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Flaws in the AIG Trust Agreement and Implications for Pending Citigroup and Other TARP Trusts

TESTIMONY

Before the House Committee on Oversight and Government Reform

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Chairman Towns, Ranking Member Issa, and Distinguished Members of the Committee:

It is a privilege to testify in this forum today. My name is J.W. Verret, and I am an Assistant Professor of Law at George Mason Law School, a Senior Scholar at the Mercatus Center at George Mason University and a member of the Mercatus Center Financial Markets Working Group. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to study of the intersection of state and federal authority in corporate governance.

My focus today will be the Trust Document set up by the New York Federal Reserve Bank to manage the government's investment in AIG.

This document represents a grave risk to the American taxpayer's $125 billion dollar investment in AIG.

I am concerned by the AIG trust because of the precedent it sets. Secretary Geithner has announced his intention to create another trust to manage the Treasury's investment in Citigroup as well as other TARP participants. If the AIG trust, crafted during the Secretary's tenure as President of the New York Fed, is used as a model for these new entities, the risk to taxpayers will be multiplied many times over.

My concerns are structural and in no way directed at the trustees themselves. By all accounts they are professionals of the highest caliber, and their nation owes them a debt of gratitude for their generous service in this time of economic crisis.

Today my focus will be the three most troubling provisions of the AIG trust. One provision requires the trustees to manage the trust in the best interest of the Treasury Department rather than the U.S. taxpayer. Another offers generous protection against liability for the trustees, and a third permits the trustees to invest personally in investment opportunities that may otherwise belong to AIG.

The first dangerous provision is Section 3.03(a). That section defines the fiduciary duty of the trustees as being to manage the investment in AIG "in or not opposed to the best interests of the Treasury."

In other financial entities tasked with managing wealth on behalf of others, the fiduciaries must manage wealth to maximize value for the beneficiaries. This is true for mutual fund trustees, Employee Retirement Income Security Act (ERISA) retirement plan trustees, and boards of directors of publicly traded companies.

This provision threatens the entire purpose of the trust itself, which is to create an independent buffer between the short term political interests of an administration and the health of the nation's financial system.

Maintaining this buffer between short term political interests and long term financial soundness is critical. The economic evidence from around the globe is overwhelmingly clear that political ownership of private banks and financial companies results in lower GDP growth, increased need for government bailout, and politicized lending practices.

For instance, in Italy, banks with government ownership lend at lower interest rates in the South, as that area is politically important to the ruling coalition in parliament. I am concerned about the temptation that we someday may see TARP banks encouraged to subsidize lending in battleground states.

This is why requiring the trustees to manage the trust in the best interest of the Treasury, and not the U.S. taxpayer, is so dangerous.

A second provision in the trust that I find troubling is the corporate opportunity provision located in section 3.05(b). Typically fiduciaries are prohibited from stealing investment opportunities that they learn about through their performance as a trustee from their beneficiaries and using those for themselves.

The AIG trust permits the AIG trustees to, in theory, secretly invest personally in investment opportunities they learn about through their performance as trustees, without the necessity to inform or seek permission from AIG or the Treasury.

This strikes me as unnecessary and particularly dangerous given the potential for the AIG trust to serve as a model for other, similar documents.

A third threat to the American taxpayer located in this trust document are the indemnity and immunity provisions of Sections 3.03(a) and 3.03(d). These stand out as the most generous liability protections I have ever seen offered to managers of wealth and represent significant deviations from standard and best practice in corporate governance.

Under no circumstances are public companies permitted to indemnify directors for actions not undertaken in good faith and in the best interest of their beneficiary shareholders. The AIG Trust has no such limitation on trustee indemnification.

I am aware of no ERISA or mutual fund trustee, or director of a public company granted such a generous immunity from liability to their beneficiaries as the AIG trustees are afforded, and I can see no good reason why those best practices should not apply here.

In short, a trust in which the trustees cannot be held accountable by their beneficiaries isn't much of a trust at all.

It is vital that when an organization manages wealth on behalf of others, the ship's compass must always point in the right direction no matter who stands at the helm. For this reason I am recommending that the flaws in this trust document not be repeated in future trusts set up by Treasury.

I thank you again for the opportunity to testify today and I look forward to answering your questions.