Bailouts, Bonuses, and the Return of Unjust Gains

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In March 2009, ailing insurance giant American International Group (AIG) triggered a national outcry when it paid out $165 million in government bailout funds for employee bonus incentives. President Obama called the bonus payments an “outrage” and promised that his administration would “pursue every single legal avenue to block these bonuses and make the taxpayers whole.” He chastised the firm for its audacity of using borrowed taxpayer monies to reward financial recklessness and greed. This was the same company, of course, who within days of receiving its first infusion of government cash in September 2008, sent its executives on a half-million dollar boondoggle retreat at a fancy desert spa. And just several months after the initial fiasco, AIG tried to award $265 million in further bonuses, adding to performance bonuses of $454 million paid to employees and executives in 2008. It was just over a year ago when AIG turned to the government for its survival. The government stepped in to assist AIG when the company faced imminent death from its risky financial derivative products that were backed by precarious mortgages. Fearful that the toppling giant would trigger a cataclysmic domino effect, the government authorized the bailout funds to keep AIG, and the entire U.S. financial sector, afloat. The
government agreed to loan AIG the money, now totaling over $173 billion, collateralized with AIG’s assets and an 80% equity ownership of the company. The first infusion of cash to AIG was authorized by the Federal Reserve in September 2008, supplemented with funds authorized in October by Congress in the $700 billion bailout bill, the Emergency Economic Stabilization Act (EESA), which established the Troubled Assets Relief Program (TARP).

As a result of the AIG bonus debacle, the President and Congress took several steps to try and avoid these problems in the future. In the EESA, Congress gave the Treasury Secretary the power to require these troubled financial institutions to meet appropriate standards for executive compensation, but did not directly prohibit the type of employee bonuses at AIG. The subsequent American Recovery and Reinvestment Act (Recovery Act), passed in February 2009 after the transition to the Obama administration, added significant new restrictions for highly-paid executives of financial institutions that receive TARP assistance, including prohibitions against paying bonuses, retention awards, or incentive compensation, except as payments of long-term restricted stock.

President Obama also installed Kenneth Feinberg, former special master of the 9/11 Fund, as the pay czar to oversee all employee bonuses and

payments for companies receiving large amounts of bailout funds, including AIG.  

AIG’s loophole for its past payments is that the Recovery Act contains an express exception permitting bonuses that were payable pursuant to written employment contracts executed prior to the passage of the act.  

AIG argued that its incentive payments were issued pursuant to pre-TARP employment contracts and thus were mandatory. Not everyone agreed, with legal commentators noting many situations in which AIG would not have been obligated to perform under the contract, such as the employee’s failure to meet performance standards, impossibility caused by the eminent bankruptcy, or the employee’s unclean hands. Yet, technically immune from the legal restrictions, AIG sought to pay additional bonuses of even larger amounts in July 2009—though it subsequently thought better of the payments and decided to hold off. Other bailout firms as well, like Citigroup and Bank of America, used taxpayer assistance to pay financial rewards to employees. The extravagance thus continues, with little change in the motivations or operations of Wall Street. But everyone and their congressperson seem to appreciate that AIG has done something wrong here. AIG’s flaunting of its newfound government riches in the face


of desperate taxpayers losing their homes, jobs, and retirement funds raises the collective ire and seems to demand some type of response.

Congress reacted quickly to the populist outrage, initially agreeing with the President and proposing a bill “to require the Secretary of the Treasury to pursue every legal means to stay or recoup certain incentive bonus payments and retention payments made by American International Group, Inc.” The House also took more strident measures, seeking to recoup the money through a 90% excise tax on the employee payments. The House Judiciary Committee responded to the AIG-like extravagance with the aptly-named “End Greed” Act (End Government Reimbursement of Excessive Executive Disbursements), though it was quickly defeated. The End Greed Act would have authorized the Justice Department to sue for the return of bonuses given to employees of companies that have received more than $10 billion from the government and authorize the Attorney General to limit executive compensation at ten times the average non-management employee, as a company would have to do in bankruptcy. The End Greed Act was modeled on principles of bankruptcy law and fraudulent transfer cases where a person transfers his assets to a friend rather than repaying debts or where an asset transfer is made by an entity in a precarious financial condition in exchange for less than reasonably equivalent value. These legislative options, however, were quickly squelched, leaving AIG essentially immunized from its past wrongdoing.

The question remains whether existing legal avenues are available to curtail the continued bilking of taxpayer funds. A good solution might have been to revise the terms of the loan to prohibit payments of bonuses. This reformation type of remedy would have rewritten the original deal to restrict the use of bailout funds for bonuses or executive payments. However, reformation requires an original meeting of the minds in agreement on the terms, which was mistakenly omitted from the written contract. Here, there was no mistake. The agreement between AIG and the government contained no restrictions on the use of the funds. Thus,

18. H. R. 1575, 111th Cong. (2009) (as reported by the Judiciary Committee).
20. Id. at 3.
reformation and other more typical contract remedies like damages are unavailable here in the absence of a breach by AIG.

One possible answer lies with the remedy of restitution. Restitution, based on unjust enrichment, is a remedy directed at the defendant that requires the wrongdoer to return all ill-gotten gains. The goal is to return the defendant to the position it would have been in but for the wrongdoing, and prevent it from profiting at the plaintiff’s expense. While some might consider the idea of an unjust enrichment remedy a “hail Mary” pass, this long shot provides a good analytical foundation to funnel the public outrage towards a legal resolution based on justice.

RESTITUTION

Restitution is aimed at requiring the defendant to disgorge all wrongfully acquired gains in order to prevent the defendant from profiting in an unfair way. Restitution is a gap-filler—it is a type of remedy that historically developed to address the gaps of the common law and the rules of equity. “The spirit behind the law of unjust enrichment is to apply the law ‘outside of the box’ and fill in the cracks where common civil law and statutes fail to achieve ‘justice.’”

A gap-filling remedy is just what is needed in the case of AIG. There is no existing remedy for damages or injunctive relief available because there is no express legal duty that AIG has breached. Most people on the street, however, think that AIG seems to be getting some unfair advantage here at the expense of the taxpayers. Restitution provides an alternative cause of action that becomes an actionable claim for unjust enrichment. Here, AIG was clearly enriched by the monies paid to it by the government pursuant to the bailout agreement. The real question is whether there is anything unjust about this.

It might be argued that AIG’s conduct constituted a type of breach of fiduciary duty. The breach would stem from an allegation that AIG mismanaged public funds through its dissipation of governmental loans,

22. RESTATEMENT OF RESTITUTION § 1 (1937).
24. RESTATEMENT OF RESTITUTION § 1 (1937); see also DAVID LEVINE, DAVID JUNG & TRACY THOMAS, REMEDIES: PUBLIC AND PRIVATE 717–23 (6th ed. 2009).
which the company was obligated to repay. The company took the funds from the taxpayers under a plea of collapse, then turned around and used them for employee perks. The CEO implicitly acknowledged as much, admitting that the company made mistakes and should be a good steward of the public’s monies.\textsuperscript{27} Some employees seemed to recognize the unjustness of the conduct as well, voluntarily refusing to accept the bonuses or returning bonuses already paid.\textsuperscript{28} Identifying the broader fiduciary breach converts the case from a mere contractual dispute to one of heightened culpability. In one U.S. Supreme Court case on restitution, \textit{Snepp v. United States},\textsuperscript{29} the Court similarly looked behind the scenes of a technical breach of contract case to find an underlying breach of trust. In \textit{Snepp}, a former CIA official failed to get administrative clearance for a book he was writing on his experiences as an agent in the Vietnam War.\textsuperscript{30} The government admitted that Snepp did not disclose any national secrets, which was the purpose for the preclearance rule, but nevertheless argued that more was at stake than mere technical non-compliance. The Court agreed, looking to the nature of the confidential relationship between the agent and the CIA to find an “extremely high degree of trust” that the agent had breached.\textsuperscript{31} So too, in the case of AIG, the nature of the relationship between AIG and the government in the context of this economic crisis suggests a heightened degree of trust and fiduciary duty that goes beyond the four corners of the bailout agreement.

The fiduciary unjustness of AIG’s actions is further supported by the concept of the “equitable clawback.” This doctrine of corporate law allows a corporation to require the return of contractually agreed upon employee bonus payments when it is later determined that the employee does not merit the payment.\textsuperscript{32} The Securities and Exchange Commission has a similar tool available to it in the clawback provision of the Sarbanes-Oxley Act, which allows it to reclaim compensation paid to a CEO of a company involved in accounting fraud even where the executive was innocent of the wrongdoing.\textsuperscript{33} The concept of corporate clawback is derived from the

\begin{itemize}
  \item \textsuperscript{28} \textit{Id}.
  \item \textsuperscript{29} 444 U.S. 507 (1980).
  \item \textsuperscript{30} \textit{Id.} at 508.
  \item \textsuperscript{31} \textit{Id.} at 510–11.
  \item \textsuperscript{33} Joanna Chung, “Clawback” Marks Tougher SEC Stance, \textit{FINANCIAL TIMES}, July 28, 2009, http://www.ft.com/cms/s/0/bca3a520-7b97-11de-9772-00144feabdc0.html?ftcamp=rss&enlick_check=1;
\end{itemize}
breach of fiduciary duty, but operates as an equitable notion of restitution. The theory is that the employee has received an unjust benefit by getting money that was not properly earned. This theory fits in the case of AIG. Employees getting the incentive payments to stay on are the same employees who have made the disastrous business decisions that led to the company’s downfall. In this context, the retention of the benefit by an undeserving employee would be unjust.

There is a good argument to be made then that the level of unjustness is sufficient to establish the viability of restitution as a remedial mechanism—if the proper procedure is available. Restitution theory generally requires that the courts proceed through the formal restitutory devices and procedures developed historically. While scholars have argued that these devices are merely fictions and needless formalities recalling the antiquated writ system of old England, the Supreme Court has held on to the formalism of restitution that works as a gatekeeper to streamline the potential for restitution’s equitable expansion. The outrage at the unjust enrichment of AIG must thus be cabined into one of the available restitution devices: partial rescission, constructive trust, or accounting for profits.

**PARTIAL RESCISSION**

The President or Congress might attempt to rescind the bailout agreement with AIG. Rescission is a legal theory of restitution that cancels the contract and returns both parties to their original, pre-contract position. This would cancel the agreement between the government and AIG for the bailout loans and require AIG to return all of the monies


35. See *Levine, supra* note 24, at 720–21.
38. *Levine, supra* note 24, at 744.
received. Except that this result is not exactly what the government wants. It is not interested in the return of all of the $173 billion, as it still believes in the importance of keeping the company solvent. Instead, the government would want only the return of the funds misappropriated to employee bonuses through the remedy of partial rescission.

Partial rescission, however, is not generally available, as it is said that a contract must be canceled in toto. A party cannot cancel only the unfavorable parts of a contract, leaving the remaining terms in place because a party might get a windfall by retaining the benefits of a contract, without the burdens. The legal rules provide that a court must cancel the contract in its entirety, unless the provision to be rescinded is severable from the rest of the contract. In the case of AIG, the government loans might be divisible into the various installments paid or the bonus payments could be severed from the bulk of the loans. Partial rescission is also possible in the case of “extreme circumstances.” Cases of extreme circumstances “do not lend themselves to satisfactory abstract statement and rest largely upon their peculiar facts,” but have been used in a few cases when important to a just result and where good faith ends. The flexibility of equitable restitution supports the use of partial rescission in the extreme circumstance of AIG, especially as the government is not seeking to avoid its burdens under the contract associated with the risk of loan repayment.

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41. See First Am. Title Ins. v. Lawson, 827 A.2d 230 (N.J. 2003) (partially rescinding professional insurance contract for two law partners who committed malpractice, but retaining contract for third, innocent partner); County of Morris v. Fauver, 707 A.2d 958 (N.J. 1998) (holding that payment provisions of contract for housing prisoners was not severable from the rest of the contract).
43. AM. JUR. CONTRACTS § 533, supra note 39. See also Veazie v. Williams, 49 U.S. (8 How.) 134 (1850) (rescinding part of an auction agreement because of fraudulent bidding, retaining the sale of the mill but rescinding the false bid price, because of the party’s unclean hands); St. Luke’s United Methodist Church v. CNG Dev. Co., 663 S.E.2d 639 (W.Va. 2008) (allowing remedy of partial rescission to cancel part of oil and gas lease for undeveloped part of land, but continuing lease as to currently producing part of tract).
44. See City of Raton, at *26 (suggesting that partial rescission would be appropriate to allow rescission of part of agreement for electric power while retaining the remaining terms of the agreement); Vadasz v Pioneer Concrete (SA) Pty Ltd. (1995) 184 C.L.R. 102 (Austl.) (permitting partial rescission to enforce debt guarantee contract for future, but not past, corporate debts, because
The real problem with a rescission remedy for AIG is whether the nature of the unjustness is the kind of wrongdoing courts have required for rescission. Cancellation of a contract has been limited by the courts to wrongs such as fraud, duress, mistake, and substantial breach of contract.\textsuperscript{45} While the American public would like to think AIG defrauded the government, it is unlikely that AIG’s actions rise to that level. Instead, the government might allege unilateral mistake in believing that the bailout loan would be used to keep the company functioning rather than paying for excessive, discretionary spending.\textsuperscript{46} It is difficult, however, to argue that the government was mistaken about this fact, given that it knew of AIG’s intent to pay the bonuses with bailout funds at least as of February 2009 when it inserted the bonus exemption into the legislation.

**CONSTRUCTIVE TRUST**

The government might also pursue another restitutionary device: the constructive trust. A constructive trust is a fictional trust imposed as a remedy to prevent unjust enrichment. The theory of the constructive trust hypothesizes that the wrongdoer acts as a trustee for the plaintiff and must return the money to the plaintiff/beneficiary, along with any appreciation.\textsuperscript{47} The restitution device is most often used to remedy certain types of wrongdoing involving fraud, breach of trust, or breach of fiduciary duty, harkening back to the remedy’s historical derivation from equitable trust law, though it is not limited to those situations.\textsuperscript{48} The constructive trust would be a logical choice here, as AIG’s actions could be conceptualized as a breach of fiduciary duty, as discussed above.

The constructive trust option offers one practical advantage—tracing. Tracing is available with the constructive trust to allow the court to trace or follow the bailout funds into the hands of third parties and obtain their recovery. Here, the funds directed to AIG were transferred into the hands of the individual employees. Tracing rules would allow the government to reach out to sue those employees directly based on the wrongdoing of the

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\textsuperscript{45} LEVINE, \textit{supra} note 24, at 745.
\textsuperscript{46} A contract may be rescinded for a mistake when “(a) the effect of the mistake is such that enforcement of the contract would be unconscionable, or (b) the other party had reason to know of the mistake or his fault caused the mistake.” \textit{RESTATEMENT (SECOND) OF CONTRACTS} § 153 (1979).
\textsuperscript{47} JAMES M. FISCHER, \textit{UNDERSTANDING REMEDIES} 596–98 (2d ed. 2006).
\textsuperscript{48} LEVINE, \textit{supra} note 24, at 772.
company to execute the return of the funds. Tracing would end if the monies were transferred to a bona fide purchaser for value, someone to whom the money was given for value and without notice of the fiduciary breach. The AIG employees may (or may not) have provided value by their employment services. After all, it was these services that led to the downfall of the company. More significantly, the employees were well aware of the company’s breach of fiduciary duty and the concurrent outrage of misappropriating the bailout funds through the employee payments. In the absence of this good faith, a court could trace the bailout funds into the hands of the employees and order their return.

ACCOUNTING FOR PROFITS

A more tailored, and perhaps the best legal claim to recover the misappropriated bailout funds, would be an accounting for profits. An accounting for profits requires the wrongdoer to account for the illegal gains by disclosing the specific amounts to the court. It then requires the disgorgement of those gains through monetary payment to the victim. There are no specific requirements for this claim other than the generalized proof of unjust enrichment, thus providing a technically easier mechanism than the constructive trust or rescission.

The accounting for profits remedy has several advantages in the case of AIG. First, it requires the company to disclose the specific amount of government funds misdirected towards these bonuses and employee payments determined to be unjust. The disclosure, or lack thereof, has been a problem with AIG, which took several months and repeated congressional questioning to disclose the full magnitude of all of its bonus payments. Second, the accounting mechanism allows the company to identify specifically those bonus amounts that were voluntarily refused by the employees in whole or in part. This assists AIG in being able to

49. See, e.g., Harris Trust & Sav. Bank v. Salomon Smith Barney, Inc., 530 U.S. 238, 250 (2000) (citing 1 DOBBS, LAW OF REMEDIES, § 4.7(10) (2d ed. 1993)); Corp. of the President of The Church of Jesus Christ of Latter-Day Saints v. Jolley, 467 P.2d 984, 985 (Utah 1970) (constructive trust may be imposed on third party who receives money or property stolen or embezzled by another, if she is not a bona fide purchaser).

50. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 58(2) (Tentative Draft No. 6, 2008).

51. See Joel Eichengrun, Remediying the Remedy of Accounting, 60 IND. L.J. 463, 468 (1985).

precisely apportion the misappropriated monies so that it does not have to return funds that are not part of the unjust enrichment.

Another key advantage of an accounting for profits is the likely availability of a jury trial. The other possible restitution remedies against AIG sound in equity, and thus would be tried to a judge rather than a jury. This would deprive the public of their ability, through their representatives on the jury, of the opportunity to weigh in on the equities of the case. The jury as a selection of ordinary people can best identify with the average taxpayer over the concerns of the economy and the betrayal by corporate America. An accounting for profits historically was both an equitable and a legal device, but the Supreme Court has held that a jury trial will often apply. Thus, an accounting might provide a preferable vehicle for the AIG mess because of its involvement of the jury.

CONCLUSION

Restitution was created to provide legal means of redressing injustices that otherwise would go unanswered. As Dan Dobbs, the author of the classic Remedies treatise, *Law of Remedies*, explained, “[u]njust enrichment cannot be precisely defined, and for that very reason has potential for resolving new problems in striking ways.” The restitution remedy continues to be an important part of the common law available to provide justice for new and evolving injustices like those presented by AIG.

53. Chauffeurs, Teamsters and Helpers, Local No. 391 v. Terry, 494 U.S. 558, 564 (1990). The Seventh Amendment preserves the right to jury trial only in “suits at common law.” U.S. CONST. amend. VIII.

54. Dairy Queen, Inc. v. Wood, 369 U.S. 469, 472–73 (1962) (quoting Beacon Theatres, Inc. v. Westover, 359 U.S. 500, 510–11 (1959)) (“Where both legal and equitable issues are presented . . . ‘only under the most imperative circumstances . . . can the right to a jury trial of legal issues be lost through prior determination of equitable claims.’”)

55. DAN B. DOBBS, LAW OF REMEDIES § 4.1(2) (2d ed. 1993).