New Federal Initiatives Project

AIG BONUS PAYMENTS

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Many have expressed outrage that 73 American International Group (AIG) employees received $165 million in bonuses after the company received a $170 billion bailout package. President Barack Obama has urged Treasury Secretary Timothy Geithner to pursue all legal avenues in order to get the bonuses back. Congressional leaders have passed emergency legislation meant to tax the bonuses away. On March 19, 2009 the House passed a bill (HR 1586), by a margin of 328-93, which imposes a 90 percent tax on bonuses given to employees with family incomes above $250,000 at AIG and other companies (including Fannie Mae and Freddie Mac) that have received at least $5 billion in government bailout money. Top members of the Senate Finance Committee, Max Baucus and Charles Grassley, have introduced similar legislation which will impose a 35 percent tax on non-retention bonuses—year-end bonuses, performance bonuses, and others—if they exceed $50,000. The Baucus-Grassley proposal will be imposed both on the company and on the recipient of the bonus.[2]

But an important question has only recently been raised in the debate: are these retrospective tax measures constitutional? Indeed, on March 20, 2009, the Washington Post, in an editorial titled "Washington Gone Wild: Congress's destructive reaction to the AIG bonuses", asserted that "The effective confiscation of legally earned and contractually promised payments may well be unconstitutional."

The Proposals

Article I, Section 9 of the United States Constitution states that "No Bill of Attainder or ex post facto Law will be passed." A Bill of Attainder is a legislative act that singles out an individual or group for punishment without trial. Some assert that the most far-reaching of the proposals may run afoul of the Bill of Attainder Clause.

Rep. Steve Israel is interested in taxing the AIG officials at 100 percent. It is argued that Israel's proposal most likely goes beyond taxation and becomes confiscation, forbidden by the Fifth Amendment's Takings Clause: "Nor shall private property be taken for public use, without just compensation." But HR 1586, like most of the other proposals, does not single out AIG or levy a 100 percent tax and thus might not be considered a Bill of Attainder or a taking. On the other hand, House Speaker Nancy Pelosi released multiple public statements announcing her plan to try to recover the AIG bonuses in particular. Given the timing of HR 1586 and statements by numerous legislators, the bill was clearly intended to target AIG bonuses.

If not clearly a Bill of Attainder or a taking, does HR 1586 or any of the proposals violate the Ex Post Facto Clause? The Supreme Court has long held that the Ex Post Facto Clause only applies to criminal laws.[3] Instead, retroactively applying civil laws is sometimes considered to violate the Due Process Clause of the Fifth Amendment: "No person shall be deprived of life, liberty, or property without due process of law." The Supreme Court has repeatedly upheld retroactive tax legislation against due process challenges, most recently in *United States v Carlton* (1994)[4]. *Carlton* involved an estate tax statute that addressed the deductibility of proceeds from the sale of an employee stock ownership plan. The Court found that the retroactive application of a revision made one year later to correct a loophole did not violate the Due Process Clause because the revision had a legitimate purpose. The Court has adopted the rational basis test for retroactive taxes: "Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches." The

Carlton opinion suggests that two criteria must be met for retroactive tax statutes to pass constitutional muster: (1) the retroactive activity must not be illegitimate and arbitrary; (2) Congress must act promptly and establish only a modest period of retroactivity.

With regard to the first prong, Justice Blackmun's opinion in *Carlton* suggests that purely curative legislation will not be considered illegitimate or arbitrary. Blackman held that Congress did not contemplate such broad applicability of the deduction when it first adopted the estate tax bill and that the retroactive measure was meant to correct a prior legislative mistake.

But can the present Congress be said to have made a prior legislative mistake? The chairman of the Senate Banking Committee, Chris Dodd, stated that he was responsible for the change in the stimulus legislation that allowed such bonuses and that he made the change at the request of the Obama Administration. Also, unlike *Carlton*, the bonus payouts were arguably foreseeable consequences of the legislation. The provision inserted by Senator Dodd's expressly allowed companies that received taxpayer bailout money to pay retention bonuses that were part of existing employment contracts.

On the other hand, the Internal Revenue Service does allow some punitive taxation schemes. For example, the federal government levies high taxes on companies in order to prevent greenmailing. Yet, these excise taxes generally do not exceed 50 percent,[5] unlike the 90 percent proposed tax on AIG.

With regard to the second prong of *Carlton*, *Welch v Henry* (1938) was controlling prior to *Carlton* in holding that "recent transactions" to which a tax law may be retroactively applied "must be taken to include the receipt of income during the year of the legislative session preceding that of its enactment." But *Carlton* suggests that retroactive effects extending for a period only slightly greater than one year can still pass constitutional muster. Since many of the AIG employment contracts were signed slightly over a year ago, *Carlton* may be controlling and the retroactivity of HR 1586 may pass constitutional muster. If HR 1586 were to apply to still older contracts and payments, it might well be constitutionally suspect on retroactivity grounds.

The fact that the executive bonuses were guaranteed by contract presents other legal issues worth considering. Article I, Section 10 of the Constitution forbids any state from passing a law that retroactively impairs the obligations of contracts. Of course, the Contracts Clause does not apply to the federal government, but some experts argue that contract impairments could run afoul of the Due Process Clause.

In the other direction, at least one constitutional law scholar asserts that the Office of Management and Budget or the Office of the Office of Legal Counsel could issue an opinion outlining how unforeseen and unanticipated circumstances changed the mission of AIG in order to justify breaking the contract[6]. (This is known as the doctrine of "frustration.") This argument is weakened because Senator Dodd's revision to the bailout bill expressly authorized the bonuses.

Others suggest that the contracts are void because they are "unconscionable"[7]. This doctrine has been invoked when contracts "shock the conscience." To hold the contracts void on unconscionable grounds could be difficult even though the bonuses have been flagged "outrageous". In the cases where the doctrine has been invoked, the Court has struck down contracts based on an asymmetry of information between parties. Here, AIG, the Treasury, the Administration, Senator Dodd, and everyone charged with knowledge of the Dodd amendment knew that this revision would protect executive bonuses, so there was no asymmetry of information.

Still others suggest that the employment contracts could be void based on the theory of unjust enrichment.[8] This doctrine states that if a person receives money or other property through no effort of his own, at the expense of the other, the recipient should return the property to the rightful owner (even if the recipient received the property/money legally). One could argue that the executives at AIG received the bonuses as part of a bailout plan. If not for the bailout, AIG would have gone bankrupt and no one would have received any bonus. Since tax dollars are contributing to the bailout money, the bonuses were clearly at the expense of the taxpayers of America, and they should be returned.

On the other hand, the unjust enrichment doctrine could be asserted to undermine the bailouts themselves. All of the firms who have been bailed out have received money through no efforts of their own at the expense of the taxpayer. The unjust enrichment doctrine gets to the core of the problem of the executive bonuses and the bailout problem in general. This argument holds that the bailout constitutes a moral hazard in that it subsidizes risky behavior. Without the bailout firms like AIG would have been left to fail; instead, firms have no incentives to change their operations, expecting that they can get an unjustly enriching handout from the government.

The Bailout Generally

On December 11th the Senate voted to reject the auto industry bailout. The Treasury was not allowed to extend the funds to the auto industry because Section 102 of the Troubled Asset Relief Program (TARP) is limited to financial institutions, so it looked like the auto industry was doomed to fail. But on December 19th President Bush used purported executive authority to declare that TARP funds may be spent on any program he deemed necessary to avert the financial crisis, and with what amounts to a line-item veto, declared Section 102 to be nonbinding on the executive branch. This allowed President Bush to extend the use of TARP funds to support the auto industry. Does this move undermine Article I of the Constitution: "All legislative powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives"? The definition of troubled assets in TARP grants a great deal of discretion to the Treasury Secretary. Given Article I, would the Founders have allowed Congress to delegate this authority to the Treasury Secretary?

The passage of TARP can also be examined vis-a-vis Article I, Section 7: "All bills for raising revenue shall originate in the House of Representatives; but the Senate may propose or concur with amendments as on other Bills." On September 28, 2008 the House Committee on Financial Services worked on the proposal and released a draft of what it titled the Emergency Economic Stabilization Act of 2008 (EESA-2008). In addition to TARP, EESA-2008 included other components to stabilize the financial sector. But on September 29 the House of Representatives rejected the plan. On October 1st a slightly revised version of the plan was passed by the Senate, and later by the House on October 3rd. Did this legislation improperly originate in the Senate?

On March 19th, 2009 the Federal Reserve announced that it will buy up to $300 billion in longer term Treasury bonds and raise the size of a lending program aimed at mortgage-backed securities by another $750 billion. This was done without Congress' approval. Does it contravene Article I, Section 9: "No money shall be drawn from the treasury, but in consequence of appropriations made by law"?

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[2] "House passes bill taxing AIG and other bonuses" by Stephen Ohlemacher. *Associated Press*. March 19, 2009. http://news.yahoo.com/s/ap/20090319/ap_on_go_co/aig_outrage.
[3] *Calder v Bull*. 3 U.S. 386 (1798)
[4] 512 U.S. 26 (1994)
[5] http://www.fedforms.gov/bgfPortal/docDetails.do?dId=10040
[6] "Congress threatens to tax back bonuses to AIG executives" by David Lightman and William Douglas. *McClatchy Newspapers*. March 17, 2009. http://www.kansascity.com/444/story/1092062.html.
[7] "How to stop AIG bonuses" by Roger Parloff. Fortune. March 17, 2009. *Fortune*. http://money.cnn.com/2009/03/16/news/companies/aig_bonuses.fortune/index.htm?postversion=2009031710.
[8] "Obama's best legal argument for taking back the AIG bonuses" by Christopher Beam. *Slate*. March 17, 2009. http://www.slate.com/id/2214054/.

Related Links:

"The Troubled Asset Relief Program and Insurers," by Laura M. Kotelman, *Engage*. http://www.fed-soc.org/publications/pubid.1270/pub_detail.asp

Conference entitled "The Financial Services Bailout: Cause, Effect and the Limits of Government Action," held on March 19, 2009. Event audio/video: http://www.fed-soc.org/publications/id.578/default.asp