personnel, there is likely to be a cost in human lives, which may also be reflected in a loss of public trust and degraded social stability. Proximity to hospital services has been found to be correlated with patient mortality.¹⁸

For a patient suffering a heart attack, the closest major hospital is a monopoly providing the essential health services. We rarely choose to become sick; the patient status is most often imposed upon individuals non-voluntarily. We need the hospital when and where we become sick, and then, we frequently need it immediately. We cannot decline the purchase of health services and are rarely in a position to safely defer their purchase. A major hospital is a situational monopoly providing the public's right to health, which is considered by many a human right,¹⁹ a derivative of the right to life.

(2) Electricity and Power Provider

On April 2001, the Pacific Gas & Electric Company (PG & E), a retail electricity supplier for most of northern and central California, serving back then a population of

¹⁸ Jon Nicholl, James West, Steve Goodacre, and Janette Turner, *The relationship between distance to hospital and patient mortality in emergencies: an observational study*, 24(9) *Emerg Med J.*, 665–668 (2007).

¹⁹ Jennifer Prah Ruger, *Toward a Theory of a Right to Health: Capability and Incompletely Theorized Agreements*, 18(2) *Yale Journal of Law & the Humanities* (2006); Aeyal Gross, *Is There a Human Right to Private Health Care?*, 41(1) *The Journal of Law, Medicine and Ethics* 138-146 (2013).

15 million, filed for Chapter 11 bankruptcy.²⁰ PG & E asserted that as a result of the energy crisis in California starting May 2000,²¹ and because its retail rates were frozen, it was unable to recover approximately \$9 billion of electricity procurement from its customers, resulting in billions of dollars of defaulted debt and a downgrading of its credit by all the major credit-rating agencies.²² Others have suggested that the roots of failure lay in a risky business strategy; an extensive acquisition policy adopted by PG& E²³; excessive debt and “abnormally large” dividend distributions.²⁴ Despite intensive borrowing, in April 2001 PG & E was out of cash, and out of methods to raise cash: it could no longer pay for wholesale power purchases made a month earlier.²⁵

After lengthy judicially-supervised settlement negotiations among PG & E, its parent corporation, the Official Committee of Unsecured Creditors and the California Public Utilities Commission, in January 2004, federal judge Dennis Montali approved both a Plan of Reorganization under Chapter 11 of the Bankruptcy Code for PG&E and a Settlement Agreement among PG&E, its parent PG & E Corporation and the California Public Utilities Commission, overruling objections to confirmation of the

²⁰ 304 B.R. 395, 42 Bankr.Ct.Dec. 131. See also the historical description at PAUL W. MACAVOY, *THE UNSUSTAINABLE COSTS OF PARTIAL DEREGULATION*, (2007), p. 70.

²¹ For a graph demonstrating the spike in power prices in the relevant period, see Macavoy, *supra* note 20, at p. 86.

²² OPINION MODIFYING THE PROPOSED SETTLEMENT AGREEMENT OF PACIFIC GAS & ELECTRIC COMPANY, PG&E CORPORATION AND THE COMMISSION STAFF, AND APPROVING THE MODIFIED SETTLEMENT AGREEMENT, December 18, 2003, Decision 03-12-35, available on line at: http://www.pge.com/includes/docs/pdfs/shared/environment/pge/stewardship/cpuc_settlementagreement.pdf (retrieved September 6, 2015).

²³ Tyson Slocum, *Electric Utility Deregulation and the Myths of the Energy Crisis*, 21(6) *Bulletin of Science, Technology & Society* (2001).

²⁴ See discussion at Macavoy, *supra* note 20 p. 83.

²⁵ See discussion at Macavoy, *supra* note 20 p. 90-91.

reorganization plan.²⁶ The purpose of the approval and of the Settlement Agreement itself was “to enable PG &E to emerge from chapter 11 and resume fully its traditional role of providing safe and reliable electric and gas service,” acknowledging “reliable electric and gas service as being of the utmost importance to the safety, health and welfare of California’s citizenry and economy.”²⁷

Because PG& E had not been able to pay for wholesale power, its liquidity crisis imposed a threat to its continued and uninterrupted operation, implying the risk of a state-wide electricity outage. Life without electricity in the 21st century is life in chaos: light, heat, appliances, trains, traffic lights, computers– all are subject to the electricity provider’s liquidity risk. California’s elected officials were not letting this bleak scenario develop into reality. The approved bankruptcy settlement provided that the California Public Utilities Commission establish a “Regulatory Asset” of \$2,210,000,000, as a new, separate and additional part of PG & E’s rate base.²⁸ This Regulatory Asset, an accounting device designed to boost PG & E equity so that it regained an investment-grade rating from the credit-rating firms, was approved to be amortized in PG & E’s electrical retail rates over nine years.²⁹ PG & E was bailed out by an IOU from its retail consumers.

More than an occasional crisis, the case of PG & E may raise a generic pattern of bounded bankruptcy options for socially important non-financial institutions. Recently in Texas, the Texas energy company Energy Future Holdings Corp (EFH) filed for

²⁶ 304 B.R. 395, 42 Bankr.Ct.Dec. 131.

²⁷ *Id.*, p. 7.

²⁸ *Id.*

²⁹ *Id.*.

bankruptcy.³⁰ EFH was purchased seven years prior to the bankruptcy filing by a consortium of private equity firms and hedge funds, in what was considered the largest leveraged buy-out in history: over 96% borrowed funds, totaling to over \$40 billion of debt.³¹ Again, debate arises as for the the reasons of failure, with possibilities stretching from a spike of power-supply wholesale prices to excessive debt and an over-generous dividend distribution.³² In its 10K form for the 2014 fiscal year, released on March 31, 2015, EFH describes a variety of bankruptcy-related risks, including “a decrease in the number of counterparties that are willing to engage in commodity related hedging transactions with us and a significant increase in the amount of collateral required to engage in any such transactions; a loss of, or a disruption in, the materials or services received from, suppliers, contractors or service providers... difficulties in the retention of employees; management distraction”; “restriction of “access to capital, the cost of such capital” and “[in]ability to generate sufficient cash flow to make interest or adequate protection payments, or refinance, our debt instruments, including the DIP Facilities,” all potentially leading to the ultimate risk of “limitations on our ability to operate our business.”³³ Meanwhile, the

³⁰ In a Current Report filed pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, EFH announced that “On April 29, 2014, EFH Corp. and the substantial majority of its direct and indirect subsidiaries, ..., filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware”. Form 8-k available on line:

<http://www.sec.gov/Archives/edgar/data/1023291/000119312514164757/d716637d8k.htm>

³¹ Peter Lattman, *A Record Buyout Turns Sour for Investors*, *The New York Times* (February 28, 2012); David Carey Sabrina Willmer, *Biggest Buyout Gone Bust in Energy Future Dims Megadeals*, Bloomberg Business (April 30, 2014).

³² Eileen Appelbaum and Rosemary Batt, *The Real Lesson From EFH Bankruptcy*, Huff Post Business Blog, May 16 2014, available at: http://www.huffingtonpost.com/eileen-appelbaum/efh-bankruptcy_b_5339343.html. See also EILEEN APPELBAUM AND ROSEMARY BATT, *PRIVATE EQUITY AT WORK: WHEN WALL STREET MANAGES MAIN STREET* (2014).

³³ Energy Future Holdings Inc, Annual Report for the 2014 Fiscal Year, available on the Edgar: <http://www.sec.gov/Archives/edgar/data/1023291/000102329115000003/efh-12312014x10k.htm>

Texas Public Utility Commission, which regulates public electricity in Texas, is facing a deficit in electrical power generating capacity, and is debating the effect on operational reliability.³⁴ The Texas Public Utilities Commission has already raised prices for Texas electricity consumers, requiring payment for availability of incremental generation through “capacity markets,”³⁵ in an action viewed by critics as a disguised bailout.³⁶

(3) Public Transportation Provider

In response to the terrorist attacks of September 11, 2001, the US congress passed the Air Transportation Safety and System Stabilization Act (ATSSSA),³⁷ signed by President Bush into law on September 23, 2001.³⁸ ATSSSA created the Air Transportation Stabilization Board (ATSB), which was authorized to issue federal credit instruments, such as direct loans or guarantees,³⁹ and provide additional \$5 billion in immediate and direct payments to airlines to compensate for the expected

³⁴ See, for example, a presentation by Kenneth W. Anderson, Jr., titled “The Reliability Triad’s Second leg: Operational Reliability, The Texas market-Based Approach”, August 2014. Available on line: http://www.puc.texas.gov/agency/about/commissioners/anderson/pp/Utility_Law_Conference_The_Reliability_Triad.pdf

³⁵ *Texas Public Utility Commission "PUCT" Approves Proposals to Raise Energy Price Offer Caps*, National Law Review, available at: <http://www.natlawreview.com/article/texas-public-utility-commission-puct-approves-proposals-to-raise-energy-price-offer-#sthash.0977AnMd.dpuf>

³⁶ See for example: Weston Hicks, *Texas Electricity Bailout*, AgendaWise Reports (October 31, 2013), available on line at: <http://www.agendawise.com/2013/10/texas-electricity-bailout/>

³⁷ Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, 115 Stat. 230 (2001).

³⁸ James D. Tussig & Stewart D. Herman, *Government Acts to Bail Out U.S. Airlines*, 226 N.Y.L.J. 1 (2001).

³⁹ Pub. L. No. 107-42, 102(b), 115 Stat. 231 (2001).

reduction in air traffic.⁴⁰ Between 2001 and 2003, the ATSB approved bailout loan guarantees worth a total of \$1,179 billion for seven private carriers.⁴¹

Governments continuously get involved in the failure of public transportation providers in order to sustain their transportation operations. In the US, the government not only bails out airlines and defacto insures their continuous operations, but also subsidizes Amtrak, the railway company.⁴² For example, under the American Recovery and Reinvestment Act of 2009 (Recovery Act), the Federal Railroad Administration awarded the National Railroad Passenger Corporation Amtrak \$1,300,000,000 for capital grants in support of intercity railroad passenger services.⁴³

B. Identifying Criteria for Socially Important Non-Financial Institutions

Systemically important financial institutions are identified by size, and are deemed too big to fail. The theory offered below suggests that socially important non-financial institutions may also be identified prior to failure, due to their increased social risk. Rather than size being a measure of systemic significance, the essay suggests the measure for socially significant non-financial firms should be their importance, based on two accumulated tests: first, operating in an essential industry sustaining social stability;

⁴⁰ Pub. L. No. 107-42, 102(c), 115 Stat. 230 (2001).

⁴¹ America West Airlines, US Airways, American Trans Air, Aloha Airlines, Frontier Airlines, Evergreen International Airlines, and World Airways. See Wikipedia, at: https://en.wikipedia.org/wiki/Air_Transportation_Stabilization_Board (last retrieved September 11, 2015).

⁴² Randal O'Toole, *Stopping the Runaway Train: The Case for Privatizing Amtrak* (2012). Cato Institute Policy Analysis No. 712, November 13, 2012. Available at SSRN: <http://ssrn.com/abstract=2226476>

⁴³ See the FRA announcement at: <https://www.fra.dot.gov/Page/P0517> (last retrieved September 11, 2015).

second, operating as a situational monopoly, for which consumers may not substitute or may substitute for with inaccessible costs. The identifying criteria are elaborated below.

(1) Essential Industries

It is only those organizations society relies on for its functional sustainability that taxpayers' money is used to rescue upon failure. No one would consider bailing out a corporation providing luxuries with a huge asset portfolio. The rescue funds are directed at firms operating in industries that taxpayers depend on for sustaining their social expectations. The market within which the socially important firm operates has to be essential.

What determines the essentiality of an industry? Defining essential industries raises both a legal and a practical challenge.⁴⁴ First, essential markets are markets in which we would expect consumers to purchase as a social moral baseline.⁴⁵ Purchase at some particular markets are essential for the minimal normative life the state aims to promise its citizens.⁴⁶ The right to live as a human being and the value of dignity evoke a minimal consumption basket that must be purchased if these rights are to be given substance.⁴⁷ Essential industries offer the content of this minimal normative

⁴⁴ For a thorough analysis of the determinants of market essentiality, see Shlomit Azgad-Tromer, *A Hierarchy of Markets: How Basic Needs Induce a Market Failure*, supra note 6 id.

⁴⁵ Wertheimer identifies three kinds of expectations: the statistical, the phenomenological, and the moral. The statistical is based on calculated probabilities, the phenomenological on subjective expectations from the future. The moral, may or may not coincide with these, and is a normative judgment. Alan Wertheimer, *Coercion* (1987), p.450, discussed by Trebilcock, MICHAEL J. TREBILCOCK, *THE LIMITS OF FREEDOM OF CONTRACT* (1997), p. 85-86, p. 79-80.

⁴⁶ And, at times, to the general public including the wider consumers group.

⁴⁷ *S v Makwanyane* 1995 (3) SA 391 (CC) at 506 (S. Afr.): "[I]t is not life as a mere organic matter that the [Interim] constitution cherishes, but the right to human life: the right to live as a human being, to be part of a broader community, to share in the experience of humanity...more than existence – it is a right to be treated as a human

basket: These are requisites for fulfilling society's promise for the protection of human rights under the constitutional and/or international human rights. Second, essential industries tend to have insufficient good substitutes: Consumers are captive in markets of essential products and may not switch to a different market for their needs-based shopping.⁴⁸ Third, purchase at essential industries is often constrained in time and is unlikely to be deferred.⁴⁹ The hospital patient is not able to defer her purchase to another time; she needs the service promptly after an injury has occurred.

Political assessment may yield a normative assessment of essentiality. Policy-makers may articulate a complete market basket for a full and healthy human life, comprising an objective list of requirements for minimum living⁵⁰, that includes products required not only for healthy nutrition but also for fitness and recreation, housing, and social and cultural integration. For example, the European doctrine of *Services of General Interest* classifies some services as being “services of general interest” and, as such, imposes on their corporate providers specific public service obligations, as well as optional state aid for requisite finance.⁵¹ When an industry is subsidized, we can

being with dignity . . . ”; *Khousa v Minister of Social Development* 2004 (6) SA 505 (CC) at 530 (S. Afr.): “ basic necessities of life [must be] accessible to all if it is to be a society in which human dignity, freedom and equality are foundational”.

⁴⁸ See Azgad-Tromer, *supra* note 44 id, at p. 15.

⁴⁹ *Id.*, at p. 16.

⁵⁰ See for example J N Morris, A J M Donkin, D Wonderling, P Wilkinson, E A Dowler, *A Minimum Income for Healthy Living*, 54 *J Epidemiol Community Health* 885-889 (2000), using an objective public health approach to identify representative minimal costs per week in the UK. The authors use research providing “consensual evidence” defining the major personal requisites for health in nutrition, physical activity and psychological relations, estimating the minimal costs and comparing them with the statutory minimum wages.

⁵¹ Article 106(2) of the Treaty of Functioning of the European Union; Official Journal L7, 11.01.2012, p. 3-10; Official Journal C8, 11.01.2012, p. 15-22, available on line here: http://ec.europa.eu/competition/state_aid/legislation/sgei.html

Of particular interest in this essay are the services of general economic interest (SGEI), economic activities which deliver outcomes in the overall public good that would not be supplied, or would be supplied under different conditions in terms of objective quality, safety, affordability, equal treatment or universal access, by the market without public intervention . Green paper on Services of General Interest, COM(2003) 270 final, p. 14.

assume that the government considers it politically essential. Subsidizing and price regulation signal the state's interest in making the subsidized service or product accessible to consumers, suggesting that policy-makers consider the industry politically essential.

The essentiality of the industry may also be assessed by an analysis of market data.⁵² Low elasticity documented at the market level is a signal of the cultural perception of a subjective need, suggesting that many consumers feel they need to purchase the product or service category regardless of its price. For popular products, a public conception of luxuries would be reflected in higher market-level elasticity of demand, whereas a public perception of necessities would be reflected in lower market-level elasticity of demand, signaling that the product is more likely to be purchased under conditions of a behavioral market failure.⁵³ Market data documenting low market-level elasticity of demand for highly popular product or service categories signals consumers' bounded voluntariness and suggests the industry is essential.

(2) Situational Monopolies

Providing an essential need does not by itself merit social significance of the providing firm. We often have ample providers of essentials to pick from. Health services are essential, but when the pediatric clinic we prefer goes bankrupt, we do not

⁵² Azgad-Tromer, *supra* note 44 *id.*, at p. 49-50.

⁵³ See OREN BAR-GILL, *SEDUCTION BY CONTRACT* (2012); Oren Bar-Gill, *Competition And Consumer Protection: A Behavioral Economics Account*, Swedish Competition Authority: *The Pros and Cons of Consumer Protection*, *Forthcoming.*; ANGUS DEATON AND JOHN MUELLBAUER, *ECONOMICS AND CONSUMER CHOICE* (1980). This would apply to popular products only, as luxuries consumed only by the very wealthy are expected to show lower elasticity due to widening wealth gaps and the rational indifference to costs in this social segment.

expect taxpayers' money to bail it out. Groceries are essential, but we do not expect taxpayers' money to rescue a supermarket chain in distress. It is likely, however, that if an isolated village had only one grocery store, residents of the village and its public officials would make a public effort to sustain its continuous service. Likewise, if the major hospital in a big city gets into liquidity distress, it becomes a public concern to sustain it, because that hospital serves as a situational monopoly providing essential services for many of its patients. Consider for example the patient suffering a heart attack: the closest major hospital is her only chance of survival, having both the medical equipment and the medical experts required to provide emergency assistance. A situational monopoly is created when "the fortuitous circumstances surrounding the interaction between the particular parties to the exchange ... create a monopoly power that [the situational monopoly]... opportunistically exploits in return for a quid pro quo that has no or negative social value."⁵⁴

The situational monopoly is thus created by consumers' "fortuitous circumstances."⁵⁵ Unlike structural monopolies, which are sole providers in their respective markets, situational monopolies may have competitors, but the competition is not accessible to their retail customers, who have no good substitutes at the particular time and place where the transaction occurs.⁵⁶ Situational monopolies are created within essential industries when the cost of substitutes for a particular provider is too high or unaffordable. In the case of the major hospital, even if the closest major hospital is only one hour away, that may be too long to enable the heart attack patient to be

⁵⁴ MICHAEL J. TREBILCOCK, *THE LIMITS OF FREEDOM OF CONTRACT* (1997), p. 93.

⁵⁵ *Id.*

⁵⁶ Substitutes are also a function of cost, and situational monopolies arise when costs of alternatives are high and unaffordable. For example, bank accounts are so costly to alter that consumers may keep paying increased fees simply because switching entails an overwhelming effort.

saved. It is the consumer's situation that grants the seller the situational monopoly status. Another example of a situational monopoly may be a major daycare chain. Even when there are several competitors, the collapse of a major daycare chain in the midst of a school year would turn consumers' switching costs considerably high, and potentially inaccessible. The state may thus intervene to sustain the daycare service until a potential bidder arrives.

Situational monopolies providing essential products or services may sometimes be subject also to essential facility claims; however, it is important to note the distinction between the socially important non-financial institution, comprised of the situational monopoly in an essential industry, and the essential facility doctrine. The essential facility doctrine is focused on the duty to share an essential facility so as to avoid cartelization and enhance competition.⁵⁷ As such, the essential facility doctrine is a "limitation on the general rule that a firm has no obligation to deal with its competitors."⁵⁸ Rather, the socially important institution is not necessarily running an essential facility that "cannot be reasonably duplicated by would-be competitors."⁵⁹ It may be possible for a competitor to duplicate the socially important firm, and the socially important firm may have competitors. But the retail consumers of the socially important firm are unable to enjoy the fruits of competition due to high or inapplicable switching costs. Rather than looking through the lens of a potential competitor, the social significance test looks through the lens of the consumer. It is not the entry costs to the essential market but rather the consumers' switching costs that make the

⁵⁷ Stephan M. Maurer and Suzanne Scotchmer, *The Essential Facilities Doctrine: The Lost Message of Terminal Railroad*, 5 California Law Review Circuit 278 (2014), 303.

⁵⁸ *Associated Press v. United States*, 326 U.S. 1 (1945), cited at Robert Pitofsky, Donna Patterson, and Jonathan Hooks, *The Essential Facilities Doctrine Under United States Antitrust Law*, 70 Antitrust L. J. 443-462, 446 (2002).

⁵⁹ *Id.*, at 446.

situational monopoly socially significant. The question here is not whether a competitor may reasonably establish a competing firm; it is whether, as a practical matter of real life, retail consumers can use the competition and switch to a different provider. When consumers are unable to switch to a different a provider for an essential service or product, the provider of that service or product becomes socially important. And as I argue below in Part II, sustaining that service or product in the face of a liquidity distress becomes a matter of public concern.

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

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

A. Liquidity versus Insolvency during a Crisis of Confidence

Too-big-to-fail institutions are widely considered beyond the boundaries of bankruptcy because their default generates a “systemic risk”:⁶⁰ a risk “pertaining to the system” rather than to the stakeholders of a particular firm.⁶¹ It is not the firm-specific risks of corporate failure that justify rescue funding from the public but rather the implications outside the firm, the risks imposed on the markets and on society as a whole that make the public particularly vulnerable to a too-big-to-fail firm’s potential failure and merits rescue funding.⁶² The financial literature offers several inconsistent definitions of “systemic risk,” including different definitions for the trigger events and for the consequences, ranging from “successive and cumulative losses” to “substantial volatility in asset prices, significant reduction in corporate liquidity” and “repercussions on other market participants.”⁶³ The common factor in systemic risk evaluations seems to be the loss of

⁶⁰ Steven L. Schwarcz, *Systemic Risk*, 97 *The Georgetown Law Journal* 193 (2008).

⁶¹ *Id.*, at 196.

⁶² Kenneth Ayotte and David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35(3) *The Journal of Corporation Law*, 469, 471 (2010).

⁶³ For a summary of interpretations, see Schwarcz, *supra* note 60 *id.*, at p. 197.

public confidence and its economic manifestation: in the illiquidity of market participants, in a rush out of credit markets, in credit spreads, in increased cost of capital and in further liquidations.⁶⁴ Federal rescue funding is designed to remedy a crisis of confidence triggered by the default of the too-big-to-fail firm.⁶⁵

The illiquidity of socially significant firms triggers a similar crisis of confidence, spreading beyond the defaulting firm itself and affecting the society as a whole. Because socially significant firms are situational monopolies of essential industries, their uninterrupted operation is an inherent expectation of our civil life. Hobbes, Locke and others insist that the sovereign has “ultimate responsibility for maintaining order” and “overseeing” the citizens’ administration: the state’s authority ultimately rests in a shared understanding of the common good.⁶⁶ Rawls argues that there are certain primary social goods “a rational man wants whatever else he wants”.⁶⁷ The sovereign is responsible to provide individuals with a sufficiently equal share of these raw resources, so as to establish a just and fair social baseline from which different individuals can pursue diverse goals.⁶⁸ Provision of the basket of products and services requisite for social order is thus a social function, sometimes provided by private organizations, that occasionally act in the private market as situational monopolies. Governments need to intervene upon

⁶⁴ See the words of William J. McDonough, President, Fed. Reserve Bank of N.Y., Statement Before the United States House of Representatives Committee on Banking and Financial Services (Oct. 1, 1998), cited in Schwarcz, *supra* note 60 *id.*, at p. 201. See also Ayotte and Skeel, *supra* note 62, in pages 490-491, comparing data documenting changes in major indices surrounding the failure of AIG and of Lehman, and suggesting that the market did not distinguish between the distress resolution procedures of the two, but rather focused on the “implications of distress itself.”

⁶⁵ Compare: Ayotte and Skeel, *supra* note 62, page 490.

⁶⁶ JEAN HAMPTON, *HOBBS AND THE SOCIAL CONTRACT TRADITION* (1986); BRIAN SKYRMS, *EVOLUTION OF THE SOCIAL CONTRACT* (1996); Russell Hardin, *Hobbesian Political Order*, 19 *POL.THEORY* 156 (1991).

⁶⁷ JOHN RAWLS, *A THEORY OF JUSTICE*, 92 (1971).

⁶⁸ *Id.*, at 90-95.

the liquidity distress of an organization if its failure imposes an imminent threat to the continued operation of this social function. The uninterrupted provision of services by the socially significant firm is a derivative of the social contract, an implied promise of the order and stability we expect the sovereign to assume.⁶⁹ Returning to the examples analyzed above, there is clearly no social order without accessibility to the services of a major hospital, an electricity provider and a monopolist public transportation provider. Rather than a Lockean unitary model of the state, we have today a blurred line between “the state” and “private society,” creating a “disaggregated state.”⁷⁰ When the private organizations assuming public roles in this disaggregated vision turn illiquid, the state comes to the rescue to secure their continued operation and uninterrupted service to the public.

Understanding the difference between illiquidity and insolvency is crucial to understanding the boundaries of bankruptcy in default events of socially important non-financial institutions. Illiquidity means that a firm does not have access to enough cash to maintain its current obligations, whereas insolvency means that the firm’s liabilities exceed the total value of its assets.⁷¹ In theory, solvent firms should always be able to sell some of their assets to resolve illiquidity or, alternatively, to be able to secure debt backed

⁶⁹ Compare this to the argument made for the privatization of prisons: Malcolm M. Feeley, *The Unconvincing Case against Private Prisons*, 89 *Indiana Law Journal*, 1401, 1416-1417 (2014). Private prisons may be considered too-important-to-fail, as the state is expected to delegate its powers to entities “capable of fulfilling the citizenry desires” but remains responsible for their ongoing operation and for future “redelegations” as may be required.

⁷⁰ See Feeley, *id.* at p. 1417; Jody Freeman, *The Private Role in Public Governance*, 75 *N.Y.U. L. Rev.* 543 (2000); Martha Minow, *Public and Private Partnerships: Accounting for the New Religion*, 116 *HARV. L. R.* 1229 (2003); Barak Medina, *Institutional Limits to Privatization: The Israeli Supreme Court Decision to Invalidate Prison Privatization*, 8 *INT’L J.CONST.L.* 690 (2010).

⁷¹ See, e.g., Douglas W. Diamond & Raghuram G. Rajan, *Liquidity Shortages and Banking Crises*, 60 *J. FIN.* 615 (2005).

by their assets. But in reality, selling illiquid assets is often a costly and lengthy procedure, and it is thus not uncommon for an organization to file for bankruptcy when it is illiquid but solvent. Even if the bankruptcy process will eventually prove the socially important firm solvent, the liquidity distress threatens its day-to-day ability to meet its operating obligations in the normal course of business. If a socially important institution runs out of cash, it cannot pay its suppliers or its employees.

Because consumers depend upon the socially important institution for the maintenance of social order, a significant part of the loss in case of an operating default due to a liquidity distress, would be absorbed by retail consumers, and by society as a whole.⁷² For example, when a major hospital is suffering liquidity distress, its current and potential patients bear the loss along with its creditors and shareholders and, arguably, bear a larger portion of it. Likewise, if an electricity provider faces an operating default due to liquidity distress, its current and potential consumers are bearing the loss, along with its investors. While investors' loss is only monetary, the consumers' loss has implications for their health and their normal course of life. In these cases, rescue funding becomes an interim measure providing temporary liquidity insurance for the socially important non-financial institution to run its business.

Liquidity distress by its very nature requires immediate attention: Even the solvent firm may be in urgent need of cash at a particular point in time. In this social context, time is of the essence, and the bankruptcy procedure is too lengthy and prolonged to ensure

⁷² Often the retail consumers of the too-important-to-fail firm are the general public of taxpayers. Consider the example of PG & E given in Part I (A) above. Retail consumers were the residents of most of California.

sustainability of the socially significant firm in order to prevent a crisis of confidence.⁷³

The operating failure of a socially important non-financial institution may bring about a corporate-made disaster, with grave consequences for a substantial number of people and widespread if less grave losses to very many people. Such a liquidity crisis may be seen as overwhelming the capacities of state and local governments, and merits intervention.⁷⁴

B. Positive Externalities

Bankruptcy offers a road to redemption. Clearly, new investors would be reluctant to subsidize the old claimholders of a distressed firm. Debtor-in-possession (DIP) financing allows firms to issue senior secured claims that take priority over other creditors, thereby mitigating the incentive to underinvest.⁷⁵ Bankruptcy renders ineffective the common negative pledge clauses that limit or prevent the incurrence of new, senior debt.⁷⁶ In addition, bankruptcy allows a potential acquirer to purchase the firm and/or the firm's assets free and clear of any claims,⁷⁷ neutralizing the risk of the buyer being held responsible for some of the accumulated liabilities of the distressed firm. Potential investors may bring fresh funds into the corporate finance of the distressed firm and thereby offer it a new era of business.

⁷³ For a similar argument made for too-big-to-fail financial institutions see Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?*, 82(2) Temple Law Review 449 (2009).

⁷⁴ Compare: Stephan D. Sugarman, *Roles of Government in Compensating Disaster Victims*, in DISASTER LAW 511 (Daniel A. Farber and Michael G. Faure, eds., 2010). It is interesting to provide a torts analysis of the liquidity distress in assessment of the de-facto governmental liquidity insurance. For an example of analysis of possible applicable norms and compensation principles, see Daniel Farber, *Adapting to Climate Change: Who Should Pay?* 23(1) Journal of Land Use and Environmental Law, 1-37 (2007), reprinted in DISASTER LAW 618 (Daniel A. Farber and Michael G. Faure, eds., 2010)

⁷⁵ George G. Triantis, *A Theory for the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901 (1993).

⁷⁶ 11 U.S.C. 541(c)(1)(B).

⁷⁷ With proceeds from the sale distributed to creditors through the reorganization plan. See Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 97 (2004). Empirical evidence suggests that most bankruptcies today involve a sale of the firm, rather than a traditional negotiated reorganization. See Kenneth Ayotte and Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1(2) The Journal of Legal Analysis, 511-551 (2009).

Yet for the socially important non-financial institution, this road to redemption is less promising. To see why, consider the positive externalities imposed by socially important institutions. A positive externality is the positive effect or benefit imposed by a corporation on an unrelated third party.⁷⁸ Socially important institutions are the organizations we depend upon for the provision of our social order and stability. As socially important institutions are exclusively supplying the requisite products and services forming the infrastructure of social stability, they inherently impose positive externalities. In their daily operations, SINFI's benefit more than merely their own investors and managers: they provide the public with an essential service or product. Consider the examples in Part I above: A hospital benefits the community as a whole, including those residents who are not in need of its services at any one particular moment. An electricity provider benefits the community and provides the public with the facility and power required for a civilized life. A provider of public transportation lowers the cost of production for other corporations; it grants the public an optional way to commute, thereby making education and work more accessible, with additional value of national connectivity.⁷⁹ Everyone benefits by the running operations of SINFI's. The value of the socially important institution far exceeds the value to its immediate stakeholders. Consumers of the socially important firm may pay the marginal cost of the service

⁷⁸ See for example the definition offered by the Business Dictionary, available online here: <http://www.businessdictionary.com/definition/positive-externality.html>

⁷⁹ Margaret Blair analyses an additional positive externality of airlines, rooted in the "hub system": any particular airline enhances value for other airlines, merely by connecting in one single destination. Blair describes a "hub-and-spoke" system under which airlines extract value from connecting to other airlines' flights and thereby offering additional destinations. This analysis is applicable to other "too-important-to-fail" institutions. For example, electricity providers may extract value from competing providers as well as from other situational monopolies located in proximity to the provider's location and offering potential backup facilities. See Margaret M. Blair, *The Economics of Post September 11 Financial Aid to Airlines*, 35 *Indiana Law Review* 1, 11-13 (2002).

provided, but they are in fact always getting a far greater benefit by its service. The hospital bill for the cost of fixing an injured leg is less than the benefit of being able to walk; the cost of electricity is below the value of civilized life and the cost of an airline ticket is below the benefit of social, national and international connectivity. By definition, socially important institutions incidentally make our life better by running: their operating default would be to the public's disadvantage.

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

The financially distressed socially important institution may require public rescue funding, similar to a public good that is subject to the collective action problems of societal communication and coordination among all beneficiaries. Notably, the moment of funding for the socially important institution changes considerably before and after failure has occurred. Private investment in a socially important non-financial institutions before failure occurs are likely to be easier to obtain, due to investors' implied assumption of a

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

The government may need to step in and finance the too-important-to-fail firm under distress, to ensure it sustains its service to the public and maintains the accompanying positive externalities. Rescue may be required, but not necessarily beyond the scope of bankruptcy. The Treasury may participate in funding the too-important-to-fail institution in adhoc bailouts, or as a debtor-in-possession, as it has done in other cases.⁸⁰ Assessment of the optimal process of financial intervention in corporate failure is a separate subject of debate.⁸¹

⁸⁰ See for example the analysis of the government's role in the car-maker bankruptcies, especially Chrysler: Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727 (2010).

⁸¹ Most reviewers, as well as policymakers, seem to stick with bailouts for systemic risks. See for example Ed Morrison, *supra* note 73, and the historical survey offered at VERN MKINLEY & GARY GEGENHEIMER, *BRIGHT LINES AND BAILOUTS* 18-19 (2009). For an opposing view see the thorough analysis suggested by Ayotte and Skeel, *supra* note 62 *id.*, suggesting that bankruptcy may be "surprisingly effective" and sometimes preferable to bailouts.

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

This part of the essay provides a structural analysis of the socially important non-financial institution. It shows that socially important institutions enhance market degradation, induce a behavioral market failure and are prone to unwarranted expansion. Corporate governance of the socially important firm is discussed. The too-important-to-fail status of the socially important firm enhances the incentives for excessive leverage and risk-taking and creates elevated agency costs and incentives for empire building, absent the corporate governance pressures to mitigate those risks.

A. Market Degradation

(1) Market Failure

Per their definition, socially important institutions are situational monopolies providing essential products or services.⁸² As such, their consumers' voluntariness is bounded. Consumers of socially important firms have limited discretion in making a purchase. They simply must obtain the socially important institution's service or product to sustain their need and provide them with the essentials of life. The values underlying consumers' purchase from socially important firms are exogenous to the market: For example, we buy water and heating in the winter not because the supply and demand curves meet at a convenient point, but simply because we need these to sustain life and for the survival of ourselves and those we love.⁸³

⁸² See Part I, *id.*

⁸³ Azgad-Tromer, *A Hierarchy of Markets: How Basic Needs Induce a Market Failure*, supra note 6 *id.*, pages 27-28, 33. Product essentiality induces situational monopolies because it is only the essentials that become urgent to get. It is rarely urgent to purchase diamonds or to dine at a fancy restaurant. The essential necessity is what creates the time constraint and grants the seller the position of situational monopoly. When product essentiality is restricted in time and place, and consumers must get the product promptly, proximity of a seller to the consumer's location grants the

Socially important non-financial institutions thus manifest the classic costs of a monopoly: because the situational monopoly is the only relevant provider of essentials in the consumers' circumstances, the socially significant firm is likely to raise its selling price above its own full costs, so that the cost to consumers is greater and the socially significant monopolist gets richer. Moreover, because the special status of a situational monopoly in an essential market is valuable, the socially important firm is likely to defend itself from attack: from potential competitors, from regulators and lawmakers, and from technological changes that would disrupt its special status, in both its market essentiality and the corporation's position within the essential market.⁸⁴ The socially important firm's investment in protection of that special status is a damage to the economy "as egregious as the lost production of the monopoly triangle."⁸⁵ Consumers shop for essentials according to their exogenous needs, and not by the virtues of the market. When a monopolist provides a non-essential service, consumers have other options for their shopping. But when a monopolist provides an essential need, its market power is boundless. Consider the monopoly of a public utility service versus the monopoly providing designer apparel. Monopolies' costs are severely heavier in markets of essentials than in markets of non-essentials.

Upward competitors are less likely to disturb the socially important firm's situational monopoly status and enter the essential market. The constant demand for quantities

seller the position of "situational monopoly", where competition cannot affect the transaction because the closest seller becomes the only one relevant for the consumer.

⁸⁴ Roe, *Structural Corporate Degradation Due to Too-Big-To-Fail Finance*, *supra note 1 id*, p. 1440.

⁸⁵ *Id*, at 1440.

sold at the essential market reduces incentives for price competition.⁸⁶ A reduction of prices by seller A is likely to increase seller A's market share but would at the same time decrease the whole pie of proceeds from the market, leaving all competitors with smaller long-term revenues because the total scope of the proceeds attained from the same amount of units sold would shrink. Foreseeing this equilibrium, sellers would be inclined to minimize price competition in markets of essential products. On the other hand, in markets of non-essential products, a reduction in prices and a price competition may result in bigger market size and a larger pie of proceeds. Competition in non-essential markets is more likely to reach the optimum point of marginal cost because it may benefit all competitors to have lower pricing levels, since the market size may increase as a result, thereby increasing all of their respective shares. Of course, this analysis is a function of market size, and in very large markets, competition on market segment may prove profitable enough to create good incentives for price competition among sellers, even with constant demand.

(2) Unwarranted Expansion

Socially significant firms are too important to fail and thus enjoy an implicit subsidy upon failure: Because of their effect on social stability and their positive externalities, governments are more likely to intervene in the event of their failure and supply them with a defacto liquidity insurance similar to the subsidy supplied to the too big to fail.⁸⁷ This subsidy lowers the effective price of capital for the socially significant firm: because potential debtors take into account the potential for rescue upon failure,

⁸⁶ Azgad-Tromer, *A Hierarchy of Markets*, supra note 6 id, pages 31-32.

⁸⁷ See discussion in Part II above.

they are willing to provide more debt with lower interest to reflect the lower risk of default. Like banks, the socially important non-financial institutions are “enjoying the safety net by being able to borrow more cheaply and with fewer restrictions and covenants.”⁸⁸

Easy access to capital may be directed “toward innovative ways to obtain, expand, and use the... subsidy” rather than “to better service the economy”.⁸⁹ Unwarranted expansion of the socially important institution may shift its business toward the segment that secures the firm the subsidy and the situational monopoly status, maximizing the firm’s private benefits rather than the interests of the economy. The implicit subsidy “encourages excessive growth and recklessness”.⁹⁰

B. Corporate Governance Distortions and a Moral Hazard

(1) Excessive Leverage and Risk Taking

The funding cost advantage enjoyed by systemically important financial firms is both well known and well documented: Financial literature offers a bounty of works measuring and quantifying the too-big-to-fail subsidy.⁹¹ But for the socially-important

⁸⁸ Compare: Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig, and Paul Pfleiderer, *Fallacies. Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Socially Expansive*, supra note 14 id, page 2.

⁸⁹ Mark Roe, *Structural Corporate Degradation Due to Too-Big-To-Fail Finance*, supra note 1 id, at 1447.

⁹⁰ Anat R. Admati, *The Compelling Case for Stronger and More Effective Leverage Regulation in Banking*, 43(3) *Journal of Legal Studies*, 35, 41 (2014).

⁹¹ See for example: ZAN LI, SHISHENG QU & JING ZHANG, MOODY’S ANALYTICS, QUANTIFYING THE VALUE OF IMPLICIT GOVERNMENT GUARANTEES FOR LARGE FINANCIAL INSTITUTIONS 14 (2011); Bryan Kelly, Hanno Lustig & Stijn Van Nieuwerburgh, *Too-Systemic-to-Fail: What Option Markets Imply About Sector-wide Government Guarantees* (March 21, 2012). Fama-Miller Working Paper; Chicago Booth Research Paper No. 11-12. Available at SSRN: <http://ssrn.com/abstract=1762312> or <http://dx.doi.org/10.2139/ssrn.1762312>; Viral V. Acharya, Deniz Anginer and Joseph A. Warburton, *The End of Market Discipline? Investor Expectations of Implicit Government Guarantees* (March 1, 2015). Available at SSRN: <http://ssrn.com/abstract=1961656> or <http://dx.doi.org/10.2139/ssrn.1961656>; Michel Araten, Michel and Christopher M Turner, , *Understanding the Funding Cost Differences between Global Systemically Important Banks (G-SIBs) and Non-G-SIBs in the United States*

non-financial institution, no empirical data have been systemically collected and published. Yet it is a plausible hypothesis that counterparties to the socially-important non-financial institutions would be more willing to do business with them than with independent firms, which do not enjoy the special status granted by the implicit governmental backup. This preference is likely to be reflected in better contracting terms and greater business volume,⁹² and is particularly applicable to debt, which is implicitly insured for the socially-important institution.⁹³

The implicit subsidy of socially-important institutions and their lower cost of borrowing may lead to excessive leverage accompanied by several agency costs. First, the agency cost between creditors on the one hand and taxpayers on the other, may lead to excessive lending by the SINFI, which may surpass the efficient sum and is based on the implicit assumption of rescue upon failure. Second, the agency cost between shareholders on the one hand and creditors and taxpayers on the other hand, may lead to excessive risk taking. Because distributions to shareholders are residual, shareholders have an incentive to increase risk-taking by the too-important-to-fail firm and thereby increase their potential for profits. When the risk materializes, it is creditors or taxpayers who pay for it, while shareholders are protected by limited liability. The implied subsidy of governmental liquidity insurance distorts incentives because managers and investors of the socially-important institution no longer bear

(March 11, 2012). Available at SSRN: <http://ssrn.com/abstract=2226939> or ; see also the summarizing tables at Mark Roe, id, appendix.

⁹² Compare: Mark Roe, *Structural Corporate Degradation Due to Too-Big-To-Fail Finance*, supra note 1 id, at 1419.

⁹³ As creditors anticipate the potential bailout, they are likely to be willing to reflect it in the terms of the debt. Compare: Admati and Hellwig, supra note 1 id, at chapter 9.

the full cost of their actions.⁹⁴ For managers and shareholders, it is a win-win gamble, where the burden of loss is always carried by other people's money.⁹⁵ If the socially-important firm appears poised to fail, it is taxpayers that are likely to foot the bill. The appetite for risk is even more exacerbated when managers of the socially-important institution are compensated with options for equity: If the exercise price is set at market level, its manager has strong incentives to increase risk as she will gain from upside but is insulated from downside.⁹⁶

(2) Empire Building

In corporate law empire building is the tendency of management to prefer excessive control over resources and to use free cash flow for extending the breadth of organizational activity at the shareholders' expense.⁹⁷ From the manager's perspective, more projects, employees, and activities mean a larger empire to control: these would maximize her job security, promotion and prestige, and may grant her further credit and more opportunities in her future career. For the shareholders, on the

⁹⁴ Louis Kaplow, *Incentives and Government Relief for Risk*, 4 *Journal of Risk and Uncertainty*, 167-175, 173 (1991).

⁹⁵ See Viral V. Acharya and Anjan Thakor, *The Dark Side of Liquidity Creation: Leverage and Systemic Risk* (January 2015). European Corporate Governance Institute (ECGI) - Finance Working Paper No. 445/2015. Available at SSRN: <http://ssrn.com/abstract=2539334>, showing in the banks context that the use of equity leads to lower ex-ante bank liquidity, whereas greater use of debt leads to a higher probability of inefficient bank liquidation. The bank's privately-optimal capital structure trades off these two costs. With uncertainty about aggregate risk, bank creditors learn from other banks' liquidation decisions. Such inference can lead to contagious liquidations, some of which are inefficient; this is a negative externality that is ignored in privately optimal bank capital structures.

⁹⁶ Compare: Lucian A Bebchuk and Holger Spamann, *Regulating Bankers' Pay*, 98(2) *Georgetown Law Journal*, pp. 247-287, (2010).

⁹⁷ Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 *American Economic Review* 323 (1986).

other hand, cash or in-kind distributions may be preferable.⁹⁸ Because shareholders' interests are residual, the interests of taxpayers are (to a good approximation) aligned with those of shareholders for empire building at the socially-important institution.⁹⁹ Taxpayers will bear the losses of empire building when rescue is required.

Socially-important institutions enhance management's incentives for empire building even further than the typical public corporation. This is because in socially-important institutions there are fewer constraints on agency costs¹⁰⁰ and the corporate cake is initially bigger, so there is more for managers to lose. We have seen that due to its status, the product market pushes the socially-important institution towards unwarranted expansion of its activities.¹⁰¹ Capital market constraints on the agency costs of the socially-significant firm are weaker too: Debt, shareholders' demand for distributions, and the potential for takeovers and spinoffs are all weaker in mitigating empire building at socially-important firms.

Debt is widely considered in financial literature as a means to mitigate incentives for empire building.¹⁰² This is because management, just like a person taking a mortgage,

⁹⁸ See Lucian A. Bebchuk, *The Case for Increasing Shareholders Power*, 118(3) Harvard Law Review 833-914 (2005).

⁹⁹ This claim requires a disclaimer. Because shareholders are only entitled to distributions when there are residual profits, and dividend distributions are subject to the solvency test, at any particular point of time, the interests of shareholders are aligned with those of taxpayers: in theory, shareholders should not get any distributions from an illiquid firm. Yet as a matter of practice, corporations filing for bankruptcy often have a history of extensive dividend distributions (see for example PG& E). For too-important-to-fail firms, taxpayers are the ultimate residual claimants, not shareholders.

¹⁰⁰ Compare this analysis to Roe's general discussion of monopolies: Mark Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. Pa. L. Rev. 2063 (2001), at part VI.

¹⁰¹ See discussion at Part III A(2) id.

¹⁰² See for example: Michael C. Jensen, and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure*, 3 *Journal of Financial Economics* 3, 305-360 (1976); Milton Harris and Arthur

would be obliged to make periodic payments to return the loan. Due to the uncertainty with regard to the scope of expected free cash flow, debt cannot efficiently solve the problem of empire building as an agency cost.¹⁰³ For too-important-to-fail socially significant firms in particular, debt is not efficient at mitigating incentives for empire building because managers are aware of the implied liquidity insurance and this knowledge creates a moral hazard. Empire building is always worthwhile when taxpayers foot the bill for potential downside, whereas upside grants the manager a larger kingdom to rule.

Granting shareholders the direct discretion to contract the firm's business and announce cash and in-kind distributions has been suggested as a means to overcome the empire-building agency cost.¹⁰⁴ However, socially-important firms are often non-profits, lacking a class of shareholders to whom they are accountable. Funding non-profits grants the donors neither control over the organization nor a right to collect distributions as rents. Non-profit boards are thus generally self-perpetuating.¹⁰⁵ Managers of non-profits face no external pressure to make distributions and reserve sufficient funds for residual profits, so their incentives for empire building are not

Raviv, *Capital Structure and the Informational Role of Debt*, 45 *Journal of Finance* 321 (1990); Martin F. Hellwig, *A Reconsideration of the Jensen-Meckling Model of Outside Finance*, *Journal of Financial Intermediation* 18, 495-525 (2009); Charles Calomiris and Charles M. Kahn, *The Role of Demandable Debt in Securing Optimal Banking Arrangements*, 81(3) *The American Economic Review*, 497-513 (1991).

¹⁰³ Consider the example given by Bebchuk, *supra* note 98, in page 905. Because corporations cannot foresee in advance exactly how much cash flow they will have available, debt cannot completely amend the problem of free cash flow: Any amount of debt would either create excessive burden (and be larger than the actual cash flow) or create excessive cash flow (when actual cash flow exceeds the expected one). Uncertainty makes debt either under-inclusive or over-inclusive for free cash flow and empire building as an agency cost.

¹⁰⁴ Bebchuk, *id.*

¹⁰⁵ THE GOVERNANCE OF NON-PROFIT ORGANIZATIONS (Edward L. Glaeser, ed., 2003).

tamed.¹⁰⁶ Consider for example the manager of a socially-important non-financial institution: a major hospital. The manager sees empire building – through staffing more jobs, building additional facilities and purchasing additional medical equipment– as a legitimate part of her job. Making the hospital better and bigger, and providing more services for patients is likely to be a higher priority for the manager, compared with the financial stability of the institution.¹⁰⁷ But if the socially-important hospital faces liquidity distress, it is likely to be rescued: It is too important to fail.

Finally, capital markets offer takeovers and spinoffs as potential corporate governance pressures that may tame the incentives for empire building.¹⁰⁸ Takeovers are “both evidence to the conflicts of interests between managers and shareholders, and a solution to the problem” of agency costs, because mergers and acquisitions are one strategy managers may adopt to avoid distributions and base their empire.¹⁰⁹ Value-creating takeovers are expected to occur in response to breakdowns in internal control processes”: takeovers and breakdowns mitigate empire building through the threat of the market for corporate control.¹¹⁰ But for the socially-important institution, takeovers are not likely to function as a corporate governance pressure that may deter agency costs. First, many socially-important firms are not public corporations, and

¹⁰⁶ Helmut K. Anheier, *NONPROFIT ORGANIZATIONS: THEORY, MANAGEMENT, POLICY* (2014), page 304; Marc Jegers, *Corporate Governance in NonProfit Organizations*, 20(2) *Nonprofit Management and Leadership*, 143-164 (2009).

¹⁰⁷ See Burcay Erus and Burton A. Weisbrod, *Objective Functions and Compensation Structures in Nonprofit and For-Profit Organizations: Evidence from the "Mixed" Hospital Industry*, at *THE GOVERNANCE OF NON-PROFIT ORGANIZATIONS* (Edward L. Glaeser, ed., 2003). The authors analyze compensation structures as indicators of organizational forms, hypothesizing that responses to fiscal stringency differed across organizational forms, and finding that nonprofit hospitals use weaker incentive mechanisms compared to for-profit hospitals.

¹⁰⁸ See Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, supra note 97, p. 11-13.

¹⁰⁹ *Id.*

¹¹⁰ Jensen, *id.*, at p. 12.

their shares may not be listed to begin with. Second, even for those socially-important firms whose securities are listed, breakups and takeovers that may cause the firm to lose the implied subsidy are likely to be repressed by the market, enlarging even further the profits of the SINFI.¹¹¹

Excessive leverage, the tendency for risk-taking and elevated incentives for empire building are negative externalities imposed by the socially-important non-financial institution. It is significant to see whether these negative externalities are not offsetting the positive externality imposed by the socially-important institution's operating role, discussed above.¹¹² While this theoretical challenge may need to be examined on a case-by-case basis, the likelihood that the negative externalities would offset the positive externality is meager, because without sustaining the positive externality through the uninterrupted operating functionality of the SINFI, it would not be granted the implied governmental subsidy to begin with. So while the negative externalities might be significant, socially-important institutions are expected to preserve their positive externalities as a high priority, as part of their defense of the subsidy. Even when risk is excessive, it is likely to be either directed at other business and/or financial directions, or monitored to sustain the operating functionality of the socially-important institution.

¹¹¹ Compare: Mark Roe, *Structural Corporate Degradation Due to Too-Big-To-Fail Finance*, supra note 1 id, page 1421. Roe analyses the too-big-to-fail subsidy of banks, arguing that it operates as a shadow poison pill, deterring unwanted takeovers and serving as a governance defense.

¹¹² Part II section B, id.

IV. Conclusion

Socially-important institutions are the most significant firms in our lives, the organizations we depend upon for social stability and the provision of essential human needs. This essay offers an initial framework for the identification of socially important non-financial institutions, and explains their limitations in bankruptcy. The essay shows that situational monopolies providing essential products or services are less likely to resolve liquidity distress through the bankruptcy process without public funding, because their illiquidity may impose an immediate threat to social stability, even when they are solvent; and because positive externalities reduce the incentives of a private investor to solve their liquidity distress through debtor-in-possession or sale of assets within the bankruptcy process. Socially-important institutions are thus too important to fail. Upon a liquidity distress, the too-important-to-fail firms are expected to receive public funding, either through bailout or through the Treasury acting as a DIP.

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

Rather than ad-hoc rescue upon a liquidity crisis, the framework suggested in this essay provides policy-makers with a toolset to track socially-important non-financial institutions well before failure occurs. The prominent role of socially-important institutions in our civil life raises further questions of accountability, financial stability, and regulatory design, to be addressed in future works, along with an empirical assessment of their actual financial structures.