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Congress and federal financial regulators have long prioritized the safety and soundness of banking firms. But at the same time, the directors and officers of banking firms are legally bound to prioritize shareholder wealth maximization, which creates incentives for risk-taking that work against these regulatory goals. This shareholder primacy norm has long been a central feature of corporate governance, but as I describe in this Article its application to banks was not a deliberate policy choice but rather a historical accident. Indeed, banks possess several unique features that make shareholder wealth maximization an inapt governance priority for them. Banks are highly leveraged, which increases the importance of creditor agency costs. Banks also enjoy government guarantees, either explicit or implicit, on their short-term debt, and thus their governance is a matter of public concern. Finally, bank failures result in high negative externalities, and this also creates a strong public interest in bank safety and soundness.

This Article argues that a new federal governance regime for banking institutions is appropriate and consistent with the historical purposes of banking regulations and charter oversight in the United States. Furthermore, such a regime would reduce the tensions between the law of state entities and the sprawling federal banking regulatory framework created by Congress, and harmonize the internal governance of banking firms with the broader goals of external banking regulations. Finally, I offer some thoughts on the key principles that should be present in any such federal governance regime for banking.

For too long, we have tolerated a "cat-and-mouse" dynamic in banking, one in which regulators have sought to identify and address risky practices while knowing that the directors and officers of banking firms have strong incentives to take on higher risk. By changing this paradigm and realigning the incentives inherent in banking governance, we can take a major step towards ensuring long-term stability in our financial system.

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INTRODUCTION

It is generally undisputed that the excessive risk taking of banks and other leveraged financial companies (LFCs)[1] was a primary cause of the 2007–08 financial crisis,[2] which wreaked massive damage to the financial system and the broader economy.[3] But why did LFCs take on

1. As I have previously noted, the term "bank" is one that is used quite inconsistently, both in popular parlance and in the law and economics literature. *See* David Min, *Understanding the Failures of Market Discipline*, 92 WASH. UNIV. L. REV. 1421, 1424 n.7 (2015) [hereinafter Min, *Market Discipline*] (explaining some of the different ways in which the term "bank" is defined). In the United States, the term "bank" (sometimes also called a "commercial bank" or "traditional bank" to distinguish it from investment banking) has often been used in its legal sense to describe federally insured depository institutions with bank charters (or similar types of charters such as thrift or credit union charters). *See* 12 U.S.C. § 1841(c) (2018) (defining bank). The term "bank" is also used in an economic sense to describe financial intermediaries (including chartered depository institutions) that rely on short-term funding (such as demand depositors) to fund long-term investments in loans and other credit instruments. *See* Min, *Market Discipline*, *supra*, at 1424 n.7 (summarizing the institutions that are considered banks). The distinction between the legal and economic definitions of the term "bank" has sharpened with the rise of "shadow banking," which serves the same credit intermediation functions as traditional banking, but outside of the legal framework that governs the insured depository institutions that have historically been understood to be "banks." *Id.* at 1449–52. In this Article, I generally use the term "bank" in a narrower sense to include only insured depository institutions. By contrast, I generally use the term "leveraged financial company" or "LFC" to refer to the broader universe of institutions that serve bank-like functions, including both traditional banks and also other institutions such as financial holding companies, bank holding companies and non-bank financial firms (such as investment banks or money market funds) that rely heavily on short-term funding to finance their investments in credit instruments.

2. *See* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, at xvii–xix (2011) [hereinafter FCIC REPORT].

3. The recent financial crisis was estimated to have cost the United States as much as $14 trillion. *See* Tyler Atkinson et al., *How Bad Was It? The Costs and Consequences of the 2007–09*

so much risk? The regulatory response to the financial crisis has to date been almost entirely focused on the prudential regulation of financial institutions, with a particular emphasis on so-called "systemically important financial institutions" (SIFIs).[4] But despite a broad consensus that the incentives of these institutions—and their directors and officers—played a major role in causing the financial crisis, regulatory reform efforts have not featured comprehensive changes to these governance incentives. To the extent that post-crisis governance changes have been implemented for financial institutions, they have been minor in scope and generally emphasized greater accountability to shareholders, reflecting the corporate governance literature's longstanding focus on reducing shareholder agency costs.

The Dodd-Frank Act of 2010 provides a very good example of this phenomenon.[5] Dodd-Frank makes a number of important changes to the prudential regulation of LFCs, particularly for SIFIs, which now face new consolidated capital and examination requirements[6] and a newly created resolution regime called the Orderly Liquidation Authority.[7] Dodd-Frank also mandates new mortgage origination and securitization standards for banks and other financial institutions,[8] and creates a Consumer Financial Protection Bureau to promulgate and enforce consumer protection rules relating to bank loans and other financial products.[9] Notably, almost all of these changes take the form of *external* regulatory measures that must be monitored and enforced by outside regulators. But Dodd-Frank barely touches the issue of the *internal* governance of LFCs. And as I describe in greater detail in Part II.A, the handful of governance changes created

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Financial Crisis, FED. RES. BANK DALL.: STAFF PAPERS, no. 20, July 2013, at 1–2 (summarizing the costs of the financial crisis). As Reinhart & Rogoff, among others, have observed, similarly large costs have always resulted from financial crises. *See generally* CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY (2009).

4. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 12 U.S.C. (2018)), created a new regulatory regime for bank holding companies with more than $250 billion in assets and certain nonbank financial companies identified as posing risks to the financial stability of the United States. *Id.* §§ 113, 115 (codified as amended at 12 U.S.C. §§ 5323, 5325 (2018)). Dodd-Frank established a new Financial Stability Oversight Council (FSOC), responsible for overseeing bank holding companies with total assets over $250 billion and non-bank financial companies that it has designated as being systemically risky. *Id.* §§ 111–116 (codified as amended at 12 U.S.C. §§ 5321–5326 (2018)). Dodd-Frank also provided the Federal Reserve with significant regulatory authority over these systemically important financial institutions as well as all bank holding companies with more than $50 billion in assets. *Id.* §§ 161–171 (codified as amended at 12 U.S.C. §§ 5361–5371 (2018)).

5. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

6. *Id.* §§ 161–176 (codified as amended at 12 U.S.C. §§ 5361–5374 (2018)).

7. *Id.* §§ 201–217 (codified as amended at 12 U.S.C. §§ 5381–5394 (2018)).

8. *Id.* §§ 941–946, 1400–1506 (codified as amended in scattered sections of 12 U.S.C. (2018).

9. *Id.* §§ 1001–1109 (codified as amended at 12 U.S.C. §§ 5481–5603 (2018)).

by Dodd-Frank are all designed to more closely align the incentives of directors and officers with the interests of shareholders, which potentially exacerbates the misalignment between the objectives of banking decision makers and the goals of regulators.

The lack of attention paid to bank governance is an enormous failure on the part of regulators. After all, under most accounts, the 2007–08 financial crisis was the result of deliberate decisions made by LFC directors and officers—often encouraged by strong shareholder pressure—to take on greater risk.[10] To increase shareholder returns, financial firms added enormous amounts of leverage—the ratio of debt to equity (or other forms of regulatory capital)—such that by the end of 2007, Citigroup had an effective leverage ratio of 48:1, Goldman Sachs had a leverage ratio of 32:1, and Morgan Stanley and Lehman Brothers had leverage ratios of 40:1.[11]

LFCs took on risk in many other ways. For example, as the FCIC documents, beginning in 2003 and continuing up through the financial crisis, Merrill Lynch's senior executives made the decision to plunge heavily into the high-margin, high-risk collateralized debt obligation (CDO) market.[12] Between 2002 and 2004, Merrill's market share of the CDO underwriting business grew from fifteenth to second, and by 2006, Merrill led the market.[13]

In July 2007, Chuck Prince, then the CEO of Citigroup, in asserting that his company would continue to play a significant role in subprime mortgage securitization despite growing concerns about the risks associated with these activities, famously stated: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."[14] This comment was widely understood as an acknowledgement of the strong market pressures to take risks, even in the face of strong indications that those risks could potentially lead to high losses, as they eventually ended up doing.[15]

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10. *See, e.g.*, FCIC REPORT, *supra* note 2, at 18–21.
11. *Id.* at 65.
12. *Id.* at 202–04.
13. *Id.*
14. Michiyo Nakamoto & David Wighton, *Citigroup Chief Stays Bullish on Buy-Outs*, FIN. TIMES (July 9, 2007), https://www.ft.com/content/80e2987a-2e50-11dc-821c-0000779fd2ac [https://perma.cc/BUV4-MBTS].
15. *See, e.g.*, FCIC REPORT, *supra* note 2, at 175 (noting that in a follow-up interview with the FCIC staff, Prince clarified this comment by explaining that "banks individually had no credibility to stop participating in this lending business" and "[i]t was not credible for one institution to unilaterally back away from this leveraged lending business"); Ing-Haw Cheng et al., *Yesterday's Heroes: Compensation and Creative Risk-Taking* 1 (Nat'l Bureau of Econ. Research, Working

As I argue in Part II of this Article, many of the problems with banking governance arise from the preoccupation, among both policy leaders and firm officers and directors alike, with serving the interests of shareholders. The corporate governance literature has long been preoccupied with the problem of reducing shareholder agency costs. But this emphasis on shareholder interests is not appropriate for governance in banks and other LFCs, for three reasons. First, LFCs are much more heavily leveraged than other types of firms, and so the interests of their equity investors are both more misaligned with those of other stakeholders and also less important from a policy perspective. Second, because the debt issued by LFCs is typically guaranteed, either explicitly as with deposit insurance or implicitly as with "too big to fail" backstops, there is a direct taxpayer interest in reducing the risk of LFCs. Finally, LFCs have steep negative external costs arising from their failures, which creates a strong public policy rationale for ensuring the safety and soundness of these institutions. These distinctions provide a strong justification for revising banking governance norms to emphasize safety and soundness over shareholder wealth maximization. Indeed, it is no small thing that the regulation of banking—which is generally acknowledged as extremely comprehensive and burdensome[16]—is almost entirely preoccupied with safety and soundness.[17]

Our experience with LFC governance in the period leading up to the financial crisis provides an apt example of exactly this point. During the 2003-07 period, financial firms that took on higher risk were rewarded with higher share prices, while firms that had more conservative risk management practices were penalized by stock markets.[18] Conversely, bank executives who tried to limit risk-taking were often punished for their actions. As the FCIC describes, two senior executives at Lehman

Paper No. 16176, 2010) ("[The Prince] quote is often attributed as market pressure (presumably being fired by impatient shareholders) forcing Citi's managers to take on such risks, whether or not they fully understood them.").

16. *See*, *e.g.*, Kathryn Reed Edge, *Obama Administration Proposal to Rebuild Financial Supervision and Regulation*, 45 TENN. B.J. 26, 26 (2009) ("Most bankers and their lawyers believe that depository institutions are already among the most highly regulated companies in the United States economy").

17. *See* Alan M. White, *Banks as Utilities*, 90 TUL. L. REV. 1241, 1259–67 (2016) (arguing that the singular focus of United States banking regulation throughout its history has been ensuring the safety and soundness of financial institutions); *id.* at 1267 ("Banking legislation and bank regulatory agencies have served primarily to protect the safety and reliability of banks' most basic deposit and payment functions.").

18. *See* FIN. SERVS. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 46 (2009) (concluding that bank share prices "delivered strong market price reinforcement to management's convictions that their aggressive growth strategies were value creative"). *See also* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 717–23 (2010) (explaining that risky choices resulted in high rewards for many financial firms).

Brothers, the head of Lehman's fixed income group and the chief risk officer, "warned against taking on too much risk in the face of growing pressure to compete aggressively against other investment banks." One left the firm shortly thereafter based on "philosophical differences," and the other was demoted to a policy position working with government regulators.[19] In a similar example, Citi's chief underwriter, concerned that Citi was taking on too much risk and "join[ing] the other lemmings headed for the cliff," made a series of sharp warnings, including to Citi's Chairman and other top executives, expressing his concern that Citi was facing billions of dollars in losses from poorly underwritten loans. After he made these warnings, he was transferred to a new position, was downgraded in his performance review, saw a bonus reduction, and went from supervising 220 employees to supervising only 2.[20]

Those banks that stayed out of the high-risk, high-return activities that led to the financial crisis did so despite strong pressure from shareholders. Wells Fargo was one prominent example of a firm that stayed away from subprime mortgages and other risky loan products during the 2002–07 period, even as most of its peers entered into these markets. John Stumpf, the CEO of Wells Fargo, stated "[These were] hard decisions to make at the time . . . we did lose revenue, and we did lose volume."[21] Toronto Dominion Bank (TD Bank) had a similar experience in 2006, when it decided at the behest of its CEO Edmund Clark that it would cease its activities in structured financial products. Clark, who justified this move by saying that he didn't understand the business and was concerned about the potential for serious losses, recalled that stock analysts at the time wrote that he was an "idiot" for exiting the structured products marketplace.[22]

But assuming we accept the idea that shareholder interests should be deemphasized in LFC governance, how might we go about reforming this area? In Part III, I argue for the creation of federal standards requiring directors and officers to prioritize safety and soundness over the interests of shareholders. Federalizing banking governance would be the most efficient pathway to realigning the internal incentives of banking institutions and is consistent with the long history of banking regulation in our country. The bifurcation of substantive regulation and

19. FCIC REPORT, *supra* note 2, at 18–19.

20. *Id.* at 19.

21. *Id.* at 108.

22. *See* Ed Clark, President and CEO, Toronto Dominion Bank Financial Group, Presentation at the National Bank 2010 Financial Series Conference (Mar. 30, 2010) (presenting TD Bank's focus on "continuous improvement" after the economic crisis); *see also* THOMAS H. STANTON, WHY SOME FIRMS THRIVE WHILE OTHERS FAIL: GOVERNANCE AND MANAGEMENT LESSONS FROM THE CRISIS 52–54 (2012).

organizational law in banking is a historical accident and not the product of any coherent or intentional policy rationale.

As I describe, the federalization of banking governance could be implemented in several ways. Federal regulators already have significant and expansive authorities over a wide array of banking and financial institutions. These powers could be utilized to encourage banking firms to adopt safety and soundness duties through a variety of mechanisms, including by negotiating covenants or reincorporating as benefit corporations. Alternatively, Congress could pass laws creating a new federal regime for banking governance. Finally, Congress could create a new banking charter for all institutions that engage in the economic activities of banking—and thus pose the same economic and financial systemic risks as banks.

In Part III, I also articulate the broad outlines of what a federal duty of safety and soundness should look like. First, it should prioritize safety and soundness over shareholder wealth maximization. Second, it should encompass not only the directors and officers of chartered banks but also of other leveraged financial companies, including bank holding companies and systemically important non-bank firms at a bare minimum. Finally, a breach of this duty should allow for a private right of action by the firm's creditors.

It should be noted that this article is focused on the question of *who should be owed* a fiduciary duty by the directors and officers of banking firms but does not address *what the appropriate standard* for this duty should be. Whether and to what extent the duty of care and duty of loyalty should be adjusted are important questions, and ones I intend to address in a subsequent paper.

Legislators and regulators have exerted enormous amounts of energy trying to improve financial stability through external restrictions and regulatory oversight on the risks taken by leveraged financial firms, even as the internal incentives of these firms have encouraged greater risk-taking. It is long past time that we addressed the misaligned incentives of these firms by reforming banking governance.

I. THE LAW OF BANK GOVERNANCE

In the aftermath of the 2007–08 financial crisis, the primary focus of financial regulators and policy makers has been the unique macroprudential risks posed by "shadow banking." Naturally, much of the post-crisis regulatory reform agenda has involved adapting existing prudential regulatory approaches to reduce the systemic risk posed by shadow banks and other financial institutions that play a large role in the global shadow banking system. These reforms have included revising capital requirements to better reflect systemic risk, adopting new liquidity requirements to limit run risk, and creating new measures to identify and address new sources of systemic risk.

However, while traditional prudential regulations have been the primary focus of financial regulators and policy makers, there has been a nascent but growing movement arguing for reforms of the governance of financial institutions, so as to reduce the incentives of directors and officers to take on greater risk. Most banking today—either shadow banking or traditional banking—takes place under the aegis of a corporate organizational form, and so this governance discussion has been grounded in a corporate law paradigm. But as I describe in greater detail in this Part, the preeminence of corporate law for banking is a relatively new phenomenon. For most of our country's history, only financial institutions with a national or state *bank* charter—distinct from a *corporate* charter—were allowed to engage in the business of banking. And as I discuss below, there are some subtle but important differences between the historical legal development of bank governance and corporate governance that are relevant for thinking about how to reform bank governance today.

A. Background

In the United States, bank charters are distinct from general incorporation charters, although they share many common features. In order to become a "bank"—which is defined by statute as any entity that is allowed to accept deposits and is engaged in the business of making commercial loans—the organizers of the business entity must first receive a bank charter either from the United States, one of the fifty states or the District of Columbia, or one of the US territories.[23] As with corporate charters, bank charters create business entities with the powers to adopt and use a corporate seal; to make contracts; to sue and be sued in a court of law; to elect or appoint directors who have the power to appoint officers; to create bylaws regulating the affairs of the bank, its directors and its general business; and to exist indefinitely.[24] But a bank charter is unique in that it also allows its recipient to engage in the "business of banking," providing it with special bank powers that are not available to other types of business entities. These include "discounting and negotiating promissory notes, drafts, bills of exchange, and other

23. *See* 12 U.S.C. § 1841(c)(1) (2018) (defining "bank" as an insured institution organized under US laws that demands deposits and issues loans). I use the term "bank charter" expansively to encompass other depository institutions with equivalent powers and regulatory oversight, such as thrifts, credit unions, industrial loan companies, and community development financial institutions.

24. *See* 12 U.S.C. § 24 (2018) (outlining the general corporate powers of national chartered banks).

evidences of debt," "receiving deposits," "buying and selling exchange, coin and bullion," and "loaning money on personal security," as well as "all such incidental powers as shall be necessary" to carry on this business of banking.[25]

While banks and general business corporations today have distinct charters, these charters share the same origins. The first business corporations were introduced to the American colonies in the seventeenth century.[26] These early corporations were created by legislative statute to serve a specific public purpose, such as constructing a bridge or operating a ferry.[27] To facilitate capital formation, corporate charters came with a number of important privileges, including limited liability for shareholders and a state-granted monopoly or oligopoly over the business activity to be performed.[28] In return, the state would receive the benefits of the public good being performed and often some form of additional fees or profit sharing.[29] Because of the unique public-private nature of the early American corporation, corporate business charters were rare in this era.[30] Only seven business corporations were created in America during the colonial period, with another 181 being formed between 1796 and 1800.[31]

Bank charters were originally granted as a type of corporate charter, given to further the important public purpose of providing banking services to their communities. Like other corporate charters of the time, bank charters gave their recipients a monopoly franchise to conduct a specific activity—in this case banking—as well as limited liability for their shareholders.[32] The first bank charters issued in the American

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25. *Id.* (Seventh).

26. *See* Simeon E. Baldwin, *American Business Corporations Before 1789*, 8 AMER. HIST. REV. 449, 450–51 (1903).

27. *See* Elizabeth Pollman, *Reconceiving Corporate Personhood*, 2011 UTAH L. REV. 1629, 1633–34.

28. *Id.* at 1634–35. *See also* LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 131–32 (3d ed. 2005) ("The corporation was, originally a kind of monopoly. . . . [I]t tended to vest exclusive control over a public asset, a natural resource, or a business opportunity in one group of favorites or investors.").

29. *See* FRIEDMAN, *supra* note 28, at 132. *See also* Richard Sylla, *How the American Corporation Evolved*, 158 PROC. AM. PHIL. SOC'Y 354, 357–58 (2014) (describing examples of states requiring their corporations to direct some of their profits or business efforts to public purposes).

30. FRIEDMAN, *supra* note 28, at 129. While the business corporation was rare during this period, corporate charters were granted more frequently for churches, charities, or cities or boroughs. *Id.*

31. *See id*. at 129–30 ("There were only seven in the whole colonial period; another 181 were granted between 1796 and 1800." (footnote omitted)).

32. *See* Richard Sylla, *Early American Banking: The Significance of the Corporate Form*, 14 BUS. & ECON. HIST. 105, 110 (1985) [hereinafter Sylla, *Early American Banking*] (citing Joseph

colonies were for "land banks" that issued paper notes—"bills on loan"—to borrowers who put up their land as collateral—essentially a form of mortgage for real estate improvements.[33] Interestingly, and in marked contrast to the European banks of the time, which were structured as partnerships, the first American banks were organized as corporations.[34] During the colonial era and early years of the Republic, charters for banks and other business corporations were rare and typically given only to the privileged or politically well connected.

Over time, and particularly beginning with the "Free Banking" era that followed the demise of the Second National Bank of the United States in 1836, the states began to liberalize the availability of charters for both banks and general business corporations.[35] In 1811, New York State passed a statute allowing any association of persons who met certain requirements to receive a charter of incorporation for manufacturing—the first general incorporation statute of its kind.[36] In 1838, New York enacted the Free Banking Law, which similarly opened up the granting of bank charters to "any person or association of persons" which were able to satisfy certain minimum capitalization requirements.[37] Other states followed suit. General business incorporation statutes, which allowed anyone meeting the statutory requirements to receive a corporate charter for a particular line of business such as manufacturing, insurance, or banking, were adopted by most of the states by the late 1850s.[38] During this period, states had exclusive jurisprudence over the chartering of both corporations and banks.

While the legal frameworks for banks and corporations have diverged over time, the shared origins of bank charters and corporate charters mean that the laws applying to the internal workings of these different types of firms are similar in many ways. As described below, banks and

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Stancliffe Davis, *Colonial Corporations Chartered in England*, *in* JOSEPH STANCLIFFE DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATION, at ch. 2 (1917)) (explaining that charters were designed as monopolies). *See also* Robert C. Hockett & Saule T. Omarova, *"Special," Vestigial, or Visionary? What Bank Regulation Tells Us About the Corporation—and Vice Versa*, 39 SEATTLE UNIV. L. REV. 453, 469–70 (2016).

33. *See* Owen F. Humpage, *Paper Money and Inflation in Colonial America*, ECON. COMMENT., no. 2015–06, May 13, 2015, at 2 (documenting the history of bank notes). *See also* Theodore Thayer, *The Land-Bank System in the American Colonies*, 13 J. ECON. HIST. 145, 145 (1953).

34. Sylla, *Early American Banking*, *supra* note 32, at 113–14.

35. *See generally id.*

36. *See* FRIEDMAN, *supra* note 28, at 134–35.

37. *See* Sylla, *Early American Banking*, *supra* note 32, at 107.

38. FRIEDMAN *supra* note 28, at 135; Gerald P. Dwyer, Jr., *Wildcat Banking, Banking Panics, and Free Banking in the United States*, FED. RES. BANK ATLANTA ECON. REV., Dec. 1996, at 2–4. *See also* Sylla, *Early American Banking*, *supra* note 32, at 107 ("The modern concept of the corporation took shape in the early nineteenth-century United States in the movement for free banking.").

corporations today have similar limited shareholder liability and fiduciary duty rules, and state common law treats banks and corporations fairly similarly. But there are some important differences between banks and corporations, deriving from their divergent historical development, which may provide an important foundation for thinking about how to reform the governance of financial institutions.

B. Limited Liability for Bank Shareholders

While bank shareholders today enjoy roughly the same limited liability as corporate shareholders, this was not always the case. Until the Civil War, bank and corporate charters were primarily issued by states,[39] and the common law rule for shareholders of both types of entities was that they were not personally liable for the firm's debts.[40] However, during the early part of the nineteenth century, a small but growing number of states enacted laws subjecting bank shareholders to "double par liability," such that in the event of the bank's insolvency, shareholders were personally liable for an amount equal to the par value of their shares (in addition to the actual value they paid for the shares themselves).[41] Double par liability saw a surge in adoption following Congress's passage of the National Bank Act of 1863 (NBA),[42] which created a system of nationally chartered banks and put in place the so-called "dual banking" system of national and state chartered banks operating side by side.[43] The NBA adopted the then-minority rule of double par liability for all

39. *See* Christine E. Blair & Rose M. Kushmeider, *Challenges to the Dual Banking System: The Funding of Bank Supervision*, 18 FDIC BANKING REV. 1, 2 (2006) ("Aside from the short-lived exceptions of the First Bank of the United States and the Second Bank of the United States, bank chartering was solely a function of the states until 1863."). Two early and notable exceptions to this were the First and Second Banks of the United States, which were Congressionally chartered corporations authorized to conduct banking activities. *See* JOHN THOM HOLDSWORTH & DAVIS R. DEWEY, NAT'L MONETARY COMM'N, THE FIRST AND SECOND BANKS OF THE UNITED STATES, S. DOC. NO. 571, at 19–22, 149–57 (2d Sess. 1910).

40. *See* Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31, 35–36 (1992) (first citing Pollard v. Bailey, 87 U.S. 520, 526 (1874); and then citing Sumner v. Marcy, 23 F. Cas. 384 (C.C.D. Me. 1847) (No. 13,609)).

41. *Id.* at 36–37.

42. National Currency Act, ch. 58, 12 Stat. 665 (1863) (repealed 1864). The National Currency Act was repealed and replaced the following year by similar legislation that aimed to improve upon the original legislation. Act of June 3, 1864, ch. 106, 13 Stat. 99 (codified as amended in scattered sections of 12 and 31 U.S.C. (2018)). Although neither bill was actually titled the "National Bank Act," they have collectively become known as such (or sometimes the "National Banking Act"). *See* Howard H. Hackley, *Our Baffling Banking System*, 52 VA. L. REV. 565, 572 (1966).

43. *See* Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 681–82 (1988). As Geoffrey Miller has argued, the national banking system created by the National Bank Act was intended to provide a stable currency and to displace state banks, and certainly not to create the dual banking system that emerged. Geoffrey P. Miller, *The Future of the Dual Banking System*, 53 BROOK. L. REV. 1, 13–14 (1987).

shareholders of national banks.[44] This quickly led to a mass adoption of the rule by the states. By 1931, double par liability had been implemented by all of the states except Alabama, Connecticut, Delaware, Louisiana, Massachusetts, Missouri, New Jersey, Rhode Island, Vermont, and Virginia.[45]

Following the banking panic of 1929–33, double par liability for bank shareholders was widely seen as a failure.[46] Congress consequently repealed double liability for all newly issued national bank shares in 1933,[47] and allowed banks to opt out of double liability for any outstanding shares in 1935.[48] By the 1950s, there were only a handful of banks left that still maintained double par liability for their shareholders, and Congress formally eliminated double liability for these banks in 1953.[49] The elimination of double par liability for national banks was paralleled by a similar movement across state legislatures. By 1944, thirty-one states had abolished double par liability for banks, and today, double liability for bank shareholders does not exist.[50] Since the 1950s, then, bank and corporate shareholders have enjoyed equivalent limited liability.

C. Fiduciary Duties of Bank Directors

Just as the laws governing shareholder liability for banks and corporations have converged over time, so too have the laws governing the fiduciary duties of bank and corporate directors.[51] While there is a robust literature—both theoretical and empirical—that has emerged discussing the fiduciary duties of corporations, banking governance has been far less studied. To the extent that banking governance issues have received scholarly attention, these have tended to revolve around two discrete areas: first, what the duty should look like; and second, to whom

44. National Currency Act § 12, 12 Stat. at 668 (stating that "each shareholder shall be liable to the amount of the par value of the shares held by him, in addition to the amount invested in such shares").

45. *See* Macey & Miller, *supra* note 40, at 37 (citing E.G.T., Jr., Note, *Ambit of Double Liability of National Bank Stockholders*, 80 U. PA. L. REV. 1133, 1133 n.1 (1932)). Several states had important substantive distinctions in their liability rules. For example, California's law had no express limitation on shareholder liability, *see* CAL. CONST. art. XII, § 3 (repealed 1930), and Colorado imposed triple liability, *see* COLO. STAT. ANN. ch. 18, § 50 (1935) (repealed 1935).

46. *See* Macey & Miller, *supra* note 40, at 37–38.

47. Banking Act of 1933, ch. 89, § 22, 48 Stat. 162, 189 (repealed 1959).

48. Banking Act of 1935, ch. 614, § 304, 49 Stat. 684, 708 (repealed 1959).

49. *See* Macey & Miller, *supra* note 40, at 38–39 (citing Act of May 18, 1953, ch. 59 § 2, 67 Stat. 27).

50. *Id.* at 39 (citing Perry L. Greenwood, Note, *Banks—Liability of Stockholders of Holding Company on National Bank Stock Held by Company*, 7 U. DET. L.J. 123, 125 (1944)).

51. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 298 (1999). Directors are also under a duty to act lawfully. *See* Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 945 (1990).

the duty should be owed.[52] This paper addresses the second area, although I intend to make a separate set of arguments around the first area in a future article.[53] Generally, the law of fiduciary duties has developed in parallel for banks and corporations.[54] But there are important, if at times subtle, differences between banks and general business corporations in who is owed a fiduciary duty, as I describe in this section.

1. Who Is Owed a Fiduciary Duty?

In corporate law, the claim that directors owe a duty of shareholder wealth maximization is well established and also the subject of great criticism. Shareholder wealth maximization has been seen as a central part of corporate law since *Dodge v. Ford* was handed down in 1919.[55] In that case, the Michigan Supreme Court famously stated:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes.[56]

This dicta has become a mainstay in corporate law, representing the maxim that officers and directors owe a duty to shareholders to maximize their profits.[57] While there has long been criticism of this view,[58] most

52. Lawrence G. Baxter, *Fiduciary Issues in Federal Banking Regulation*, 56 LAW & CONTEMP. PROBS. 7, 13 (1993).

53. Generally speaking, as I describe in a forthcoming article, the duties of care and loyalty in banking have long tracked those same fiduciary duties in corporate law. But as Frank Partnoy has argued, the Delaware courts have established a duty of oversight (part of the duty of loyalty) for corporate directors with the *Caremark* decision, *In re Caremark Int'l, Inc.*, 698 A.2d 959, 971 (Del. Ch. 1996), which can potentially be interpreted as requiring a heightened standard of care for the directors of institutions with unique risks, such as financial firms. *See generally* Frank Partnoy, *Delaware and Financial Risk*, *in* THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP?, at ch. 6 (Steven Davidoff Solomon & Randall Stuart Thomas eds., 2019).

54. Partnoy, *supra* note 53.

55. *See generally* Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

56. *Id.* at 684.

57. *See, e.g.*, ROBERT CHARLES CLARK, CORPORATE LAW 678 (1986) (citing *Dodge v. Ford* to establish that corporate law requires the maximization of shareholder profits); Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 337–38 ("The law's basic position . . . famously was articulated in *Dodge v. Ford Motor Co.*").

58. *See, e.g.*, Kent Greenfield, *New Principles for Corporate Law*, 1 HASTINGS BUS. L.J. 87, 88 (2005) ("[S]hareholders are not owners in any traditional sense of ownership. They are not owners in any other meaningful way either . . . ."); Blair & Stout, *supra* note 51 (proposing an alternative "team production" paradigm of the corporation and arguing that this model illustrates the normative and descriptive flaws with shareholder wealth maximization); Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1411–19 (1993) (arguing that corporate law should and does allow for a multi-fiduciary approach

who study and practice corporate law believe that a duty of shareholder wealth maximization is well established as a matter of law.[59] For example, the prominent corporate law professors Henry Hansmann and Reinier Kraakman have stated that "[t]here is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value."[60] The American Law Institute has said that corporations should be managed "with a view to enhancing corporate profit and shareholder gain."[61] The current Chief Justice of the highly influential Delaware Supreme Court, Leo E. Strine, Jr., has repeatedly and forcefully asserted in several influential law review articles that Delaware corporate law clearly imposes a duty on directors to maximize shareholder profits.[62] Indeed, as Chief Justice Strine has

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to managerial responsibilities); *see generally* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1155–56 (1932).

59. *See infra* notes 60–73 and accompanying text. *But see generally* Lynn A. Stout, *Why We Should Stop Teaching* Dodge v. Ford, 3 VA. L. & BUS. REV. 163 (2008) (arguing that corporate law does not necessarily require officers and directors to maximize shareholder wealth). A potential caveat to the rule that directors owe a fiduciary duty to the long-term interests of shareholders lies in the so-called "zone of insolvency." In *Credit Lyonnais*, the Delaware Chancery Court stated:

> At least where a corporation is operating in the vicinity of insolvency, the board of directors is not merely the agent of the residue risk bearers [i.e. shareholders], but owes its duty to the corporate enterprise . . . in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and fair) course to follow for the corporation may diverge for the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991). However, a line of subsequent decisions by Delaware courts have seemingly narrowed, or perhaps even eliminated, the zone of insolvency concept. *See* Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772 (Del. Ch. 2004); Trenwick Am. Litig. Tr. v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006); N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

60. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001).

61. A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(a) (1994). As J. Haskell Murray describes, this language reflects a compromise with those who are opposed to the principle of shareholder wealth maximization, as the language itself describes "enhancing" rather than "maximizing" corporate profits and shareholder gains. Furthermore, § 2.01(b), states that the corporation may take into account reasonable ethical considerations and may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes. *See* J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1, 7 n.22 (2012).

62. *See* Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 763–68, 785–86 (2015) [hereinafter Strine, *The Dangers of Denial*] (arguing that the power structure of the corporation—including the exclusive rights of shareholders to vote and to sue under the Delaware General Corporation Law or for breaches of fiduciary duties—makes clear that directors are required to maximize long-term shareholder value); Leo E.

pointed out, "[i]n the corporate republic, no constituency other than stockholders is given any power."[63] Shareholders have several rights unique to them that give them some control over the powers of the corporation, including the right to elect corporate directors,[64] approve certificate amendments[65] and significant changes such as mergers[66] or major asset sales,[67] amend the bylaws,[68] and to sue directors for breaching their fiduciary duties to shareholders.[69]

In support of this claim that shareholders are owed a duty of wealth maximization are a number of prominent Delaware cases, including *Katz v. Oak Industries*,[70] *Revlon v. MacAndrews*,[71] *TW Services v. SW Acquisition*,[72] and *eBay v. Newmark*.[73] While Delaware law obviously

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Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 151–55 (2012) ("[C]orporate law requires directors, as a matter of their duty of loyalty, to pursue a good faith strategy to maximize profits for the stockholders."); Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1, 3 (2007) (stating that while it may be fair to describe corporations as "social institutions," it must still be recognized that they must be run with "the ultimate goal of producing profits for stockholders").

63. Strine, *The Dangers of Denial*, *supra* note 62, at 766.

64. *See, e.g.*, DEL. CODE ANN. tit. 8, § 211(b) (2020).

65. DEL. CODE ANN. tit. 8, § 242(b)(1)–(2) (2020).

66. DEL. CODE ANN. tit. 8, § 251(c) (2020).

67. DEL. CODE ANN. tit. 8, § 271(a) (2020).

68. DEL. CODE ANN. tit. 8, § 109(a) (2020).

69. DEL. CODE ANN. tit. 8, § 327 (2020).

70. Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986) ("It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders . . . .").

71. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 177–82 (Del. 1986) ("A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders. However, such concern for non-stockholder interests is inappropriate when . . . the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.").

72. TW Services Inc. v. SW Acquisition Corp., Nos. 10427, 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989) ("[D]irectors may be said to owe a duty to shareholders as a class to manage the corporation within the law, with due care and in a way intended to maximize the long run interests of shareholders. There is a time, however, when the board's duty becomes more targeted and specific and its range of options become narrower. In [*Revlon*], the Supreme Court held that the board's duty was a single one: to exercise its judgment in an effort to secure the highest price available . . . .").

73. eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010) (rejecting a corporate policy approved by the founders of Craigslist, who owned a majority of the voting shares, that would have expressly not allowed for profit maximization, and stating that "[h]aving chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. The "Inc." after the company name has to mean at least that."). *See also* CLARK, *supra* note 57, at 682 (aside from "a possible exception or two . . . courts have not retreated from the assumption that the primary or residual purpose of a business corporation is to make profits for its shareholders").

does not bind the courts of other states, it is disproportionately influential given both the tremendous number (and aggregate asset size) of companies choosing to incorporate in Delaware and the high degree of deference given by other states to the expertise of Delaware courts in dealing with corporate law matters.

It may be relatively clear that corporate directors owe a fiduciary duty to maximize shareholder wealth (although it is more controversial *whether* they should owe such a duty),[74] but this is less settled for bank directors. It is generally uncontested that bank directors owe a fiduciary duty to the bank's shareholders, but many observers have argued that bank fiduciary duties are broader, with bank directors also owing a general fiduciary duty to depositors, to the federal government, and/or to the general principle of safety and soundness.

This disagreement over the scope of bank fiduciary duties is largely due to the historical development of banking law. Following the collapse of the Second Bank of the United States of America and the subsequent "Free Banking Era," and continuing through much of the nineteenth century, bank fiduciary duties were considered purely a matter of state common law. Consequently, they mostly developed in parallel with corporate fiduciary duties, with a high deference to board autonomy and an increasing emphasis on maximizing shareholder profits.[75] As Patricia McCoy has documented, during this period, bank directors were given very broad latitude to pursue shareholders' interests, with a robust business judgment rule and effectively no judicial enforcement against excessive risk-taking by bank managers and directors.[76] Reflecting the mores of the era, bank depositors were generally denied standing to sue for a breach of fiduciary duty, as it was assumed that their relationship with the bank was a contractual one and did not extend to the bank's

74. For example, Senator Elizabeth Warren recently sponsored the Accountable Capitalism Act, which would require all business corporations with more than $1 billion in annual revenues to receive a newly created federal corporate charter. This charter would specifically require that corporate directors consider the interests of all of the corporation's stakeholders, not just its shareholders, and that at least 40 percent of its directors be made up of representatives from labor. Press Release, Elizabeth Warren, Warren Introduces Accountable Capitalism Act: Comprehensive Legislation to Eliminate Skewed Market Incentives and Return to the Era When American Corporations and American Workers Did Well Together (Aug. 15, 2018), *available at* https://www.warren.senate.gov/newsroom/press-releases/warren-introduces-accountable-capitalism-act [https://perma.cc/B7JV-3H8L].

75. *See* Patricia A. McCoy, *A Political Economy of the Business Judgment Rule in Banking: Implication for Corporate Law*, 47 CASE W. RES. L. REV. 1, 22–25 (1996) (discussing the historical development of bank fiduciary duties).

76. *Id.* at 22–30.

officers and directors.[77] Shareholder wealth maximization was seen as the primary goal of bank directors, even at the expense of depositors.[78]

But this period was also marked by an epidemic of bank panics. By 1891, the United States had experienced at least twelve different panics with their accompanying ruinous effects on economic growth and capital formation.[79] Perhaps reflecting second thoughts on the laissez-faire model of banking, judicial attitudes towards bank governance began to shift in the late nineteenth century. In an 1875 opinion addressing the extent to which state usury laws could apply to nationally chartered banks, the United States Supreme Court expressly rejected the notion that banks were purely private enterprises, describing them rather as "instruments designed to be used to aid the government in the administration of an important branch of the public service."[80] Similarly, in a 1911 opinion, the Kansas Supreme Court, in upholding the state charter board's decision to refuse a bank charter to a group of applicants based on a determination that there was no community need for another bank, stated that banking was not "a matter of private concern only" but rather, "for all purposes of legislative regulation and control it may be said to be 'affected with a public interest.'"[81]

Perhaps because of the view of banks as quasi-public enterprises, the courts were more open to the idea that bank stakeholders other than just shareholders might be owed a fiduciary duty. In the 1891 *Briggs* decision discussed above, Justice Harlan's dissent explicitly takes into account the fiduciary interests owed to depositors as well as shareholders.[82] Justice Harlan's dissent was highly influential in subsequent cases in which

77. *Id.* at 24–25 (first citing Union Nat'l Bank v. Hill, 49 S.W. 1012 (Mo. 1899); then citing Hart v. Evanson, 105 N.W. 942 (N.D. 1895); then citing Swentzel v. Penn Bank, 23 A. 405, 414–15 (Pa. 1982); then citing Deadrick v. Bank of Commerce, 45 S.W. 786 (Tenn. 1898); and then citing Zinn v. Mendel, 9 W. Va. 580 (1876)). One notable exception to this common law antipathy to depositor standing came in the case of mutual savings banks, which did not have shareholders or directors, but rather were owned by the depositors and supervised by trustees who owed express fiduciary duties to the depositors. *Id.* at 30–33. In states where mutual savings banks were permitted by law, including New York, courts generally did confer standing on depositors and their representatives. *Id.*

78. *Id.* at 25.

79. *Id.* at 30.

80. Farmers' & Mechs.' Nat'l Bank v. Dearing, 91 U.S. 29, 33 (1875).

81. Schaake v. Dolley, 118 P. 80, 83 (1911).

82. Briggs v. Spaulding, 141 U.S. 132, 166 (1891) (discussing the mismanagement of the bank in managing the money of the bank's shareholders *and* depositors); *id.* at 171 (stating that "the abdication by directors of their duties and functions . . . puts in peril the interests of stockholders *and* depositors" (emphasis added)). Notably, the majority opinion in *Briggs* does not take a shareholder primacy position, but rather states instead that bank fiduciary duties are owed "not to stockholder[s] nor to creditors, as such, but to the bank." *Id.* at 149–50.

courts found a fiduciary duty owed to depositors[83] or otherwise expanded bank director liability.[84] Many lower courts and state courts adopted the view that bank directors owe a fiduciary duty not only to the bank's shareholders but also to its depositors and creditors.[85] Correspondingly, as discussed above, there was also a notable trend towards curtailing the business judgment rule for bank directors and officers during this period, effectively expanding the scope of liability.[86] By the early twentieth century, there was a growing movement in the courts towards recognizing that the governance of banks was distinct from that of other types of business corporations, and that bank directors owed a duty to their depositors.[87]

The common law of bank director liability was complicated by Congress's banking reforms of the 1930s, including the establishment of federal deposit insurance and expansive resolution powers for the regulators administering this federal deposit insurance, such as the authority to act as the receiver or conservator of a failing or troubled

83. *See, e.g.*, Robinson v. Hall, 63 F. 222, 227 (4th Cir. 1894) (citing Justice Harlan's dissent in reversing the lower court's decision to sustain the demurrer of the defendants, who were national bank directors, against claims that they breached a fiduciary duty owed to depositors); Anderson v. Bundy, 171 S.E. 501, 507 (Va. 1933) (citing Justice Harlan's dissent to support its holding that state bank directors "must exercise ordinary care and prudence in the protection of their depositors").

84. *See, e.g.*, Dudley v. Hawkins, 239 F. 386, 389 (S.D. Ga. 1917) (citing Justice Harlan's dissent to hold that national bank directors owe a duty of ordinary care); Bank of Commerce v. Goolsby, 129 Ark. 416 (Ark. 1917) (citing Justice Harlan's dissent in support of its holding that Arkansas state bank directors owe a duty of ordinary care).

85. *See, e.g.*, United Soc'y of Shakers v. Underwood, 9 Bush 609, 616–18 (Ky. 1873) (holding that bank directors owe a fiduciary duty to the bank's creditors and customers); Hun v. Cary, 82 N.Y. 65, 74 (1880) (holding that the trustees of a savings bank who approved the building of a new bank headquarters despite being near insolvency were liable to the depositors because they had "invited depositors to confide to them their savings, and to intrust the safe-keeping and management of them to their skill and prudence"); Delano v. Gardner, 17 Ill. App. 531, 538 (1887) (holding that directors of a state commercial bank who ignored warnings that the bank's officers were engaged in fraud were liable to the bank's depositors under a standard of gross negligence); Marshall v. Farmers' & Mechs.' Sav. Bank, 8 S.E. 586, 590, 591 (Va. 1889) ("The directors of a bank are not trustees for the stockholders alone, but they owe an even earlier duty to the depositors. . . . [D]irectors of banks [hold a trustee relationship] with stockholders, depositors and creditors . . . ."); Solomon v. Bates, 24 S.E. 478, 480 (N.D. 1896) (holding that state bank directors were liable to depositors "for injuries resulting from gross negligence on their part").

86. *See supra* notes 75–76 and accompanying text.

87. *See, e.g.*, Campbell v. Watson, 50 A. 120, 124 (N.J. 1901) (stating that depositors have "a right to rely upon the character of the directors and officers of the bank, and that they will . . . devote to its affairs the same diligent attention which ordinary, prudent, diligent men pay to their own affairs"); Gause v. Commonwealth Tr. Co., 89 N.E. 476, 482 (N.Y. 1909) (differentiating between general business corporations and banks and concluding that bank directors owe a higher duty of care than their counterparts in other business corporations because a bank invites depositors to "submit to it the possession and care of their money and property").

bank.[88] As a result of these reforms, bank losses shifted from depositors to the federal government, and investor suits against banks were mostly displaced by litigation initiated by the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC)—and eventually the Resolution Trust Corporation, which was created by Congress to replace FSLIC and deal with the collapse of the savings and loan industry—or the federal agencies responsible for overseeing the resolution of failed depository institutions.[89] At the same time, one important byproduct of this phenomenon was that these cases went from primarily being decided by state courts (which is still the case with corporate director liability cases) to being primarily decided by federal courts.[90]

As the federal government displaced bank investors as the primary plaintiff—and bearer of losses—following bank failures, the courts became more willing to expand the liability of bank directors, and to find that these directors owed a fiduciary duty to depositors (or the federal deposit insurance funds that guaranteed them). For example, in a prominent New York case in 1934, the court noted the trend towards holding bank directors to a higher standard than other types of directors, and explained:

> The reason for the higher standard of diligence required of banking as compared with that of other corporations is obvious. While legalistically the relation between the bank and its depositors is that of debtor and creditor, practically the directors are charged with the trust responsibility to see that depositors' funds are safely and providently invested.[91]

In 1935, the US Supreme Court, in hearing a case in which state chartered building-and-loan associations[92] sought to convert to federally chartered savings-and-loan institutions, described these institutions as "quasi public instruments" distinct from other types of business corporations, and owing a duty to protect the interests of not only their shareholders but also their creditors.[93] Extending this logic to national

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88. McCoy, *supra* note 75, at 22–25; *see also id.* at 53 ("The vast majority of reported bank director negligence cases since 1945 has been brought by the [Federal Deposit Insurance Corporation], or its one-time sister agency, the Resolution Trust Corporation ("RTC"), either in their corporate capacities or as conservators or receivers.").

89. *Id.* at 52 n.175.

90. *Id.* at 53 ("[T]he principal forum for bank director liability cases has shifted from state courts to federal courts . . . .").

91. Broderick v. Marcus, 152 Misc. 413, 418 (N.Y. Sup. Ct. 1934).

92. This is a type of depository institution with shareholders meant to encourage home mortgage lending, essentially the same as the more ubiquitous terms "savings and loan association" or "thrift institution."

93. Hopkins Fed. Sav. & Loan Ass'n v. Cleary, 296 U.S. 315, 336 (1935); *see also id.* at 340

banks, the Sixth Circuit made clear in a 1938 opinion that bank directors owe a common law fiduciary duty to depositors, saying:

> [T]he law requires and depositors have a right to expect that directors should retain and maintain a reasonable control and supervision over the affairs of the bank . . . [i]n the discharge of this duty the directors are required not only in the observance of their official oath but by common law to use ordinary diligence. . . . They must keep in mind that *a national bank is not a private corporation in which stockholders alone are interested. It is a quasi governmental agency, and one of its principal purposes among others is to hold and safekeep the money of its depositors*.[94]

In a 1940 case called *Litwin v. Allen*,[95] a New York court—describing the conventional wisdom of the time—stated that "[u]ndoubtedly, a director of a bank is held to stricter accountability than the director of an ordinary business corporation [because he or she] is entrusted with the funds of depositors. . . ."[96]

But the trend towards recognizing bank fiduciary duties to depositors waned in the post-World War II era. As discussed below, the extraordinary stability of the banking industry following the New Deal era reforms meant that there was virtually no bank failure-related litigation for several decades. As a result, case law addressing the issue of bank director negligence essentially disappeared for several decades. It was only with the spate of bank failures beginning in the late 1970s and accelerating into the late 1980s and early 1990s that questions of bank fiduciary duties arose again. As courts began to revisit the issue of whether and to what extent bank depositors are owed fiduciary duties under state tort law, many reverted back to the old legal standards governing this issue and concluded that the bank-depositor relationship is a form of debtor-creditor relationship that does not give rise to any fiduciary obligations.[97] Conversely, many other courts went the other

("In the creation of corporations of this quasi-public order . . . the state is *parens patriae*, acting in a spirit of benevolence for the welfare of its citizens. Shareholders and creditors have assumed a relation to the business in the belief that the assets will be protected by all the power of the government against use for other ends than those stated in the charter . . . . [T]here is thus the duty of the *parens patriae* to keep faith with those who have put their trust in the parental power [including creditors].").

94. Atherton v. Anderson, 99 F.2d 883, 888 (6th Cir. 1938) (emphasis added) (citations omitted).

95. Litwin v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940).

96. *Id.* at 678 (citing Gause v. Commonwealth Tr. Co., 89 N.E. 476, 482 (N.Y. 1909)).

97. *See, e.g.*, Linden Place, LLC v. Stanley Bank, 167 P.3d 374, 379 (Ky. Ct. App. 2007) ("[T]he general rule is that the relationship between a bank and its depositor is a debtor-creditor relationship, not a fiduciary relationship."); Geiger v. Crestar Bank, 778 A.2d 1085, 1091 (D.C. 2001) (quoting Miller v. Am. Nat'l Bank & Tr. Co. of Chi., 4 F.3d 518, 520 (7th Cir. 1993)) ("[A] bank generally owes no fiduciary duty to its depositors."); Kaser v. Swann, 141 F.R.D. 337, 341

way and held that bank depositors are owed a duty of care.[98] Secondary authorities and commentators have been similarly split on this issue, with

(M.D. Fla. 1991) (citing Hooper v. Barnett Bank, 474 So.2d 1253, 1257 (Fla. Ct. App. 1985)) ("Generally, a bank-depositor transaction is treated as a debtor-creditor relationship and does not create a fiduciary duty."); Copesky v. Superior Court, 229 Cal. App. 3d 678, 693–94 (Cal. Ct. App. 1991) (rejecting the claim that the bank-depositor relationship is "quasi-fiduciary" and concluding that "banks . . . are not fiduciaries for their depositors . . . such as to give rise to tort damages when an implied contractual covenant of good faith is broken"); Wood & Huston Bank v. Malan, 815 S.W.2d 454, 458 (Mo. 1991) (citing Estate of Parker, 536 S.W.2d 25, 29 (Mo. 1976)) ("G]enerally, the relationship between a bank and its depositor involves a contractual relationship between a debtor and a creditor."); Irons v. Cmty. State Bank, 461 N.W.2d 849, 852 (Iowa Ct. App. 1990) (citing Kurth v. Van Horn, 380 N.W.2d 693, 696 (Iowa 1986)) ("Generally, a fiduciary duty . . . does not arise solely from a bank-depositor relationship."); Mann Farms, Inc. v. Traders State Bank, 801 P.2d 73, 76 (Mont. 1990) ("[T]he relationship between a bank and its customer usually does not give rise to fiduciary duty."); Paskas v. Illini Fed. Sav. & Loan Ass'n, 440 N.E.2d. 194, 198–99 (Ill. 1982) ("[We are unaware of any authority] which could indicate that, in Illinois, a fiduciary relation exists as a matter of law between a bank and its depositor. . . . Rather a debtor-creditor relationship exists between the depositor and the bank and the contract between the two controls their relationship." (citations omitted)). Some states, such as Louisiana, enacted "clarifying" legislation stating explicitly that there is no fiduciary relationship between a bank and its depositors or other non-shareholders. *See* LA. STAT. ANN. § 6:1124 (2019). *See also* ABA SECTION LITIG., 9 BUSINESS & COMMERCIAL LITIGATION IN FEDERAL COURTS § 92:45 (4th ed. 2019) (stating that "most courts have found that a bank does not owe a fiduciary duty to its depositors in the absence of special circumstances. The relationship between a bank and a depositor is a contractual, rather than a fiduciary one").

98. *See, e.g.*, Champaigne v. Scarso, No. CV 970348470S, 1999 WL 54851, at *8 (Conn. Super. Ct. Jan. 27, 1999) ("Banks and their depositors are bound by a special relationship. Because of this relationship, banks owe a duty of ordinary care to their depositors."); *In re* Hutchins, 216 B.R. 11, 14 (Bankr. E.D. Ark. 1997) (stating that directors of financial institutions owe fiduciary duties to the bank's depositors); FDIC v. Eltrex Int'l Corp., No. CIV. 91-434-JD, 1994 WL 258673, at *5 (D.N.H. Feb. 1, 1994) ("Pursuant to New Hampshire law, a bank owes a fiduciary duty to its depositors."); Billman v. State of Md. Deposit Ins. Fund Corp., 593 A.2d 684, 697–98 (Md. 1991) (stating that directors and officers of a savings and loan institution "owe a higher duty of care than is owed by their counterparts in a general corporation . . . because they are entrusted with funds belonging to the general public"); Mercury Serv., Inc. v. Allied Bank of Tex., No. 88-6550, 1990 WL 90216, at *3 (9th Cir. July 2, 1990) (citing Commercial Cotton Co. v. United Cal. Bank, 163 Cal. App. 3d 511 (1985)) (noting that, in California, "a bank owes fiduciary duties to its depositors"); Irving Bank Corp. v. Bd. of Governors of the Fed. Reserve Sys., 845 F.2d 1035, 1039 (D.C. Cir. 1988) (holding that bank directors owe a duty to "shareholders and depositors alike"); Francis v. United Jersey Bank, 432 A.2d 814, 820–24 (N.J. 1981) (stating that, in New Jersey, bank directors owe a duty of ordinary care to depositors); First Nat'l Bank of La Marque v. Smith, 436 F. Supp. 824, 830–31 (S.D. Tex. 1977) (noting that, in Texas, bank directors owe a higher duty than other types of directors "because of the duty to depositors"), *vacated in part on other grounds*, 610 F.2d 1258 (5th Cir. 1980); Lane v. Chowning, 610 F.2d 1385, 1388–89 (8th Cir. 1979) (citing WILLIAM M. FLETCHER, 3 FLETCHER'S CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 845 (1975)) ("[I]t is well settled that the fiduciary duty of a bank officer or director is owed to the depositors and shareholders of the bank . . . ."). *But see* Keith R. Fisher, *Nibbling on the Chancellor's Toesies: A "Roguish" Concurrence with Professor Baxter*, 56 LAW & CONTEMP. PROBS. 45, 58–59 (1993) (arguing that *Lane v. Chowning* incorrectly cited the fiduciary duty concept articulated in *Fletcher's Cyclopedia*, which referred specifically to mutual savings banks owned by their depositors).

many observers concluding that there is no fiduciary duty owed to bank depositors,[99] and others arguing the contrary view.[100]

The banking regulators themselves have consistently and forcefully argued that bank directors and officers owe a fiduciary duty not only to their shareholders but also to their creditors. Indeed, at least one prominent regulator has gone much further, arguing that bank directors owe a fiduciary duty not only to depositors but also to the federal government in its role as the insurer of those depositors.[101] This argument was famously made by Harris Weinstein, the then-Chief Counsel of the Office of Thrift Supervision (OTS)—at the time, the primary federal regulator for nationally chartered thrift institutions—who stated that "every fiduciary of a federally insured depository institution owes the federal insurer, at the very minimum, the very same high fiduciary duties that are owed depositors. . . [including] the duty not to risk insolvency and the resulting loss of funds deposited with the institution."[102]

In support of this claim, Weinstein advanced three "Hornbook principles" of law. First, Weinstein argued that under principles of insurance law, "the insurer who covers a loss is subrogated to the rights of the insured," which in the case of depositors include the right to seek "money damages against fiduciaries who have failed to safeguard deposits."[103] Second, citing Judge Stanley Sporkin, Weinstein asserted that the federal deposit insurer was analogous to equity investors, since the "federal government's interest. . . is many times that of [any other equity holder]."[104] Since the government in its role as deposit insurer

99. *See, e.g.*, Baxter, *supra* note 52, at 24–25 (arguing that the statutory prohibition on unsafe or unsound conduct is distinct from a fiduciary duty, and that no fiduciary duty to depositors exists); Fisher, *supra* note 98, at 57–58 (arguing that the claim that bank depositors are owed a fiduciary duty stems from the judicial misinterpretation of several key opinions and sources); 10 AM. JUR. 2D *Banks and Financial Institutions* § 708 (2020) ("[W]hile banking institutions undertake and solicit the trust of their depositors and as a consequence thereof are burdened with heavy responsibility, the relationship of this institution to the depositor is not typically deemed to be fiduciary in nature." (citations omitted)).

100. *See, e.g.*, Stephen Bainbridge, *The Fiduciary Duties of Bank Directors*, PROFESSORBAINBRIDGE.COM (Mar. 21, 2013), http://www.professorbainbridge.com/professorbainbridgecom/2013/03/the-fiduciary-duties-of-bank-directors.html [https://perma.cc/G6HW-HV4D] (concluding that bank directors owe a fiduciary duty to depositors, even if this is not "what the law ought to be"); Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1478 (1993) ("[D]irectors of banking institutions owe fiduciary duties to depositors."); Richard M. Cieri et al., *The Fiduciary Duties of Directors of Financially Troubled Companies*, 3 J. BANKR. L. & PRAC. 405, 407 (1994) ("[D]irectors of banking institutions owe fiduciary duties to the bank's depositors . . . .").

101. *See* Harris Weinstein, Address at Southern Methodist University in Dallas, Texas (Sept. 13, 1990), *in* 55 BNA BANKING REP. 508, 510–11 (1990).

102. *Id.* at 511.

103. *Id.*

104. *Id.* (citing Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 905 (D.D.C. 1990)).

holds "an unlimited negative equity risk while it has none of the potential for gain that common shareholders enjoy," it deserves "the highest conceivable standard of fiduciary conduct."[105] Finally, Weinstein analogized the federal government's role as deposit insurer of a failing bank to the role of a creditor of an insolvent or near insolvent debtor, noting that such a debtor owes a fiduciary duty to creditors under well settled principles of bankruptcy law and arguing that a similar fiduciary duty should be owed to the federal government.[106]

Weinstein's contention that bank directors and officers owe a fiduciary duty to the federal government was controversial and met with a great deal of criticism at the time it was made.[107] But while Weinstein's arguments may have been unsuccessful in reshaping the law, the claim that bank directors owe duties beyond those owed by corporate directors remains salient. For example, in recent Congressional testimony, the Comptroller of the Currency reiterated the point that the "primary fiduciary duty [of bank directors] is to ensure the safety and soundness of the national bank or federal savings association."[108] The FDIC continues to maintain as a matter of policy that bank directors and officers owe fiduciary duties to "the shareholders *and* creditors of their institutions".[109]

As the preceding analysis illustrates, there is some dispute over the issue of whether a fiduciary duty is owed to anyone other than bank shareholders. While there was a clear movement towards expanding bank fiduciary duties to depositors in the late nineteenth and early twentieth centuries, this movement was disrupted by the extraordinary stability of the banking system—and consequent absence of litigation against bank

105. *Id.*

106. *Id.*

107. Notably, the General Counsel of the FDIC, the other main federal deposit insurer, publicly declined to agree with Weinstein's position. *See FDIC General Counsel Declines to Embrace Higher Duty for Fiduciaries in Failing Banks*, 55 BNA BANKING REP. 941, 941–42 (1990). Other commentators at the time also publicly critiqued Weinstein's expansive conception of fiduciary duties. *See generally* Brian W. Smith & M. Lindsay Childress, *Avoiding Lawyer Liability in the Wake of* Kaye*,* Scholer, 8 ST. JOHN'S J. LEGAL COMMENT. 385, 388–90 (1993); Lawrence J. Fox, OTS v. Kaye, Scholer*: An Assault on the Citadel*, 48 BUS. LAW. 1521, 1522–25 (1993); Fisher, *supra* note 98, at 46; Baxter, *supra* note 52, at 15–23; Andrew J. Nussbaum, *Like Money in the Bank? An Economic Analysis of Fiduciary Duties to Protect the S&L Deposit Insurance Fund*, 44 ADMIN. L. REV. 355, 359–83 (1992); H. Brent Helms, *Financial Institutions Reform, Recovery, and Enforcement Act: An Ethical Quagmire for Attorneys Representing Financial Institutions*, 27 WAKE FOREST L. REV. 277, 283–87 (1992); Thomas C. Rice & Blake A. Bell, *Liability of Lender's Counsel*, A.L.I.-A.B.A. CONTINUING LEGAL EDUCATION C665, at 277–282 (Oct. 31, 1991).

108. *Implementing Wall Street Reform*, 112th Cong. 25 (2012) (statement of Thomas J. Curry, Comptroller of the Currency).

109. FED. DEPOSIT INS. CORP., STATEMENT CONCERNING THE RESPONSIBILITIES OF BANK DIRECTORS AND OFFICERS, STATEMENT OF POLICY 5000 (1992) (emphasis added), *available at* https://www.fdic.gov/regulations/laws/rules/5000-3300.html [https://perma.cc/4M85-PNPH].

directors and officers—in the post-New Deal era. By the time the question of bank fiduciary duties was next seriously revisited in the late twentieth century, most courts had largely reverted back to the shareholder-centric view that was dominant in corporate law. That being said, federal banking regulators have continued to maintain that bank directors and officers owe a fiduciary duty of safety and soundness, which may be tied to their duties to depositors.

2. Statutory Duties

The issue of bank fiduciary duties is further complicated by Congress's creation of statutory duties for bank directors. The National Banking Act of 1863 and subsequent Congressional legislation allowed bank directors to be held personally liable for certain violations committed by the bank or its officers, but only if the directors had *actual* knowledge of these acts.[110] These violations historically included exceeding certain statutory limits on loans made to a single borrower, real estate lending, and securities underwriting.[111]

Congress also created a duty of safety and soundness for bank directors with its passage of the Banking Act of 1933, which was revised and expanded over time. The Banking Act of 1933 authorized the removal of national bank directors for engaging or participating in any "unsafe or unsound banking practices." While the term "unsafe or unsound banking practices" may be vague, the "authoritative definition"[112] was provided by John Horne, then the Director of the Federal Home Loan Bank Board, in an influential 1966 memorandum, in which he stated:

> Like many other generic terms widely used in the law, such as "fraud," "negligence," "probable cause," or "good faith," the term "unsafe or unsound practices has a central meaning which can and must be applied to constantly changing factual circumstances. Generally speaking, an "unsafe or unsound practice" embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.[113]

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110. 12 U.S.C. § 93(a) (2019).

111. McCoy has an informative discussion of these limits on national bank activities. *See* McCoy, *supra* note 75, at n66–67 and accompanying text.

112. *See* Gulf Fed. Sav. & Loan Ass'n v. Fed. Home Loan Bank Bd., 651 F.2d 259, 264 (5th Cir. 1981), *cert. denied*, 458 U.S. 1121 (1982) (noting that both Houses adopted John Horne's definition of "unsafe or unsound practices"); *see also* Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175, 190–91 (1995) (describing how courts definining unsafe or unsound banking practices "have relied on either Chairman Horne's definition or one almost identical to it").

113. *Financial Institutions Supervisory and Insurance Act of 1966: Hearings on S. 3158 and S. 3695 Before the House Comm. On Banking and Currency*, 89th Cong. 50 (1966).

As Heidi Mandanis Schooner has described, the duty to refrain from unsafe or unsound practices has expanded over time, and today "serve[s] as a statutory trigger for every important formal enforcement proceeding available against bank directors."[114] Congress greatly expanded the scope of the safety and soundness duty of bank directors—both in terms of the parties that are impacted by the duty as well as the potential consequences of violating the duty—with its passage of the Federal Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).[115] FIRREA grants federal banking regulators the authority to levy penalties against not only directors and officers, but also "institution-affiliated parties"—including third parties such as controlling stockholders, consultants, lawyers, and accountants[116]—who have "engaged or participated" in unsafe or unsound conduct.[117] These penalties include cease-and-desist orders,[118] removal from the bank,[119] removal and prohibition from participation in the bank's affairs,[120] removal and prohibition from participation in *any* banking activities,[121] civil money penalties ranging up to as high as $1 million a day,[122] and criminal liability including up to five years in prison.[123]

Congress also passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),[124] which among other things created a host of new statutory rules banning, limiting, or otherwise regulating many lending practices that were once excluded from liability by the business judgment rule. In particular, FDICIA required federal banking regulators to "adopt uniform regulations prescribing standards"

114. Schooner, *supra* note 112, at 188 (citing Banking Act of 1933, ch. 89, § 30, 48 Stat. 162, 193-94). *See also* Baxter, *supra* note 52, at 11–13 (describing how Congress increased the range of enforcement options available to bank regulators over time).

115. Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183 (Aug. 9, 1989).

116. 12 U.S.C. § 1813(u) (2019).

117. *See* 12 U.S.C. § 1818(e)(1)(A) (2019) FIRREA also articulates a third basis for removing or otherwise levying penalties against a bank or institution-affiliated party: violating a law, regulation, final cease-and-desist order, or written agreement between the institution and the FDIC. *Id.* at (II)(7). In order to initiate removal proceedings, the bank regulator must also find that the improper conduct resulted in certain negative consequences, *see* 12 U.S.C. § 1818(e)(1)(B), and that certain scienter requirements are satisfied. *See* 12 U.S.C. § 1818(e)(1)(C). *See also* Robert J. Basil, *Suspension and Removal of Bank Officials Under the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA)*, 18 J. LEG. 1, 16–17 (1992) (describing the agency's ability to regulate or eliminate an official's participation in the banking community indefinitely).

118. 12 U.S.C. §§ 1818(b)–(c) (2019).

119. 12 U.S.C. § 1818(e)(1).

120. 12 U.S.C. § 1818(e)(3).

121. 12 U.S.C. § 1818(e)(7).

122. 12 U.S.C. § 1818(i)(2) (2019).

123. 12 U.S.C. § 1818(j) (2019).

124. FDIC Improvement Act of 1991, Pub. L. No. 102-242, § 131, 105 Stat. 2236, 2258 (codified as amended in scattered sections of 12 U.S.C.).

related to real estate loans.[125] These interagency regulations and guidelines, applicable to all federally insured banks and thrifts, were issued in their final form in December 1992, and imposed an array of new duties and obligations on bank directors related to real estate lending.[126]

In the aftermath of the financial crisis, the Office of the Comptroller of the Currency (OCC)—the primary federal regulator for nationally chartered banks—developed and implemented a new set of "heightened expectations" for corporate governance and oversight for large national banks.[127] These new guidelines were promulgated into law as an appendix to the OCC's regulations on safety and soundness standards for large national banks and savings associations.[128] Under these guidelines, the boards of large national banks are required to establish and oversee an effective risk management framework, provide active oversight of management, exercise independent judgment, include at least two independent directors on the board, and provide ongoing training to all directors.[129] While these requirements were not framed as fiduciary duties, the Comptroller has made clear that the OCC views these heightened standards as related to directors' fiduciary responsibilities, which he described as follows: "The [bank] charter is a special corporate franchise that provides a gateway to federal deposit insurance and access to the discount window, and the highest fiduciary duty of the Board of Directors is to ensure the safety and soundness of the national bank or federal thrift."[130]

One important question on the relationship between statutory duties and fiduciary duties is whether the former replace or complement the latter. This question was resolved in a 1938 Sixth Circuit case called *Atherton v. Anderson* involving a bank receiver's claims of negligence against the bank's officers and directors based in part on the bank's

125. 12 U.S.C. § 1828(o) (2019).

126. 12 C.F.R. pt. 34, subpt. D, app. A (2018); *id*. pt. 208, app. C; *id*. pt. 365, app. A; *id*. pt. 563, subpt. D, app. A. *See also* McCoy, *supra* note 75, at 50–52 (discussing federal bank regulators' new rules regulating loan practices that once qualified for the business judgment rule).

127. *See* Press Release, Office of the Comptroller of the Currency, OCC Finalizes Its Heightened Standards for Large Financial Institutions (Sept. 2, 2014), https://www.occ.treas.gov/news-issuances/news-releases/2014/nr-occ-2014-117.html [https://perma.cc/KG4N-MUY3]. *See also* Thomas J. Curry, Comptroller of the Currency, Remarks Before the Clearing House Second Annual Business Meeting and Conference 5 (Nov. 15, 2012), *available at* https://www.occ.treas.gov/news-issuances/speeches/2012/pub-speech-2012-165.pdf [https://perma.cc/Q8JY-CK8U] ("We have adopted and are implementing what we refer to as 'heightened expectations for corporate governance and oversight.'").

128. OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations, 79 Fed. Reg. 54,518, 54,518 (Sept. 11, 2014).

129. *Id.* at 54,537–38.

130. Curry, *supra* note 127, at 7.

excessive and reckless lending to a single borrower.[131] The defendants argued that these common law negligence claims were barred by the existence of statutory liability for the same misconduct.[132] The Sixth Circuit rejected this logic and stated quite clearly that the statutory liability for bank directors created by the National Banking Act, while "exclusive of all other rules . . . does not modify or change the common law defining the duties of bank directors or the judicial methods by which the performance or non-performance of such duties may be determined."[133] In other words, the statutory creation of duties on bank directors does not replace any common law fiduciary duties that may already exist.

The distinction between statutory duties and common law fiduciary duties may seem like a theoretical one from the perspective of bank directors and officers facing potential liability, but these differences are potentially significant. As Prof. Lawrence Baxter has argued, statutory duties are clearly delineated, well understood, and utilized by bank regulators as part of their formal enforcement powers, whereas fiduciary duties are vague, open-ended and typically utilized by aggrieved shareholders under a common law cause of action.[134] Moreover, federal statutory liability for bank directors requires either *actual knowledge* of specified bank misconduct or *engagement or participation* in unsafe or unsound conduct. These standards are much higher than the gross negligence standard used in common law actions based on a breach of fiduciary duty.

But while statutory duties may be distinct from common law fiduciary duties, as a practical matter, both types of duties affect the incentives of bank directors and officers in similar ways. From the perspective of a bank director, the open-ended liability that may accompany a breach of fiduciary duty should have similar effects as the statutory penalties that accompany unsafe or unsound conduct. As Professor McCoy has aptly put it, "[b]ank director negligence law, as it stands today, is a strange and baffling amalgam. State law provides the nominal rule of decision, but federal, code-based standards largely define the duty of care."[135]

131. Atherton v. Anderson, 99 F.2d 883, 893 (6th Cir. 1938).

132. *Atherton*, 99 F.2d 883 at 897 ("It is said that if there was no violation of the statute at all or if there was and yet appellants did not knowingly permit it or participate in it, or assent to it . . . they incurred no liability whatever because the liability imposed by the statute was exclusive.").

133. *Id.* The Sixth Circuit's decision was made on remand from the Supreme Court. In its initial decision in this matter, the Sixth Circuit held that the common law negligence claims were barred based on procedural grounds. Atherton v. Anderson, 86 F.2d 518, 522 (6th Cir. 1936). The Supreme Court reversed in a succinct per curiam opinion. Anderson v. Atherton, 302 U.S. 643, 643 (1937).

134. *See generally* Baxter, *supra* note 52, at 8–9.

135. McCoy, *supra* note 75, at 55.

D. The Bifurcation of Governance and Prudential Regulation

The uneasy coexistence of bank safety and soundness duties (based on federal law) and bank fiduciary duties (based on state law) described in the previous section, is part of a deeper schism between prudential regulation and bank governance whose origins are rooted in the National Bank Act of 1863 (NBA).[136] which created a "dual banking system" of federal- and state-chartered banks that is unique to the United States. Prior to the enactment of the NBA, the chartering and regulation of banks had been exclusively the province of the states,[137] many of which had liberalized the granting of bank charters as part of the Free Banking Era.[138] Congress passed the NBA to create a uniform national currency, and also to stimulate demand for US debt instruments in the midst of a costly Civil War.[139]

To achieve these aims, the NBA authorized the chartering of national banks to be overseen by the newly created Office of the Comptroller of the Currency.[140] Congress also passed a parallel 10 percent tax on notes issued by state-chartered banks, which was intended to both facilitate the adoption of national bank notes and also to tax state banks out of existence.[141] But state banks managed to survive and thrive by inventing

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136. *See supra* notes 42–44 and accompanying text.

137. *See supra* notes 34–38 and accompanying text. During the Free Banking Era, state banking authorities allowed any organizers that met certain minimum thresholds for capital and other requirements to obtain a bank charter. During this period, there were generally three types of safety and soundness regulations in place: first, a requirement that banks deposit a minimum amount of designated bonds (typically the chartering state's bonds, although federal and other bonds were often acceptable as well) with the state banking authority; second, a requirement that the bank maintain enough specie on hand to pay any notes presented for redemption; and third, the double liability for shareholders described *supra* at notes 41–45 and accompanying text. *See also* Arthur J. Rolnick & Warren E. Weber, *Banking Instability and Regulation in the U.S. Free Banking Era*, 9 FED. RES. BANK MINNEAPOLIS Q. REV. 2, 4 (1985) (discussing the history of the Free Banking Era).

138. Rolnick & Weber, *supra* note 137, at 3–5 (discussing policies allowing for the unrestricted entry of new banks).

139. *See* BRAY HAMMOND, BANKS AND POLITICS IN AMERICA: FROM THE REVOLUTION TO THE CIVIL WAR 725–27 (2d ed. 1985) (describing Congressional discussion on the proposed legislation); KENNETH SPONG, BANKING REGULATION: ITS PURPOSES, IMPLEMENTATION, AND EFFECTS 18–19 (5th ed. 2000); John Wilson Million, *The Debate on the National Bank Act of 1863*, 2 J. POL. ECON. 251, 251–52 (1894).

140. OFFICE COMPTROLLER CURRENCY, FOUNDING OF THE OCC AND THE NATIONAL BANKING SYSTEM, *available at* https://www.occ.treas.gov/about/who-we-are/history/founding-occ-national-bank-system/index-founding-occ-national-banking-system.html [https://perma.cc/VV45-JAZR].

141. The original bank bill of 1863 and 1864 contained a 2% tax on state bank notes, but this did not significantly reduce the outstanding supply of state bank notes and had no effect on the number of state banks in existence. *See* Bruce Champ, *The National Banking System: A Brief History*, 9 (Fed. Res. Bank of Cleveland, Working Paper No. 07-23R). So, Congress increased the tax on state bank notes to 10 percent. *See* Lissa Lamkin Broome, *The First One Hundred Years of*

bank deposits and checking accounts as a means to avoid this tax.[142] These deposits were incredibly successful and as a result, the state banking system was able to survive and thrive despite the tax on state bank notes.[143]

The establishment of a national bank system coupled with the failure to kill off the existing state banking system led to the much studied and oft criticized "dual banking system," which the OCC has described as:

> . . .the parallel state and federal banking systems that co-exist in the United States. The federal system is based on a federal bank charter, powers defined under federal law, operation under federal standards, and oversight by a federal supervisor. The state system is characterized by state chartering, bank powers established under state law, and operation under state standards, including oversight by state supervisors.[144]

At the federal level, the National Bank Act established a series of new prudential regulations for national banks, which included minimum capital requirements, reserve requirements, loan restrictions and regular examinations to be administered by the newly created Office of the Comptroller of the Currency.[145] Initially, these federal prudential regulations were limited to national banks, while state banks were overseen by the state banking authority under the prudential regulatory framework contemplated by the state's laws. But over time, federal prudential regulation expanded to cover more and more state-chartered banks.

In the aftermath of the Panic of 1907, Congress enacted the Federal Reserve Act of 1913,[146] which established the Federal Reserve System as a form of decentralized central bank made up of twelve regional

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Banking in North Carolina, 9 N.C. BANKING INST. 103, 121–22 (2005). The Supreme Court upheld this tax in *Veazie Bank v. Fenno*, 75 U.S. 533 (1869). As Hammond has documented, the Congressional proponents of the state bank note tax were explicit in their aim of destroying the state banks. HAMMOND, *supra* note 139, at 733.

142. HAMMOND, *supra* note 139, at 734. *See also* Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks Before the Annual Meeting and Conference of the Conference of State Bank Supervisors, (May 2, 1998), https://www.federalreserve.gov/boarddocs/speeches/1998/19980502.htm [https://perma.cc/W97X-S6YB] ("Forced to find a substitute for notes, state banks pioneered demand deposits. Within ten years after the note tax, state banks had more deposits than national banks . . . .").

143. *See* HAMMOND, *supra* note 139, at 734.

144. OFFICE COMPTROLLER CURRENCY, NATIONAL BANKS AND THE DUAL BANKING SYSTEM 1 (2003), *available at* https://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/national-banks-and-the-dual-banking-system.pdf [https://perma.cc/W97X-S6YB].

145. *See* SPONG, *supra* note 139, at 19; Richard Sylla, *Federal Policy, Banking Market Structure, and Capital Mobilization in the United States, 1863-1913*, 29 J. ECON. HIST. 657, 659–62 (1969).

146. The Federal Reserve Act, 12 U.S.C. § 226 (2019).

Federal Reserve Banks meant to serve as a lender of last resort during times of crisis.[147] National banks were required to join the Federal Reserve System, while state banks were given the option to join.[148] The Federal Reserve Act required that any state banks that joined the Federal Reserve System submit to the same minimum capital requirements, reserve requirements, loan restrictions, and regular examinations that applied to national banks, effectively placing them into a federal prudential regulatory framework.[149]

The federalization of bank prudential regulation—even for state-chartered banks whose organizational activities and duties were overseen by state law—was massively expanded with the Banking Act of 1933. The Banking Act established federal deposit insurance and a new federal regulator—the FDIC—to administer and oversee this framework.[150] The FDIC was given significant regulatory authority over banks to which it provided federal deposit insurance. Before admitting a bank to the federal deposit insurance program, the FDIC is required to examine the applicant bank, consider the adequacy of its capital, its future earnings prospects, the quality of its management, and its usefulness in serving the convenience and needs of the community.[151] Once insured, banks are subject to rigorous examinations, and the FDIC can terminate its insurance to banks that were found to have unsafe or unsound practices.[152] State nonmember banks are required to obtain FDIC approval before opening new branches, reducing their capital, or merging with other institutions.[153] While state banks were generally not required to apply for federal deposit insurance (national banks and state banks that were members of the Federal Reserve were required to be insured by the FDIC),[154] federal deposit insurance came to be seen as a "competitive

147. *See* Michael Wade Strong, *Rethinking the Federal Reserve System: A Monetarist Plan For a More Constitutional System of Central Banking*, 34 IND. L. REV. 371, 376–77 (2001). The Federal Reserve System was also tasked with providing a flexible national currency that would be responsive to changes in supply and demand, supervising the banking industry across the fifty states, and improving the nation's check-clearing system. *Id.*

148. *Id.* at 377.

149. *See* EUGENE NELSON WHITE, THE REGULATION AND REFORM OF THE AMERICAN BANKING SYSTEM, 1900–1929, at 97–99 (1983).

150. Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.). The FDIC was originally established as a temporary government corporation. *Id.* Congress enacted the Banking Act of 1935, which among other things, established the FDIC as a permanent federal agency. Pub. L. No. 74-305, 49 Stat. 684 (1935) (codified as amended in scattered sections of 12 U.S.C.).

151. Banking Act of 1935, § 101(g). *See also* FED. DEPOSIT INS. CORP., FEDERAL DEPOSIT INSURANCE CORPORATION: THE FIRST FIFTY YEARS A HISTORY OF THE FDIC 1933–1983, at 51–52 (1984).

152. FED. DEPOSIT INS. CORP., *supra* note 151, at 52.

153. *Id.*

154. *Id.* at 44.

necessity" that was almost universally adopted by state banks.[155] The ubiquity of federal deposit insurance coupled with the significant regulatory authority this gave to the FDIC meant that federal prudential regulation was expanded to cover virtually all banks.[156]

E. The Declining Importance of Bank Charters

While there are differences between bank governance and corporate governance, as outlined above, the importance of these differences has been sharply diminished by two modern trends. First, banks over time have become increasingly held by bank holding companies, which are typically organized as state-chartered corporations.[157] Second, the economic importance of banks has been reduced over time by the rapid rise of "shadow banking," which serves the economic functions of banking—and has many of the same systemic vulnerabilities—but operates outside of the traditional banking framework. Shadow banking is performed by investment banks, hedge funds, and other financial conduits that are not organized as banks and therefore not subject to the laws regulating bank governance.

The principal economic or functional activity of banking has been described as the credit intermediation or maturity transformation that occurs when a bank uses the proceeds from its short-term liabilities (such as demand deposits) and invests them in long-term assets (such as mortgage loans).[158] For most of our country's history, this activity was performed almost exclusively within banks—depository institutions that had received a state or national banking charter.[159] During this period, the "business of banking" was performed almost exclusively by financial institutions operating with a banking charter and its concomitant governance requirements. But over time, more and more of the activity of banking was overseen by non-bank officers and directors, due both to the increasing importance of bank holding companies and the rise of "shadow banking"—the functional activity of banking occurring outside

155. *See* Butler & Macey, *supra* note 43, at 699.

156. The federal prudential regulatory footprint was further expanded with the passage of the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (1987), which extended Glass-Steagall's prohibitions on the commingling of commercial banking and investment banking, which had previously only applied to banks that were members of the Federal Reserve System, to all banks. *See* Butler & Macey, *supra* note 43, at 696–97.

157. A bank holding company is defined as any company that controls one or more banks. *See* 12 U.S.C. § 1841(a)(1) (2019). A company can include a corporation, partnership, business trust, association or similar organization. *See id.* at § 1841(b).

158. *See* Bryan J. Noeth & Rajdeep Sengupta, *Is Shadow Banking Really Banking?*, REG. ECON., Nov. 2011, at 8.

159. MICHAEL S. BARR, HOWELL E. JACKSON & MARGARET E. TAHYAR, FINANCIAL REGULATION: LAW AND POLICY 159–63 (2d ed. 2018). There are numerous types of banking charters including those for banks, thrifts, credit unions, and industrial loan companies.

of traditional deposit-taking banks, typically through investment banks.[160]

1. The Dominance of Bank Holding Companies Today

A bank holding company (BHC) is a company that owns or controls a US bank and, as Professor Omarova and Ms. Tahyar have noted, is a "legal and organizational form unique to the US system of bank regulation."[161] BHCs first developed as a form of regulatory arbitrage, as this organizational structure allowed bankers to effectively bypass the severe geographic restrictions on chartered banks that historically existed in the United States.[162] State laws limiting branching and other forms of geographic expansion, both within and across state borders, limited the ability of banks to expand beyond a single location.[163] In 1933, Congress passed the McFadden Act establishing similar limits on the ability of national banks to branch.[164] As a result, "unit banking"—in which small local banks served the banking needs of the public—was the norm in the United States through much of the nineteenth and twentieth centuries.[165]

But these restrictions did not apply to BHCs, which could hold separately chartered banks in different states and localities, and effectively bypass geographic limitations on bank expansion. While the Banking Act of 1933 (amended in 1935), provided for the regulation of BHCs by the Federal Reserve Board, this regulatory authority was quite anemic and had limited scope. This Act applied only to BHCs that had 50 percent ownership or control of a bank that was a member of the Federal Reserve system and sought to exercise voting control over its

160. *See* Paul McCulley, *Teton Reflections*, PIMCO: GLOBAL CENT. BANK FOCUS (2007).

161. *See* Saule T. Omarova & Margaret E. Tahyar, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States*, 31 REV. BANKING & FIN. L. 113, 114 (2011) (citing PAULINE HELLER & MELANIE FEIN, FEDERAL BANK HOLDING COMPANY LAW § 1.04(5), at 1–20 (2009)). *See also* Bank Holding Company Act of 1956, Pub. L. No. 84-511, § 2(a), 70 Stat. 134 (1956) (codified as amended in 12 U.S.C. § 1841(a)(1) (2019) (defining a bank holding company as "any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this chapter").

162. *See* Omarova & Tahyar, *supra* note 161, at 120–21 (noting that state laws frequently prohibited out-of-state banks from establishing branches within their state, due largely to the interest of local bank owners in protecting themselves from competition by larger banks).

163. *Id.* (citing LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 69 (4th ed. 2011)); Robert T. Clair & Paula K. Tucker, *Interstate Banking and the Federal Reserve: A Historical Perspective*, ECON. REV., Nov. 1989, at 1, 3.

164. 12 U.S.C. § 36 (1933) (current version at 12 U.S.C. § 36 (2019)). The McFadden Act permitted national banks to establish branches within a state only to the extent permitted by that state's law.

165. *See* Carl Felsenfeld, *The Bank Holding Company Act: Has It Lived Its Life?*, 38 VILL. L. REV. 1, 9–11 (1993).

bank shares.[166] As a result, many BHCs took advantage of the "regulatory gaps" that formed to "circumvent and evade sound banking principles, regulatory statutes, and declared legislative policy."[167] BHCs were created to avoid prohibitions on bank ownership of commercial concerns such as manufacturing businesses, restrictions on bank branching, and supervisory oversight of banks.[168]

In response to these concerns and the rapid growth of BHCs,[169] Congress enacted the Bank Holding Company Act of 1956 (BHCA),[170] which created a formal regulatory framework for BHCs in the United States. Under the BHCA, all bank holding companies are subject to consolidated prudential oversight by the Federal Reserve and any nonbank subsidiaries they acquire must engage in activities "closely related to banking."[171] The BHCA was passed with several goals in mind: (1) to protect the public from banking monopolies and the concentration of economic power; (2) to preserve existing restrictions on bank branching and geographic expansion; and (3) to reinforce the Glass-Steagall prohibitions on banks engaging in financial or industrial activities.[172]

Following the passage of the BHCA and its amendments,[173] the importance of BHCs in the US banking system grew rapidly, with 1567

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166. Banking Act of 1933, Pub. L. No. 73-66, § 2, 48 Stat. 162 (1933); 12 U.S.C. §§ 61, 161, 221 (2019).

167. BD. OF GOVERNORS FED. RES. SYS., 30TH ANNUAL REPORT 34–37 (1943).

168. *Id.* at 36–37.

169. The first independently capitalized BHC was organized in 1927. *See* GAINES THOMSON CARTINHOUR, BRANCH, GROUP, AND CHAIN BANKING 96 (1931). By 1954, there were at least 114 BHCs, according to the Federal Reserve Board. *See* H.R. REP. NO. 84-609, at 8 (1955).

170. Bank Holding Company Act of 1956, Pub. L. No. 84-511, §§ 1–12, 70 Stat. 134, 135 (1956).

171. 12 U.S.C. § 1843(c)(8) (2019). The "closely related to banking" test governing BHC subsidiary activities was significantly revised with the 1970 Amendments to the BHCA. This standard was again changed with the passage of the Gramm-Leach-Bliley Act of 1999. *See infra* note 177 and accompanying text (explaining the Act's sweeping changes to banking regulation).

172. *See* George R. Hall, *Bank Holding Company Regulation*, 31 S. ECON. J. 342, 343 (1965). *See also* Omarova & Tahyar, *supra* note 161, at 120–25. (explaining the BHCA structure as an anti-monopoly law).

173. Congress amended the BHCA in 1966 and 1970. As Omarova and Tahyar describe, Congress amended the BHCA in 1966, with the primary changes in these amendments being to expand the definition of "company" to cover long-term trusts and religious, charitable and educational institutions, and to narrow the definition of "bank" to cover only institutions that accepted demand deposits or their equivalent. Omarova and Tahyar, *supra* note 161, at 139–42; Act of July 1, 1966, Pub. L. No. 89-485, § 2(b), 80 Stat. 236. In 1970, Congress again amended the BHCA, primarily to cover BHCs that only controlled or owned one bank, which were not previously covered by the BHCA. Bank Holding Company Act of 1970, Pub. L. No. 91-607, § 103, 84 Stat. 1763–66. *See also* Samuel B. Chase, Jr. & John J. Mingo, *The Regulation of Bank Holding Companies*, 30 J. FIN. 281, 281–82 (1975). The 1970 Amendments also revised the "closely related to banking" test, described *supra* in note 171 and accompanying text, so that BHC subsidiaries

BHCs registered with the Federal Reserve at the end of 1971.[174] At year-end 1980, there were 2860 BHCs owning 4942 banks, which was 34.3 percent of all banks.[175] By year-end 1995, there were 5194 BHCs owning 7509 banks, which was 76.7 percent of all banks.[176] The importance of BHCs was supercharged by the passage of the Gramm-Leach-Bliley Act of 1999 (Gramm-Leach-Bliley), which made sweeping changes to the BHCA and the bank regulatory framework.[177] Gramm-Leach-Bliley greatly expanded the powers and permissible activities of banks, bank subsidiaries and BHCs.[178] Most notably, Gramm-Leach-Bliley allowed BHCs with well managed and well capitalized bank subsidiaries to opt for "financial holding company" (FHC) status. FHCs and their subsidiaries would no longer be limited to activities "closely related to banking," but could engage in securities and insurance activities that had long been separated from banks under Glass Steagall.[179]

The actions of regulators and Congress led to a massive consolidation in the traditional banking industry, as more banks and a greater share of

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were limited to activities that are "closely related to banking as to be a proper incident thereto." Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, § 101(a), 84 Stat. 1760. *See also* 12 U.S.C. § 1843(c)(8) (2019); Charles D. Salley, *1970 Bank Holding Company Amendments: What Is "Closely Related to Banking?"*, 56 FED. RES. BANK ATLANTA MONTHLY REV. 98, 100 (1971).

174. *See* Chase & Mingo, *supra* note 173, at 282 (explaining that the number of BHCs increased as a result of the formation of one-bank holding companies).

175. Chart of "Bank Ownership by BHCs December 1980 to December 2007," BD. OF GOVERNORS FED. RESERVE: PARTNERSHIP FOR PROGRESS [hereinafter BHC Chart], *available at* https://www.fedpartnership.gov/-/media/bank-life-cycle/charts/bank-ownership-by-bhcs.pdf?la=en [https://perma.cc/285G-6GLF].

176. *Id.* Another major contributor to the rising importance of the BHC was Congress's enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (codified as amended in scattered sections of 12 U.S.C.), which allowed BHCs to acquire banks in every state and removed most state restrictions on branching. *See* FCIC REPORT, *supra* note 2, at 52 (explaining large banks' success in acquiring banks).

177. Graham-Leach-Bliley Act, Pub. L. No. 106-102, § 103, 113 Stat. 1338, 1342 (1999).

178. *See* Paul J. Polking & Scott A. Cammarn, *Overview of the Gramm-Leach-Bliley Act*, 4 N.C. BANKING INST. 1, 3 (2000). In the decades preceding the passage of Gramm-Leach-Bliley, federal banking regulators—especially the Federal Reserve Board and the Office of the Comptroller of the Currency—had greatly expanded the permissible activities of banks and BHCs through new regulations and regulatory inaction, allowing banks and BHCs to engage in insurance and securities activities that had long been forbidden under Glass-Steagall. *Id.* at 2–3. The movement to relax Glass-Steagall by regulatory action (or lack thereof) reached its apex with the Federal Reserve's conditional approval of the proposed merger of Citicorp, then the largest bank holding company in the United States, with Travelers Group, Inc., a financial services company engaging in insurance and securities activities. *See generally* Fed. Reserve Bd., *Order Approving Formation of a Bank Holding Company and Notice to Engage in Nonbanking Activities*, 84 FED. RES. BULL. 985 (1998). *See also* Jonathan R. Macey, *The Business of Banking: Before and After Gramm-Leach-Bliley*, 25 J. CORP. L. 691, 691–92 (2000) (arguing that Gramm-Leach-Bliley was simply a "formal recognition to the changes that had been taking place" due to regulatory evisceration of Glass-Steagall).

179. Polking & Cammarn, *supra* note 178, at 4–6.

bank assets became rolled up into the organizational structures of BHCs, and especially the largest FHCs. Between 1990 and 2005, there were seventy-four "megamergers" involving banks with assets of more than $10 billion each. Today, roughly 80 percent of all banks are owned by a BHC,[180] and this figure significantly understates the importance of BHCs, as nearly all bank assets in the United States are controlled by BHCs.[181] In total, US BHCs control over $15 trillion in total assets.[182] Thus, to the extent that there may be differences between bank governance and corporate governance, the former has become far less important over time. While bank directors may be subject to bank governance law, most of these banks operate within the structure of a larger corporation, whose directors are subject to corporate governance law.[183]

2. The Importance of Shadow Banking

The rapid rise of "shadow banking" has also reduced the relative importance of banks.[184] As I have described previously:

> Shadow banking utilizes a variety of capital market conduits and instruments, particularly money market mutual funds, short-term repurchase agreements, asset-backed commercial paper, and asset-backed securitization. Like traditional banking, shadow banking uses short-term, high-quality, liquid liabilities to fund long-term, illiquid loans. But whereas traditional banking does this all "under one roof," shadow banking performs this intermediation "through a daisy-chain of non-bank financial intermediaries in a multi step process."[185]

There is a growing literature finding that shadow banking serves the same economic functions of credit intermediation and maturity transformation as traditional banking, and is vulnerable to the same problem of bank panics.[186] But because shadow banking utilizes capital markets institutions and products to perform this function, until Dodd-Frank, it largely fell outside of the regulatory umbrella that covers

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180. BHC Chart, *supra* note 175.

181. *See* Dafna Avraham, Patricia Selvaggi & James Vickery, *A Structural View of U.S. Bank Holding Companies*, FED. RES. BANK N.Y. ECON. POL'Y REV., July 2012, at 65, 66–67 (noting the rapid growth in the size and scope of BHCs from 1990 through 2010).

182. *Id.* at 65.

183. *See* Renée Adams & Hamid Mehran, *Is Corporate Governance Different for Bank Holding Companies?*, FED. RES. BANK N.Y. ECON. POL'Y REV., Apr. 2003, at 123, 124 (arguing that the existence of regulations should affect the structure of internal governance mechanisms).

184. The term "shadow banking" was coined by economist Paul McCulley to describe the enormous amount of credit intermediation occurring outside of the balance sheets of traditional banks. McCulley, *supra* note 160.

185. *See* Min, *Market Discipline*, *supra* note 1, at 1449–50.

186. *Id.* at 1448–57.

traditional banks.[187] By its very nature of regulatory arbitrage, shadow banking takes place primarily in non-bank financial firms, including the non-bank subsidiaries of FHCs as well as non-bank entities unaffiliated with bank holding companies, such as investment banks, insurance companies, mutual funds, and hedge funds. As a result, shadow banking actors (such as investment bank or BHC directors and officers) are not subject to bank governance law and are typically instead subject to liability under common law corporate fiduciary duties.[188]

The displacement of banks by their capital markets counterparts has had substantial effects on the financial system. For example, looking just at investment banks, in 2004, the combined assets of the five largest US investment banks totaled $2.5 trillion, more than half of the $4.7 trillion held by the five largest US BHCs, and this figure would grow to $4.3 trillion by 2007.[189] At the same time, the largest BHCs are all financial holding companies, and their non-banking activities account for a sizeable share of their overall balance sheets.[190] Overall, shadow banking has grown tremendously over the past several decades, and according to some estimates has surpassed the size of the traditional banking system, reaching a peak of $20 trillion prior to the 2007–08 financial crisis.[191]

In summary, while the fiduciary duties of bank directors may be broader than those of corporate directors, both in terms of their scope and to who these duties are owed, these fiduciary duties have largely become irrelevant over time, as most banking activities today take place either under the organizational umbrella of a BHC or FHC, or even outside of the regulated banking context altogether.

II. WHY SHAREHOLDER PRIMACY IS INAPT FOR BANK GOVERNANCE

As discussed in Part I, despite having had divergent bodies of law over time, the fiduciary duties for general business corporations and banking firms (either chartered banks, bank holding companies, or shadow banks)

187. *Id.* at 1449–50.

188. As Claire Hill and Richard Painter describe, beginning in the 1970s, most investment banks transitioned from being partnerships with unlimited liability for their equity investors to being corporations with limited liability for their equity investors. Claire Hill & Richard W. Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE UNIV. L. REV. 1173, 1176–83 (2010).

189. FCIC REPORT, *supra* note 2, at 150.

190. *Id.* at 56 ("The biggest bank holding companies became major players in investment banking."). The actual share of assets accounted for by domestic banking subsidiaries varies sharply among the largest FHCs: at JPMorgan Chase & Co., domestic bank assets account for 86.1 percent of total FHC assets; at Bank of America Corp., they account for 77.9 percent of total assets; at Citigroup Inc., they account for 68.8 percent of total assets; at Wells Fargo & Co., they account for 92.5 percent of total assets; while at Goldman Sachs Group, Inc. and Morgan Stanley, domestic bank assets account for just over 10 percent of total assets. Avraham et al., *supra* note 181, at tbl. 1.

191. Noeth & Sengupta, *supra* note 158, at 8–9.

are generally treated equivalently by the courts today. But is the legal treatment of bank fiduciary duties sound from a policy perspective? In particular, is the shareholder wealth maximization norm appropriate for banks and other leveraged financial institutions? Even within corporations, shareholder primacy is not a clearly obvious proposition. Shareholder primacy is most frequently justified in corporate governance with the argument that shareholders face uniquely high and intractable agency costs in dealing with the corporation and its decision makers.[192] But of course, the shareholder is not the only corporate stakeholder who incurs these agency costs. Creditors, employees, and others also own a piece of the corporation's treasury and put their trust in corporate directors and officers to manage these invested resources. Thus, these non-shareholders also face principal-agent conflicts in their dealings with the firm.[193] The corporate law literature has largely justified shareholder primacy in corporations based on the argument that shareholders, as the residual claimants, benefit most from fiduciary duties in their favor.[194] But as I argue in this Part, banks and other leveraged financial intermediaries have characteristics that undercut the arguments for elevating the interests of shareholders over other corporate constituents, particularly creditors.

This Part lays out the traditional justifications for shareholder wealth maximization in corporate governance and then presents several arguments as to why these are inapt for the governance of banks and other leveraged financial intermediaries. There are three principal differences between banks and other types of businesses that are germane here. First, the high degree of leverage inherent to banks greatly increases the creditor-shareholder agency conflicts in bank governance and also makes it more likely that shareholder interests will be contrary to social welfare maximization. Second, the government's role as either *de jure* or *de facto* guarantor of most bank liabilities effectively transforms the creditor-shareholder conflict into a taxpayer-shareholder conflict. Third, the steep negative externalities that arise from bank failures provide a strong rationale against shareholder wealth maximization, since shareholders do not bear the full costs of bank risk-taking (even as they gain the full benefits).

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192. David Min, *Corporate Political Activity and Non-Shareholder Agency Costs*, 33 YALE J. REG. 423, 438–43 (2016) [hereinafter Min, *Corporate Political Activity*].

193. *Id.* at 443–44.

194. As described *supra* in notes 58 and 59, there has been a strong push against this view. Most notably, the stakeholder model and the team production model have been posited as alternative theories of the firm that are both more descriptively accurate and normatively more justified than the agency cost model. *See* Min, *Corporate Political Activity*, *supra* note 192, at 441–43.

A. Corporate Law Justifications for Shareholder Primacy

The New Deal era banking reforms—and the legislative and regulatory changes that have been made since then—emphasize external prudential regulations such as examinations or minimum capital requirements, and have mostly ignored measures that could optimize the internal governance of these institutions. The deemphasis of governance, combined with the absence of litigation or other developments in the law of bank fiduciary duties as described *supra* in Part I, resulted in a lengthy scholarly neglect of *bank* governance.[195] At the same time, for a variety of reasons, there was a significant body of *corporate* governance scholarship being developed over the same period, which has primarily focused on the agency costs between shareholders and managers that arise out of the corporate form and its separation of ownership and control.[196]

From a theoretical perspective, the separation of ownership and control creates a principal-agent conflict between outside shareholders and inside directors and managers.[197] These conflicts in turn create "agency costs," the costs incurred by principals in trying to motivate optimal behavior on the part of agents as well as the costs incurred from suboptimal agent behavior.[198] While shareholders are not the only corporate stakeholders to incur such agency costs,[199] it has been argued that their agency costs

195. *See* Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, 9 ECON. POL'Y REV. 1, 91 (2003) ("[V]ery little attention has been paid to the corporate governance of banks.").

196. *See, e.g.*, ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 113–16 (1932); Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976); Min, *Corporate Political Activity*, *supra* note 192, at 436–43. In recent decades, there has been an increasing recognition of the importance of non-shareholder agency costs, including those borne by creditors and employees. *Id.* at 443–50.

197. *See* BERLE & MEANS, *supra* note 196, at 113–16; Andreas Kokkinis, *A Primer on Corporate Governance in Banks and Financial Institutions: Are Banks Special?*, *in* THE LAW ON CORPORATE GOVERNANCE IN BANKS 1, 4 (Iris H-Y Chiu ed., 2015).

198. *See* Jensen & Meckling, *supra* note 196, at 308–10 (defining agency costs as the sum of the monitoring and bonding costs incurred to ensure that the agent acts in accordance with the best interests of the principal plus any residual loss that may accrue to the principal from agent behavior that deviates from the principal's interests).

199. The dominant theory in corporate finance today is the so-called "nexus of contracts" model, which asserts that the corporation is best understood as a nexus between different corporate constituents such as equity shareholders, creditors, and employees, and serves to mitigate the significant transaction costs that would arise were these different stakeholders to contract with each other separately. Two other theories of the corporation that have gained some popularity in the corporate law literature are the "team production" and stakeholder approaches. Notably, all three of these theories recognize the importance of non-shareholder interests in the corporation, and that these can create potentially significant agency costs. *See* Min, *Corporate Political Activity*, *supra* note 192, at 438–43.

are most important, for a number of reasons.[200] First, as residual claimants with unlimited upside, they have the most to gain from a corporate governance structure in which their interests are prioritized.[201] Thus, shareholders would be willing to pay the most (and compensate other stakeholders) for fiduciary duties that emphasize their own wealth maximization.[202] Second, because shareholders, as the residual claimants, are paid only after all other claimants are paid in full, their incentives are aligned with other stakeholders insofar as they seek outcomes that benefit all stakeholders.[203] Third, because other corporate stakeholders are fixed claimants, they are better able to protect their interests through contractual covenants, whereas shareholders, who essentially hold an open-ended claim, are most poorly positioned to protect their interests through contract.[204]

The longstanding focus on shareholder agency costs has led to a corresponding emphasis in corporate law and corporate finance scholarship on minimizing agency conflicts between corporate decision makers and shareholders. As Professor Frederick Tung has described: "Traditionally, the central challenge [in corporate law] has been to design governance arrangements optimally to close the gap between ownership and control: to channel managers' discretion to benefit one specific class of investor—common shareholders."[205] In particular, corporate governance scholars have focused on three general areas of concern—executive compensation, excess free cash flow, and managerial empire-building.[206] Executive compensation is thought to be a source of potential agency costs between corporate managers and shareholders—especially when that compensation is primarily or entirely given in the form of a fixed salary, as was the norm among corporations for most of the

200. *Id.* at 450–55.

201. *See* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 65–68 (2008).

202. *Id.*

203. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983).

204. BAINBRIDGE, *supra* note 201, at 69; *see also* Jensen & Meckling, *supra* note 196, at 337–39. *See also* Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 25 (1991) (arguing that shareholder primacy is justified because shareholders are "the group that faces the most severe set of contracting problems with respect to defining the nature and extent of the obligations owed to them by officers and directors"). Macey points specifically to poison puts for creditors and golden parachutes for employees as examples of contractual provisions that more than adequately protect the interests of non-shareholder corporate constituents. *Id.* at 40.

205. Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 118 (2009).

206. *See* Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1913–15 (2013) (tracing the shift in academic's focus from separation of ownership and control to shareholder-manager agency costs).

twentieth century—and there has been a great deal of academic research focused on how to change executive compensation to more closely align the interests of corporate managers and shareholders.[207] Excess cash flow has also been a major area of research in corporate governance, as the presence of large uninvested or undistributed cash flows has been argued to be a sign of high agency costs, since these are not allocated for the shareholders' benefit.[208] Finally, empire-building—the investment of resources into acquisitions and other forms of expansion which may provide suboptimal returns—has also long been seen as a key agency cost problem in corporate governance, as it is argued that this type of decision making represents managers acting on behalf of their own interests rather than the interests of shareholders.[209]

A large body of corporate governance literature has arisen exploring both private and regulatory mechanisms for addressing these concerns. These proposed solutions include changes to executive compensation, altering the composition of the board of directors, increasing or improving disclosures, providing greater proxy access, and weakening poison pills and other barriers to shareholder action.[210] Many of these proposals have been successfully implemented, to the point where one prominent scholar has referred to corporate governance today as a "shareholder-centric reality."[211]

Banks and corporations share the same agency conflicts between outside shareholders and inside managers.[212] Because of the relative dearth of bank governance scholarship, many of the policy solutions in this area have tended to mirror the proposals offered in corporate governance. Thus, Dodd-Frank contemplates only a handful of minor

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207. *See, e.g.*, Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 257–58 (1990) (discussing political pressures relating to corporate management compensation which do not extend to gains from stock ownership).

208. *See, e.g.*, Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986) ("Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial [excess cash flow].").

209. *See generally* ROBIN MARRIS, THE ECONOMIC THEORY OF MANAGERIAL CAPITALISM (1964); Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831 (1993); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990).

210. *See infra* notes 255–258 and accompanying text.

211. *See generally* Rock, *supra* note 206.

212. This was not always the case with banking. Due to strict limitations on branching and interstate banking through much of the 19th and 20th centuries, a high percentage of banks were small and closely held up until the latter half of the 20th century. *See* Bernard Shull, *Corporate Governance, Bank Regulation and Activity Expansion in the United States*, *in* CORPORATE GOVERNANCE IN BANKING: A GLOBAL PERSPECTIVE 3 (Benton E. Gup ed., 2007). From a theoretical perspective, the agency problems that occupy so much of the corporate governance literature are largely moot for small and closely held companies. *Id.*

changes to the internal corporate governance of financial institutions,[213] including: provisions calling for increased disclosures related to executive compensation (including whether there are any "golden parachutes");[214] a non-binding shareholder vote on executive compensation;[215] increased proxy access;[216] and "clawback" mandates requiring corporations to develop and enforce policies that would take back incentive-based compensation from executives in the event of an accounting restatement.[217] These measures are all aptly described as *corporate* governance solutions that are primarily concerned with reducing shareholder agency costs, by either more closely aligning the incentives of corporate executives and shareholders, or increasing shareholder control of managerial conduct. These solutions do not primarily address the concerns of bank creditors or safety and soundness (other than through the prism of shareholder concerns).

B. Why Shareholder Primacy Is Inapt for Banking

While the arguments for shareholder primacy may be convincing when it comes to the governance of general business corporations (and many do not find them so),[218] there are strong counterarguments against the prioritization of shareholder interests in banks and other leveraged financial institutions. As I detailed in the previous section, the prioritization of shareholder interests in corporate governance is largely based on the claim that shareholder agency costs are the most intractable and that prioritizing shareholders thus provides the optimal aggregate value for all corporate stakeholders.[219]

But banks and other leveraged financial companies are distinct from non-financial companies in several important ways. First, they rely much more heavily on debt to fund their balance sheets. Second, most of this

213. As Skeel et al. note, in addition to internal governance reforms, Dodd-Frank also affects LFC governance indirectly through its regulatory changes for key outside influencers of LFC governance, particularly credit rating agencies and the derivatives markets. David A. Skeel, Jr. et al., *Inside-Out Corporate Governance*, 37 J. CORP. L. 147, 153 (2011).

214. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. §§ 951, 953 (2019)).

215. *Id.* at § 951.

216. *Id.* at § 957. The SEC's rule implementing Dodd-Frank's § 957 was famously vacated by the D.C. Circuit in its controversial decision, *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011). The D.C. Circuit found that the SEC had failed to adequately consider the economic consequences of its rule. *Id.* at 1148.

217. 12 U.S.C. § 954 (2019).

218. *See*, *e.g.*, Blair & Stout, *supra* note 51, at 249 (taking issue with the principal-agent corporate model and the shareholder wealth maximization goal); Charles W.L. Hill & Thomas M. Jones, *Stakeholder-Agency Theory*, 29 J. MGMT. STUD. 131, 132 (1992) (noting that the stakeholder-agency model results in a "paradigm whose predictions are not always consistent").

219. *See supra* notes 199–204 and accompanying text.

debt is guaranteed by the federal government, either explicitly as in the case of bank deposits, or implicitly such as with commercial paper issued by systemically important financial institutions. Third, it is well recognized that the failure of weak LFCs can spill over and potentially cause the failure of even the strongest LFCs, and moreover that this contagion can create massive costs for the broader economy. These negative externalities are unique to banking and are not understood to exist for other types of business enterprises. As I argue in this section, these characteristics make the arguments for shareholder primacy inapt for LFCs.

1. High Leverage Creates Higher Creditor Agency Costs

The first important difference between LFCs and other types of business firms is that LFCs typically have much higher levels of debt funding due to the nature of their business. This higher degree of leverage heightens the conflict between shareholders and creditors when it comes to risk. Since at least the 1970s, corporate finance and corporate law scholars have been studying the problem of creditor agency costs in the firm. The rise of the shareholder rights movement and the concomitant internalization of shareholder preferences by corporate directors and officers has heightened the tensions between creditors and the firm. Of course, shareholders and creditors share many interests when it comes to the activities of the firm—avoiding fraud, investing in profitable projects, and sound management. In general, both shareholders and creditors want to increase the value of the firm's equity, as this means greater return for shareholders but also a larger buffer against insolvency for creditors. Indeed, bank regulators have long emphasized earnings and profitability as a measure of a bank's health.

But shareholders and creditors may also have opposed interests, especially when it comes to risk. In general, shareholders prefer greater risk, because as residual claimants they are entitled to whatever profits the firm makes once it has paid off its fixed obligations (including to creditors), but their potential losses are limited to the value of their investments. In any firm, there are theoretically situations in which shareholders will prefer a high risk, high reward project, as that maximizes their expected returns, even if that results in lower expected returns (perhaps even negative expected value) for creditors than alternative projects or investments.[220] The divergence between shareholder and creditor risk preferences is widened by the high degree of leverage inherent to LFCs. From the perspective of shareholders, more

220. David Min, *Balancing the Governance of Financial Institutions*, 40 SEATTLE U. L. REV. 743, 752–55 (2017).

debt funding can enhance their return on equity, even as it increases the risk of insolvency for creditors.[221]

Because leverage can greatly enhance the potential for shareholder profits, a high level of debt, such as exists in LFCs, creates more antagonism between shareholders and creditors. Shareholders may want to drive the firm towards activities and investments that carry greater risk, even if these are against the broader interests of the firm as a whole. Shareholders may also have strong incentives to delay or prevent bankruptcy or resolution proceedings, since at that point their equity is nearly worthless and any chance at returning to solvency—however risky—is in their self-interest.[222] At the same time, investors in LFC debt are particularly risk averse and, for a number of reasons, place a particular premium on the stability and low risk of these instruments.[223] The strong risk aversion of bank debt investors effectively increases the costs of any losses they may incur, and exacerbates the potential conflicts between bank creditors and shareholders.

The idea that shareholder pressure may drive LFCs to take on greater risk is not merely a theoretical concern. The growing emphasis on shareholder wealth maximization in corporate boardrooms has led to greater risk taking, especially among financial firms. Indeed, as described above, many observers have identified shareholder pressure as a key factor in the excessive risk in Wall Street firms that has been blamed for the 2007–08 financial crisis.[224] Financial firms that took on higher levels of risk from 2003–07 were rewarded with higher valuations than their more conservative counterparts.[225] Shareholder pressure caused even reluctant bank managers to take on higher risk and more aggressive

221. As I discuss in a previous paper, this dynamic is easy to conceptualize by looking to the expected returns for shareholders and creditors on the same project with two different funding models—one funded 50-50 with debt and equity, and the other funded with 90 percent debt. This project might have a negative expected value for creditors and the firm as a whole but still have a positive expected value for shareholders. *Id.*

222. *See* Macey & Miller, *supra* note 40, at 53 (noting that shareholders have nothing to lose if risks do not pay off after they have lost their investments already).

223. *See* Min, *Market Discipline*, *supra* note 1, at 1480–81. One of the key reasons for this risk aversion is because much of the debt issued by banks and LFCs serves the functional role of money. There is growing evidence that there is a significant "money premium" given to instruments that have the price stability, safety and liquidity needed to serve as money. *Id.*; *see generally* MORGAN RICKS, THE MONEY PROBLEM 29–49 (2016); Adi Sunderam, Money Creation and the Shadow Banking System (Dec. 2013) (unpublished manuscript), *available at* https://www.hbs.edu/faculty/Publication%20Files/money_20131221_e9123de9-351b-43bc-bd83-5f5053b45e3a.pdf [https://perma.cc/UWH6-FADB].

224. *See supra* note 10.

225. *See supra* notes 18–22 and accompanying text; Bratton & Wachter, *supra* note 18, at 720–21.

growth strategies.[226] This risk-taking was detrimental to the interests of creditors.

In short, while there are always potential conflicts between the shareholders and creditors of any business concern, the high degree of leverage for LFCs and the particular emphasis that creditors place on the safety of LFC debt heightens the relative agency cost concerns of these creditors and weakens the theoretical arguments for prioritizing the interests of shareholders of banks and other financial intermediaries.

2. Government Guarantees Implicate the Public Interest

A second key difference between LFCs and other types of firms is that LFCs enjoy government guarantees on much of the debt they issue. Some of these guarantees are explicit, such as with FDIC's guarantee on bank deposits, which is backed by the full faith and credit of the United States.[227] It is also widely understood that many other liabilities issued by LFCs, particularly short-term liabilities that pose a risk to the financial system, enjoy implicit government guarantees.[228] The federal government is thought to effectively guarantee the vast majority of short-term debt instruments that fund both the traditional and shadow banking sectors.[229]

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226. Bratton & Wachter, *supra* note 18, at 720–21. *See also* Min, *Market Discipline*, *supra* note 1, at 1485–88. Even the financial institution decision makers who managed to avoid taking on high risk during this period remarked on how difficult it was to do so in the face of strong shareholder pressure. For example, Wells Fargo's Chairman and CEO John Stump recalled that avoiding high-risk products such as option ARMs were "hard decisions to make at the time . . . we did lose revenue, and we did lose volume." FCIC REPORT, *supra* note 2, at 108. According to Toronto Dominion CEO Edmund Clark, he was called an "idiot" for deciding to cease the bank's activities in structured finance. Ed Clark, President & CEO, Toronto Dominion Bank, Remarks at National Bank 2010 Financial Services Conference, at 3 (Mar. 30, 2010).

227. *See* David Min, *How Government Guarantees Promote Housing Finance Stability*, 50 HARV. J. LEG. 437, 447–48 (2013) [hereinafter Min, *Government Guarantees*].

228. These include the implicit federal guarantee on obligations issued by Fannie Mae and Freddie Mac, *see id*. at 454–57, and implicit government guarantees on the debt obligations of "systemically important" financial institutions. *See generally* Zan Li, Shisheng Qui & Jing Zhang, *Quantifying the Value of Implicit Government Guarantees for Large Financial Institutions*, MOODY'S ANALYTICS (Jan. 2011), https://www.moodysanalytics.com/-/media/whitepaper/2011/2011-14-01-quantifying-the-value-of-implicit-government-guarantees-for-large-financial-institutions-20110114.pdf [https://perma.cc/8G6Q-SK6X]. During the 2007–08 financial crisis, the federal government also took steps to guarantee money market mutual funds, asset-backed securities, commercial paper, asset-backed commercial paper, and other short-term financial instruments, leading many to believe that investors in these types of financial instruments and markets also enjoy implicit government guarantees against loss. *See generally* BAIRD WEBEL & MARC LABONTE, CONG. RESEARCH SERV., R43413, COSTS OF GOVERNMENT INTERVENTIONS IN RESPONSE TO THE FINANCIAL CRISIS: A RETROSPECTIVE (Sept. 12, 2008).

229. *See* David Luttrell et al., *Understanding the Risks Inherent in Shadow Banking: A Primer and Practical Lessons Learned*, 18 FED. RES. BANK DALLAS STAFF PAPER, Nov. 2012, at 19, 19–20.

The prevalence of government guarantees in banking is relevant to LFC governance for at least two reasons. First, these guarantees reduce or eliminate the incentives of creditors to monitor and discipline the activities of banks and other LFCs. While I have previously argued that creditor discipline is not an effective means of reining in bank risk,[230] even for those who might disagree with this assertion, it is uncontroversial that creditor discipline is largely absent in today's banking system due to the prevalence of government guarantees of bank liabilities.[231] If creditors are not fully monitoring and disciplining LFC risk taking, then the private ordering justification for shareholder primacy falls apart. After all, if creditors aren't keeping bank risk in check, why should the legal framework preference the interests of shareholders, who generally prefer much greater risk than other stakeholders?

Second, and relatedly, government guarantees—whether explicit or implicit—on LFC debt liabilities effectively transfer the credit risk on these obligations from creditors to taxpayers. This transforms the creditor agency cost problem into a taxpayer concern, taking it out of the realm of private ordering and directly implicating the public interest. It is taxpayers, not creditors, who bear the risk of loss from bank failure. Therefore, it is inappropriate to simply allow shareholder interests to dominate based on a private ordering justification when there is a clear and compelling public policy rationale for a governance arrangement that limits LFC risk.

3. Negative Externalities in Banking

A third difference between LFCs and other types of business concerns is that the failures of LFCs, unlike other firms, can create large negative costs for those who are not investors or direct stakeholders in the failed LFC. This problem of negative externalities in banking is well understood and the subject of much study. The failure of a single bank can cause runs to occur at other banks, even those that are well managed and well capitalized against losses.[232] These runs can potentially lead to a financial

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230. *See generally* Min, *Market Discipline*, *supra* note 1.

231. *See, e.g.*, Robert P. Bartlett III, *Making Banks Transparent*, 65 VAND. L. REV. 293, 303–04 (2012) ("[T]hese regulatory safety nets induce a bank's suppliers of capital to disregard the riskiness of a bank's loans.").

232. Bank runs occur when short-term creditors, such as bank depositors, rush to redeem their funds. While banks keep some liquid funds on hand to meet redemption requests, if enough short-term creditors "run to the bank" all at once, this exhausts the bank's liquidity and forces it to sell illiquid assets—perhaps at a loss—in order to meet these demands. *See* Min, *Government Guarantees*, *supra* note 227, at 475–77. As Professors Diamond and Dybvig have described, this problem of bank runs can cause even healthy and well managed banks to fail, by forcing them to liquidate performing assets in a fire sale dynamic and thereby suffer losses. *See* Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 410 (1983).

crisis with devastating macroeconomic consequences, affecting those who are not directly invested in any of the underlying banks.

Banks have several features that make them vulnerable to runs. First, as discussed above, they are highly leveraged.[233] Second, their core business activity is investing in loans and credit products with high evaluation and monitoring costs, creating steep information asymmetries between bank insiders and outside investors.[234] Third, banks have a severe maturity mismatch between their short-term liabilities (such as demand deposits) and long-term assets (such as loans).[235] As I've described previously, these characteristics of banks and other LFCs make them prone to runs:

> The high level of debt means that a relatively small credit loss can render a bank insolvent. At the same time, the informational asymmetries inherent in banking mean that [short term creditors] do not know whether a particular sign of bank problems . . . is an indication that the bank is insolvent. Finally, the maturity mismatch of bank assets and liabilities means a bank does not have sufficient liquid assets to pay off more than a very small fraction of its liabilities at any given time. If a large number of depositors simultaneously seek to withdraw their funds from the same bank, that bank must find new sources of liquidity, and this may entail selling off its loans in a "fire sale" environment.[236]

Because bank runs can cause even healthy banks to become insolvent, they can occur without any obvious trigger. Some banking scholars have postulated that bank runs can even be caused by random occurrences such as sunspots.[237] Indeed, the vulnerability of banks to runs is a key cause of runs themselves. As one prominent banking regulator has said, it may not be rational to start a bank run, but it is rational to participate in one once it has started.[238] Because of the informational opacity of bank investment portfolios, the average bank creditor is ill equipped to know whether her bank is well managed or not. But she does know that if she is first to redeem her funds from the bank she will likely be paid in full, whereas if she waits too long to join a bank run, she may find herself receiving only a fraction of the amount she is owed, or even nothing at all.

233. *See* Ben Bernanke & Mark Gertler, Banking in General Equilibrium 1–2 (Nat'l Bureau of Econ. Research, Working Paper No. 1647, 1985).

234. *Id.*

235. *Id.*

236. Min, *Market Discipline, supra* note 1, at 1429.

237. *See* Diamond & Dybvig, *supra* note 232.

238. Wolfgang Münchau, *The Only Way to Stop a Eurozone Bank Run*, FIN. TIMES (May 20, 2012), https://www.ft.com/content/5d7ff324-a0e6-11e1-9fbd-00144feabdc0 [https://perma.cc/GPX2-HL25] (quoting former governor of the Bank of England Mervyn King).

At the same time, a run on one bank can easily spread fears among creditors of other banks, causing further bank runs that can in turn potentially lead to a widespread banking panic or financial crisis. Banking panics are incredibly costly, not only for bank investors, but also for the broader economy. Until the New Deal era banking reforms were implemented in the 1930s, such panics were a regular part of the financial landscape in the United States, with major financial crises occurring in 1814, 1819, 1837, 1839, 1857, 1861, 1873, 1890, 1893, 1907, 1914, and of course from 1929–1933.[239] These crises are devastating for economic growth and capital formation. As Reinhart and Rogoff have found, due to a combination of declining tax receipts and increased public expenditures to stave off economic downturns, government debt increases on average more than 80 percent in the three-year period following a major financial crisis.[240]

Even if we ignore the prior arguments against shareholder primacy and assume for the sake of argument that shareholder wealth maximization is the optimal outcome of private ordering among corporate stakeholders, the large negative externalities associated with LFC failures offer another potent basis for discarding shareholder primacy for these types of institutions. Because the costs of LFC failures can potentially affect parties that have no direct connection with the LFC, these costs—and the risk-taking that can lead to LFC failures—are necessarily a matter of public—and not just private—concern.

C. Shareholder Primacy and Prudential Regulation

Because of the problems posed by banking panics, banking regulation is first and foremost designed to rein in excessive risk taking by banks and other leveraged financial intermediaries, as I describe in this section. Because of the very large negative externalities associated with bank failures, the regulatory regime for banks is singularly intrusive, with an extraordinary scheme of capital requirements and intensive examinations, among other things, designed to ensure the safety and soundness of these financial intermediaries. And yet—as is clear to anyone who studies banking law—safety and soundness regulation has historically emphasized *external* restrictions and mandates on bank behavior, and, with the exception of fraud, self-dealing, or other wrongdoing, has traditionally ignored the *internal* governance of banks and other financial intermediaries.

Modern banking regulation, both in the United States and abroad, has

239. *See* Charles W. Calomiris & Gary Gorton, *The Origins of Banking Panics: Models, Facts, and Bank Regulation*, *in* FINANCIAL MARKETS AND FINANCIAL CRISES 109, 113–19 (R. Glenn Hubbard ed., 1991).

240. REINHART & ROGOFF, *supra* note 3, at 142.

largely taken a three-pronged approach to limit the problem of banking panics. First, to protect against the problem of runs and panics, banks have been offered access to a "lender of last resort" (LOLR) (such as the Federal Reserve) and access to government guarantees on short-term funding (such as FDIC deposit insurance). The lender of last resort ensures that banks will have access to sufficient liquidity to meet all redemption demands, while the government guarantees obviate the economic rationale behind runs, by ensuring that all depositors will be paid at par (so long as the government itself is solvent) and therefore have no reason to run to the bank to redeem their funds.

Second, to limit insolvency risk (which can cause runs but can also cause losses to taxpayers when LOLR and government guarantees are implemented), banks have been subjected to a relatively stringent regulatory regime meant to ensure that they will have sufficient capital relative to their risk, such that they will survive major credit losses, or alternatively, cause minimal losses to taxpayers if they do fail. This "safety and soundness" or "prudential" regulatory scheme emphasizes bank capital,[241] but has also historically operated through other mechanisms as well, including activity restrictions, branching and other affiliate restrictions, and a relatively rigorous examination process.[242]

Finally, in the event that insolvency occurs, bank resolution schemes are supposed to minimize taxpayer losses and also any moral hazard effects that might arise from providing bailouts to non-insured investors. Since the passage of the FDIC Improvement Act of 1991, federal banking regulators have been required to resolve distressed banks using the method that results in the lowest cost to the FDIC's Deposit Insurance Fund.[243] This "least cost resolution" requirement is intended, among other things, to prevent the bailouts of uninsured investors, thereby eliminating or at least reducing expectations that they will benefit from implicit government guarantees. More recently, Dodd-Frank[244] and Basel III[245] also have emphasized measures meant to dissuade

241. As I discuss *infra*, bank safety and soundness regulation also looks to several other factors including asset quality, management, earnings, liquidity, and sensitivity to market risk. *See infra* notes 265–75 and accompanying text.

242. *See* SPONG, *supra* note 139, at 63–84; *id.* at 98–138.

243. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. § 1823(c)(4) (2019)).

244. *See generally id.*

245. The Basel Committee on Bank Supervision includes the central banks of all of the OECD countries and is the primary global standard setter for the prudential regulation of banks. *See About the BCBS*, BANK FOR INT'L SETTLEMENTS, https://www.bis.org/bcbs/about/overview.htm?m=3%7C14%7C573 [https://perma.cc/L63K-3V8T]. The Basel Committee issues recommended prudential regulation guidelines that are intended to be adopted by the Committee's members. *See History of the Basel Committee*, BANK FOR INT'L SETTLEMENTS,

government bailouts of uninsured investors in their resolution of banks. Dodd-Frank's "Orderly Liquidation Authority," set forth in Title II of the bill, creates a new resolution regime for systemically important ("too big to fail") financial institutions that is intended to provide regulators with a viable alternative to the choices it previously faced during a financial panic—either put the company into bankruptcy and risk jeopardizing the economic and financial stability of the country, or bail out the investors of the company.[246] This Orderly Liquidation Authority is intended to prevent bailouts and impose losses on shareholders and creditors of failing financial institutions, thus avoiding the moral hazard effects that might otherwise arise. Basel III takes a different approach to avoiding bailouts, by requiring banks to issue "bail-in" debt—debt obligations that are contractually required to be written down or converted into equity when the bank's health deteriorates to the point that a resolution is required.[247] Because this bail-in debt is by its very nature not allowed to be bailed out, it serves as a private buffer against government rescues of other creditors.

Notably, these regulatory mechanisms operate as *external* restrictions or mandates on bank activity. Bank safety and soundness regulation, for the most part, does not seek to affect the internal governance of banks. To the very limited extent that Congress or federal regulators have sought to influence bank governance in recent years, it has been with the aim of more closely aligning the interests of LFC managers and directors with LFC shareholders. For example, Title IX of the Dodd-Frank Act of 2010 contains a handful of provisions intended to influence bank governance. These include increased disclosures related to executive compensation (including whether there are any "golden parachute" compensation packages),[248] greater proxy access,[249] and "clawback" provisions requiring corporations to develop and enforce policies that would require executives to return incentive-based compensation to the firm in the event

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http://www.bis.org/bcbs/history.htm [https://perma.cc/4BZD-5VD2]. "Basel III" refers to a series of recommended reforms to bank prudential regulation issued between 2011 and 2014, meant to update the previous two sets of recommendations offered by the Basel Committee, commonly known as Basel I and Basel II. *Id.*

246. S. REP. NO. 111-76, at 4 (2010).

247. *See* PRICEWATERHOUSECOOPERS, BASEL III AND BEYOND—THE TRILLION DOLLAR QUESTION: CAN BAIL-IN CAPITAL BAIL OUT THE BANKING INDUSTRY? 2–3 (Nov. 2011), *available at* https://www.pwc.com/jg/en/publications/basel-and-beyond-trillion-dollar-question.pdf [https://perma.cc/G2UT-4398].

248. Dodd-Frank §§ 951, 953, 124 Stat. at 1376.

248. *Id.*

249. The SEC's rule implementing Dodd-Frank's § 957 was famously vacated by the D.C. Circuit in its controversial decision, *Business Roundtable v. SEC.* 647 F.2d 1144 (D.C. Cir. 2011). The D.C. Circuit found that the SEC had failed to adequately consider the economic consequences of its rule. *Id.* at 1148.

of an accounting restatement.[250] All of these seem to primarily benefit shareholders, either by improving bank transparency (which in turn helps shareholders to better monitor and discipline bank management) or by more closely aligning the incentives of managers with shareholders.

Modern banking regulation's emphasis on external regulatory oversight (as opposed to internal governance) has led to two problems that have undermined its overall goals of safety and soundness. First, because banking regulation has mostly ignored the incentives of bank managers and directors, the relationship between banks and their regulators has increasingly been an adversarial one, in which bank decision makers seek to take on greater risk while regulators seek to reduce bank risk. This puts regulators in a cat-and-mouse dynamic vis-à-vis banks that have superior information, greater resources, and strong incentives to try to avoid regulation. As one leading banking consultancy has described:

> In a game of cat and mouse between regulators and shadow bankers, the mice will win. There are far more mice; they are typically better informed and better motivated than the cats; and the extraordinary complexity of modern financial products and the global scope of the industry give the mice a nearly limitless supply of nooks and crannies to hide in.[251]

Second, banking regulation's historical disregard of governance has meant that banking scholarship has also mostly ignored governance as a topic worth researching and developing. As Professor Christopher Bruner has observed, "[o]ne of the first intriguing insights to arise in the wake of the 2007 financial crisis was the realization that, as recently as 2009, the empirical literature on corporate governance in financial firms was quite thin."[252] Thus, even as policy makers have been seeking to reform the governance of LFCs, there has been a paucity of banking-specific research and solutions to draw from in this regard.[253] As a result, many of the changes to LFC governance that have been implemented reflect the corporate governance scholarship and its emphasis on reducing shareholder agency costs, and do reflect the specific agency cost

250. Dodd-Frank § 954, 124 Stat. at 1376.

251. OLIVER WYMAN, STATE OF THE FINANCIAL SERVICES INDUSTRY 2011: THE FINANCIAL CRISIS OF 2015, AN AVOIDABLE HISTORY 8–9 (2011), *available at* https://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/jan/OW%20SoFS%202011.pdf [https://perma.cc/6THM-SUV8].

252. Christopher M. Bruner, *Conceptions of Corporate Purpose in Post-Crisis Financial Firms*, 36 SEATTLE L. REV. 527, 534 (2013).

253. To be sure, there has been a nascent but growing movement among policy makers and scholars that has begun to recognize the inherent conflict between governance frameworks and prudential regulatory goals for banking. But this movement has led to only a handful of proposals, and most of these have been developed well after the 2007–08 financial crisis. *See generally* Min, *supra* note 220.

problems in banking. These reforms have tended to increase shareholder influence over LFC behavior, even as there are ample reasons, as described in this Part, to believe that shareholder empowerment tends to lead to greater risk taking that is adverse to the broader safety and soundness concerns of financial regulators and policy makers. In short, the corporate governance reforms adopted in response to the financial crisis have tended to exacerbate rather than address the misalignment of internal governance incentives with external macroprudential regulations.

III. FEDERALIZING BANK GOVERNANCE

For all the reasons discussed above, deemphasizing shareholder wealth maximization for banks and other leveraged financial institutions is an appropriate goal. But how might we achieve this? There are a number of different pathways we might consider. One possibility is to reduce the risk-taking incentives of LFC *executives*, either by imposing personal liability on them[254] or altering the compensation packages they receive.[255] Another possibility is to realign the incentives of LFC *shareholders* by increasing their liability, with the goals of both decreasing shareholder pressure for greater risk-taking and also increasing shareholder monitoring of firm activity.[256] Finally, we can

254. *See, e.g.*, Dodd-Frank § 954, 124 Stat. at 1376 (requiring corporations to implement "claw back" provisions recovering compensation from officers in the event of an accounting restatement); CLAIRE A. HILL & RICHARD W. PAINTER, BETTER BANKS, BETTER BANKS: PROMOTING GOOD BUSINESS THROUGH CONTRACTUAL COMMITMENT 149–51 (2015) (proposing the imposition of personal liability on financial executives for losses incurred in the firm's insolvency); KENNETH R. FRENCH ET AL., THE SQUAM LAKE REPORT: FIXING THE FINANCIAL SYSTEM 50–51 (2010) (proposing setting aside some portion of executive compensation to be paid out at a later date if the firm has not received a government bailout or declared bankruptcy).

255. *See, e.g.*, Lucian Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 249, 253 (2010) (proposing that bank executive compensation be based on an indexed scale reflecting a mixture of common shares, preferred shares, and debt analogous to the overall financing structure of the company); Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 15 NW. U. L. REV. 1205, 1207 (2011) (proposing that bank executive compensation include subordinated debt); Wulf A. Kaal, *Contingent Capital in Executive Compensation*, 69 WASH. & LEE L. REV. 1821, 1850–72 (2012) (suggesting the use of "contingent capital"—debt that converts into equity upon certain events—as a part of executive compensation).

256. Several scholars have proposed restoring double par liability—described *infra* in notes 40–50 and accompanying text—for shareholders of financial institutions. *See, e.g.*, Richard Ridyard, *Toward a Bank Shareholder-Orientated Model: Using Double Liability to Manage Excessive Risk-Taking*, 2 UCL J.L. & JURIS. 141 (2013); Richard S. Grossman, *Double Liability and Bank Risk Taking*, 33 J. MONEY, CREDIT & BANKING 143 (2001); Macey & Miller, *Double Liability of Bank Shareholders*, *supra* note 40. Peter Conti-Brown has argued for an elective option in which shareholders of systemically important financial institutions could vote for unlimited shareholder liability in return for significantly lower regulatory requirements. Peter Conti-Brown, *Elective Shareholder Liability*, 64 STAN. L. REV. 409, 428–41 (2011).

look to rebalance the internal governance priorities of LFCs by changing the fiduciary duties owed by their directors and officers.[257]

In this Part, I argue that changing fiduciary duties is likely to be an effective tool for improving the safety and soundness of banks and other LFCs. I further contend that such changes should be implemented at the federal level, rather than through the states, for a number of reasons. Finally, I provide some thoughts on how a federalization of fiduciary duties in banking might be implemented, and a set of parameters for what this duty should look like.

A. Why Fiduciary Duties?

Before proceeding, I should address the threshold question of why fiduciary duties are an appropriate area for reform. This question has two parts—why governance generally, and why fiduciary duties particularly. With respect to the first question—why governance—some of this is addressed in the previous Part, but the short answer is that our current governance incentives for financial institutions are working at cross-purposes with the safety and soundness goals we have emphasized for these firms. If we believe the policy priority of bank safety and soundness is of sufficient importance that it justifies the incredibly complex and cumbersome regulatory architecture that now exists for banking firms, then we should be eager to adopt changes to banking governance that are comparatively much less costly and intrusive. While policy leaders have made enormous efforts to reform and revise our external prudential regulation of banks over the past several decades, bank governance has remained largely untouched, and so even minor changes in this area could have far-reaching effects.

At the same time, changes to the fiduciary duties of banking directors and officers could map on neatly to the existing regulatory framework that exists for US banking firms, which are governed both by state corporate law and by federal banking regulations (which themselves heavily influence firm behavior, as described below in Section C of this Part). As I explain below, changes to fiduciary duty standards could be utilized by both private actors using traditional corporate law as well as

257. There have been at least two proposals for changes in the fiduciary duties owed under state law by SIFI directors and officers. Armour & Gordon have argued for amending the duties of care and loyalty to expand liability and heighten scrutiny. John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 64–70 (2014). Schwarcz has pushed for a "public governance duty" that would exist side-by-side with existing fiduciary duties requiring directors and officers to consider the costs and benefits of risky activities against the potential systemic harms that might be caused to society. Steven L. Schwarcz, *Misalignment: Corporate Risk-Raking and Public Duty*, 92 NOTRE DAME L. REV. 1, 29–30 (2016).

by bank regulators wielding the expansive powers granted to them by the United States Congress.

Finally, fiduciary duty changes are a natural starting point that, once adopted, would help to facilitate other downstream changes, particularly with respect to executive compensation and liability. After all, as the FDIC has noted, "[t]he board of directors is the source of all authority and responsibility. In the broadest sense, the board is responsible for formulation of sound policies and objectives of the bank, effective supervision of its affairs, and promotion of its welfare."[258] If we change the incentives of LFC directors and officers such that they no longer prioritize a principle of shareholder wealth maximization, it is far easier to imagine that changes to executive compensation or liability could and would be adopted as part of a broader realignment of internal governance priorities.

B. Why a Federal Solution Makes Sense

If fiduciary duties are an appropriate mechanism for reform, then the next question we should ask is how they should be revised. We could seek to change the state fiduciary duty laws for some universe of financial institutions. Indeed, changing Delaware's laws alone would have a massive impact, given the outsized influence that state has as far as corporate law. But doing this might be difficult, given the deep entrenchment of shareholder wealth maximization in that state's case law, and an attempt to change longstanding laws that have been relied upon for decades could lead to significant litigation. Moreover, for changes in state corporate law to be truly effective, we'd need to change the laws of all fifty states, so as to prevent regulatory arbitrage and a race to the bottom. That could be difficult and would obviously be time-consuming and inefficient. Thus, it would seem that changing federal laws would be a comparatively cleaner, simpler, and more efficient approach to changing the fiduciary duties of LFC directors and officers.

A move towards federalization of LFC fiduciary duties would also help to ameliorate some of the structural problems with banking regulation. As Professors Camacho and Glicksman have described, prudential banking regulation in the United States has historically suffered from excessive decentralization and overlapping authority[259] for many of the reasons described above in this article. In recent years, and particularly since the 2007–08 financial crisis, there has been a strong push to try to

258. FED. DEPOSIT INS. CORP., RISK MANAGEMENT MANUAL OF EXAMINATION POLICIES, § 4.1–1 (2018), *available at* https://www.fdic.gov/regulations/safety/manual/section4-1.pdf [https://perma.cc/QT3N-5J3M] [hereinafter FDIC RISK MANAGEMENT MANUAL].

259. ALEJANDRO E. CAMACHO & ROBERT L. GLICKSMAN, REORGANIZING GOVERNMENT: A FUNCTIONAL AND DIMENSIONAL FRAMEWORK 176 (2019).

centralize and coordinate the regulation of financial institutions (and particularly large and systemically important financial institutions). Examples of this in Dodd-Frank include the creation of a new Financial Stability Oversight Council, to identify and oversee problems with systemic risk, and also the elevation of the Federal Reserve Board into a central role in regulating financial institutions.[260] Federalizing fiduciary duties would help to centralize an important part of bank regulation—one that is currently administered almost entirely through state courts—and address some of the current issues of decentralization and overlapping authority that exist in this area.

Relatedly, the creation of federal standards for fiduciary duties would bring prudential regulation and governance standards under the aegis of federal banking regulators, which would improve the efficiency of safety and soundness regulations and potentially eliminate the conflicts between these two areas of law. After all, as this Article has described, the schism between prudential regulation and bank governance is a recent phenomenon and not the result of any reasoned normative rationales. Until recently, banking regulation was a relatively simple and unified concept. Only firms with bank charters could engage in the business of banking, and this charter, whether issued by a state or the federal government, was tied to both a legal framework for governance and a prudential regulatory regime meant to ensure the safety and soundness of depositor monies and limit the threat of banking panics.[261]

It was only with the rise of bank holding companies and shadow banks that the legal frameworks for prudential regulation and governance became untethered. Today, a slew of federal statutes and regulations meant to reduce banking risk apply not only to nationally chartered banks but also to state banks, bank holding companies, and even to non-bank financial firms designated as systemically important financial

260. *Id.* at 179.

261. The particulars of bank prudential regulation varied over time in the pre-Glass Steagall period. In the lightly regulated "free banking era," described *supra* at notes 35–38 and accompanying text, the state banking authorities generally imposed three types of regulations: first, a requirement that banks deposit designated bonds (typically the chartering state's bonds, although many states also allowed federal or other state bonds as well) with the state banking authority; second, a requirement that the bank maintain enough specie on hand to pay any notes presented for redemption; and third, the double liability for shareholders, described *supra* at notes 41–45 and accompanying text. *See* Rolnick & Weber, *supra* note 137, at 4. The widespread bank failures of the free banking era led Congress to enact the National Currency Act of 1863 and National Bank Act of 1864 with the goals of establishing a unified national currency and a national banking system. *See* SPONG, *supra* note 139, at 18–19; John Wilson Million, *The Debate on the National Bank Act of 1863*, 2 J. POL. ECON. 251, 251–52 (1894). This federal banking legislation established a national bank charter that was accompanied by a regulatory regime that included minimum capital requirements, reserve requirements, loan restrictions, and regular examinations to be administered by the newly created Office of the Comptroller of the Currency. *See* SPONG, *supra* note 139, at 19; Sylla, *supra* note 145, at 659–62.

institutions.[262] Yet virtually all of these institutions are organized under the umbrella of a state business charter that requires the firm's directors and officers to pay fealty to the principle of shareholder wealth maximization. As a result, we have a regulatory system whose component parts are quite often working at cross-purposes with each other: the state laws setting the incentives for governance in banking firms tend to encourage greater risk taking, even as the increasingly complex and cumbersome federal regime for banking institutions is almost entirely focused on limiting risk in these same firms.

Until relatively recently, activities that were considered to fall within the definition of the "business of banking" were limited to those institutions with a bank charter.[263] But the explosive growth of bank holding companies, financial holding companies, and shadow banking—often aided by compliant regulators seeking to improve the competitiveness of their regulated entities—has meant that many firms other than traditional banks are now effectively engaging in the business of banking. The recent implementation of Dodd-Frank, the different Basel accords and financial regulatory rulemaking have expanded prudential regulation to cover many of these non-bank institutions. But there has been no similar expansion of financial firm governance. This has complicated the tasks of financial regulators, who now operate with a baseline assumption that the directors and officers of the firms they oversee are incentivized by state corporate law to act on behalf of their

262. The Dodd-Frank Act established the Financial Stability Oversight Council (FSOC) and granted it the authority to designate a non-bank financial company as a SIFI if the FSOC determined that the firm could potentially threaten US financial stability. 12 U.S.C. § 5323 (2019). Any firm designated as a non-bank SIFI becomes subject to a number of stringent regulatory requirements that are normally only applicable to banks and BHCs, including risk-based capital, leverage, liquidity, and risk management requirements. *See* 12 U.S.C. § 5365(b)(1) (2019) (developing prudential standards for enhanced supervision and prudential standards for nonbank financial companies). Initially, the FSOC designated four non-bank SIFIs—the insurance conglomerates Prudential, AIG and MetLife, as well as General Electric's financial subsidiary GE Capital. *See* Jeremy C. Kress, *The Last SIFI: The Unwise and Illegal Deregulation of Prudential Financial*, 71 STANFORD L. REV. ONLINE 171, 173 (2018) (arguing that Prudential's declassification as SIFI was not only unwise but illegal). In response to this SIFI designation, AIG and GE Capital shrunk their asset portfolios and reduced their exposure to risk, and were de-designated SIFIs by the FSOC. *Id.* at 173–74. MetLife sued over its SIFI designation and won its case in district court. After the Trump administration took control, the FSOC dropped its appeal and allowed MetLife to avoid SIFI designation. *Id.* at 174. President Trump's appointees to the FSOC were highly critical of Dodd-Frank and its regulatory burden, and in October 2018, the FSOC formally de-designated Prudential as a SIFI. *Id.* at 174–75. As of today, there are no non-bank SIFIs despite a widespread view that many non-bank (and non-BHC) financial entities pose significant risks to the financial system. *Id.* at 176–81.

263. *See* Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the Business of Banking,* 63 U. MIAMI L. REV. 1041, 1048–50 (2009) (discussing the historical meaning of the "business of banking").

shareholders, even if this may be contrary to the broader goal of safety and soundness.

In short, the separation of governance from safety and soundness regulation is a historical accident lacking any persuasive policy justification. There is simply no good argument for having a complex federal regime for limiting the risk of leveraged financial companies and a separate stand-alone body of state corporate law that guides the incentives of the people that run these leveraged financial institutions. It is long past time we reconciled and harmonized governance with the rest of banking regulation.

C. How Does Federal Law Already Impact Banking Governance?

But before we can discuss how we might change federal laws and regulations to deemphasize shareholder wealth maximization in banking in favor of a stronger emphasis on safety and soundness, we must first understand what authorities already exist for federal regulators that might affect LFC governance. In addition to state fiduciary duties and federal statutory duties that directly apply to directors and officers of depository institutions, described in Part I, there are a number of federal laws and regulations that, while not directly impacting fiduciary duties, do affect the decision making of LFC directors and officers, as this section describes. These affect not only directors and officers of banks, but also bank holding companies (BHCs), financial holding companies (FHCs), and non-bank financial firms that are designated by financial regulators as "systemically important."

1. CAMELS Examination Framework for Banks

In addition to the statutory authorities allowing federal regulators to penalize or remove bank directors and officers, described *supra*,[264] bank examiners wield significant discretionary authority over the directors and officers of depository institutions through their examination processes. US bank examinations largely revolve around capital levels and examination ratings. Examination ratings are assessed as a composite score based on so-called "CAMELS" factors: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk.[265] Officially known as the Uniform Financial Institutions Rating System, this ratings system was first adopted by the Federal Financial Institutions Examination Council, a formal interagency body of financial regulators that is empowered to prescribe uniform principles, standards,

264. *See supra* text accompanying notes 112–23.

265. *See* FDIC RISK MANAGEMENT MANUAL, *supra* note 258, at § 1.1-1 (listing the six financial and operational components evaluated to determine a financial institution's composite rating).

and reports for the examinations of financial institutions,[266] in 1979 and later updated in 1996.[267]

Under the CAMELS rating system, a depository institution is assigned a composite rating between 1 and 5 (with 1 indicating the highest rating) based on assessments of the six CAMELS components.[268] This CAMELS composite rating is meant to provide a uniform assessment of the soundness of banks and other depository institutions.[269] A downgrade in a bank's CAMELS rating has numerous negative consequences for a bank, including an increase in the rates paid on federal deposit insurance,[270] and the loss of "well managed" status,[271] which as described below can have potentially devastating consequences for the bank's parent company.[272] Less than satisfactory assessments for the different CAMELS components also trigger certain mandatory regulatory responses, such as a recapitalization requirement, restrictions on transactions with affiliates or asset growth, changes to management, and potentially forced divestment of affiliates.[273]

As part of the CAMELS framework's management component, banks are assessed on the capability and performance of their management and board of directors.[274] Moreover, as financial regulators have made clear,

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266. *About the FFIEC*, FED. FIN. INSTITUTIONS EXAMINATION COUNCIL, https://www.ffiec.gov/about.htm [https://perma.cc/BV9R-CX9E].

267. *See* FDIC RISK MANAGEMENT MANUAL, *supra* note 258, at § 1.1-2 (discussing the history of the FFIEC's Uniform Financial Institutions Ratings System).

268. *Id.* § 1.1-3 (providing an overview of the UFIRS composite and component ratings methodology).

269. *See* Uniform Financial Institutions Rating System, FDIC Statement of Policy 5000, *available at* https://www.fdic.gov/regulations/laws/rules/5000-900.html#fdic5000uniformfi [https://perma.cc/T3XE-6KAN].

270. *See* 81 Fed. Reg. 6108, 6109-6111 (Feb. 4, 2016) (codified at 12 C.F.R. pt. 327).

271. To qualify as well managed, a depository institution must have a composite rating of '1' or '2' and also have received a rating of '1' or '2' for the management component of the CAMELS rating. *See* 72 Fed. Reg. 17,798, 17,801 (Apr. 10, 2007) (codified at 12 C.F.R. pts. 4, 208, 211, 337, 347, and 563).

272. *See infra* text accompanying notes 282–87 (discussing the Federal Reserve Board's broad authority over financial institutions).

273. *See* FDIC RISK MANAGEMENT MANUAL, *supra* note 258, at § 15.1-11. A downgrade in CAMELS works through two mechanisms. First, a decline in the institution's capital to the next lowest threshold automatically triggers certain responses under the Prompt Corrective Action framework. Second, under Section 38(g) of the FDI Act, the FDIC may also reclassify an institution to the next lowest capital category (thus triggering PCA) if the FDIC determines that the institution is in an unsafe or unsound condition, or if the FDIC determines that the institution has less than satisfactory Asset quality, Management, Earnings, or Liquidity (the non-capital components of CAMELS). *Id.* at 15.1-10–11.

274. *See* FDIC RISK MANAGEMENT MANUAL, *supra* note 258, at § 1.1-24–25. This evaluation is based on a number of factors, including the level and quality of oversight by the board and management; the ability of the board and management to plan for and respond to risks arising from changing business conditions or the initiation of new activities or products; the adequacy of internal

the management component "is given special consideration" in the overall evaluation of a depository institution's soundness, as management is understood to be critical to the institution's ability to respond to changing circumstances and mitigate risk accordingly.[275]

2. Bank Holding Companies and the Source of Strength Doctrine

While the statutory provisions that allow for federal regulators to penalize or remove bank directors and officers do not apply to the directors and officers of bank holding companies,[276] the longstanding "source of strength doctrine" provides some basis for asserting authority over these decision makers. The source of strength doctrine is derived from a 1978 Supreme Court decision that allowed the Federal Reserve Board to deny a BHC application based on the determination that the applicant holding company "would not be a sufficient source of financial and managerial strength to its subsidiary Bank."[277] This doctrine was later promulgated into rulemaking with the 1984 addition of section 225.4(a)(1) to Regulation Y, which governs bank holding companies.[278] This section simply states that a "bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner."[279] The Dodd-Frank Act codified this source of strength doctrine into statute in 2010.[280]

While the source of strength doctrine does not explicitly provide the Federal Reserve Board with the authority to penalize or remove BHC directors, it is generally understood to impose at least some type of duty to refrain from unsafe or unsound conduct.[281] However, it is not clear

policies and controls addressing the operations and risks of significant activities; and a number of other items. *Id.* at 1.1-25–26. Shareholder wealth maximization and its concomitant pressures to potentially take on greater risk are not evaluated as a factor. *Id.*

275. *See* Uniform Financial Institutions Rating System, FDIC Statement of Policy 5000, *supra* note 269.

276. While 12 U.S.C. § 1818(b)(3) explicitly states that the authority to issue cease-and-desist orders, removal orders, and civil penalties under § 1818 extends to bank holding companies, it does not extend this authority to the directors and officers of BHCs. Rather, as is made clear in § 1818(b)(1) and elsewhere, these enforcement options are available for "institution-affiliated parties," a category that includes directors and officers of insured depository institutions, but not directors or officers or BHCs. *See* 12 U.S.C. § 1813(u) (2019).

277. Bd. of Governors v. First Lincolnwood Corp., 439 U.S. 234, 252 (1978) (citing S. REP. NO. 95-323, at 11 (1977)).

278. 12 C.F.R. § 225.4(a)(1) (2016).

279. *Id.*

280. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1616 (2010), § 616(d) (codified as amended at 12 U.S.C. § 1830o-1 (2019)).

281. *See, e.g.*, Paul L. Lee, *Directors' Duty to Monitor: Experience in the Banking Sector—Part II*, 133 BANKING L.J. 483, 492 (2016) ("The safety and soundness requirements applicable to

how strong this duty is, particularly given the Fifth Circuit's decision in *MCorp Financial*, where the court held that the Federal Reserve's interpretation of its source of strength doctrine as requiring a BHC to provide funds to prop up its struggling bank subsidiaries "would amount to a wasting of the holding company's assets in violation of its duty to its shareholders."[282] As the *MCorp Financial* decision makes clear, the mere assertion of the source of strength doctrine does not eliminate the fiduciary duties owed to shareholders under state law by BHC directors. That said, the source of strength doctrine at least provides some formal guidance to BHC directors that the consideration of safe and sound practices is appropriate in their decision making. Comparable guidance does not exist for directors of non-financial corporations.

3. FHC "Well Capitalized" and "Well Managed" Requirements

As described in Part I, Gramm-Leach-Bliley created a new category of bank holding company called a financial holding company that, unlike other BHCs, would be allowed to own and operate affiliates that engaged in activities that were not "closely related to banking," including securities and insurance.[283] As with BHCs, there are no specific provisions calling for penalties or removals against FHC directors or officers for unsafe or unsound conduct. However, to be approved for FHC status, a BHC and all of its bank subsidiaries must be well capitalized and well managed.[284]

Relatedly, to retain FHC status, at least in theory, the company and its bank subsidiaries must *remain* well capitalized and well managed, as Gramm-Leach-Bliley specifically authorizes the Federal Reserve Board to take action against any FHC that is non-compliant with the well capitalized or well managed standards.[285] This authority is broad and includes any limitation on the conduct or activities of the FHC or its affiliates that the Federal Reserve Board "determines to be appropriate under the circumstances."[286] Moreover, if a FHC remains out of compliance with these requirements for 180 days or more, the Fed is explicitly given the discretionary authority to revoke the company's FHC status and force the divestiture of any (or all) of its bank subsidiaries.[287]

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the directors of a bank are in effect transposed [by the source of strength doctrine] to the directors of a bank holding company as well.").

282. MCorp Fin., Inc. v. Bd. of Governors of the Fed. Reserve Sys., 900 F.2d 852, 863 (5th Cir. 1990), *aff'd in part, rev'd in part on other grounds*, 502 U.S. 32 (1991).

283. 12 U.S.C. § 1843(k) (2019).

284. 12 U.S.C. § 1843(l)(1).

285. 12 U.S.C. § 1843(m).

286. 12 U.S.C. § 1843(m)(3).

287. 12 U.S.C. § 1843(m)(4).

The Federal Reserve Board has never actually exercised this authority,[288] but the threat of losing FHC status and being forced to divest bank subsidiaries should provide at least some theoretical incentive for FHC directors to consider the safety and soundness of the company and its bank subsidiaries.

4. Dodd-Frank and Systemically Important Financial Institutions

The Dodd-Frank Act was enacted in response to the 2007–08 financial crisis and, among other things, created a new set of regulatory responsibilities for all bank holding companies with total consolidated assets of $50 billion or more, as well as any other financial firm designated as systemically important by the Financial Stability Oversight Council.[289] These "systemically important financial institutions" or "SIFIs" are subject to enhanced prudential regulation, which includes heightened risk-based capital requirements, liquidity requirements, risk management requirements, and the submission of resolution plans (so-called "living wills"), among other things.[290]

a. Living Will Requirement

The living will requirement, laid out in Section 165(d) of Dodd-Frank, requires that each SIFI submit a plan to the Federal Reserve Board and FDIC for the rapid and orderly resolution of the company in the event it is near insolvency.[291] This living will must be expressly approved by the company's board of directors,[292] and is expected to provide a detailed plan for a rapid and orderly resolution of the company, with supporting analysis across a number of areas, including as to the company's organizational structure and liabilities,[293] its management information systems (including risk management, accounting, and regulatory reporting),[294] its interconnectedness with other entities,[295] and the key

288. *See* Jeremy Kress, *BankThink: Fed Should Force Wells Fargo Into Being a Simpler Bank*, AM. BANKER (Oct. 26, 2018), https://www.americanbanker.com/opinion/fed-should-force-wells-fargo-into-being-a-simpler-bank [https://perma.cc/87RP-BUS5] ("The Federal Reserve . . . has never publicly rescinded a firm's FHC status.").

289. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. § 5325 (2019)); *see also* MARC LABONTE & DAVID W. PERKINS, CONG. RESEARCH SERV., R45036, BANK SYSTEMIC RISK REGULATION: THE $50 BILLION THRESHOLD IN THE DODD-FRANK ACT 2 (2017) (noting those financial institutions subject to enhanced prudential regulation under the Dodd-Frank Act).

290. Dodd-Frank § 165, 124 Stat. 1376.

291. Dodd-Frank § 165(d), 124 Stat. 1376. The Fed and FDIC adopted a final rule implementing this statute in November 2011. *See* Resolution Plans Required, 76 Fed. Reg. 67,323 (Nov. 1, 2011) (codified at 12 C.F.R. pt. 243).

292. 12 C.F.R. § 243.3(e).

293. 12 C.F.R. § 243.4(e).

294. § 243.4(f).

295. § 243.4(g).

assumptions used in its analysis.[296] Importantly for purposes of this Article, the living will requirement also requires the submission of a detailed description of "[h]ow resolution planning is integrated into the corporate governance structure and processes of the covered company."[297]

While the living will requirement explicitly eschews a private right of action,[298] it does provide financial regulators with broad enforcement authorities over SIFIs that fail to timely submit a satisfactory resolution plan.[299] These enforcement authorities include the imposition of more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities or operations of the company or its subsidiaries.[300] In extreme cases, financial regulators are authorized to order the divestment of any such assets or operations deemed appropriate.[301] While not affecting fiduciary duties, the living will requirement may provide additional incentives for SIFI directors to closely consider the safety and soundness of the company's governance, operations and activities.

b. Capital and Liquidity Risk Management

Utilizing its authority under Dodd-Frank and other federal statutes, the Federal Reserve has been quite active in adopting new safety and soundness rules and requirements for SIFIs, in the form of various capital, liquidity, and stress testing requirements that impose affirmative responsibilities on the directors and officers of large BHCs and sometimes also systemically important nonbank financial companies.

One important such rule is the Federal Reserve Board's adoption of the Capital Planning Rule,[302] which requires that all SIFIs[303] develop and maintain a capital plan.[304] Under this rule, the SIFI's board of directors, or a designated committee of the board, must submit a comprehensive capital plan each year.[305] In its release of the final rule, the Federal Reserve Board seemed to express a view that the capital planning requirement merely augmented the existing fiduciary duties already owed by SIFI directors and officers, stating:

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296. § 243.4(c).
297. § 243.4(d).
298. 12 C.F.R. § 243.8(b).
299. 12 C.F.R. § 243.6.
300. *Id.*
301. 12 C.F.R. § 243.6(c).
302. Capital Planning, 12 C.F.R. § 225.8 (2020).
303. This includes any BHCs with more than $50 billion in total consolidated assets as well as any nonbank financial company designated as systemically important by the Financial Stability Oversight Council. *See* 12 C.F.R. §§ 225.8(b), 225.8(d)(11).
304. 12 C.F.R. § 225.8(e)(1)(i).
305. § 225.8(e)(1)(iii)(C).

> As part of their fiduciary responsibilities to a bank holding company, the board of directors and senior management bear the primary responsibility for developing, implementing, and monitoring a bank holding company's capital planning strategies and internal capital adequacy process. The final rule does not diminish that responsibility. Rather, the final rule is designed to (i) establish common minimum supervisory standards for such strategies and processes for certain large bank holding companies; (ii) describe how boards of directors and senior management of these bank holding companies should communicate the strategies and processes, including any material changes thereto, to the Federal Reserve; and (iii) provide the Federal Reserve with an opportunity to review large bank holding companies' proposed capital distributions under certain circumstances.[306]

Whether or not there is an existing fiduciary duty of safety and soundness owed by SIFI directors and officers, the Federal Reserve Board has made clear, both with this rule and also with subsequent interpretative guidance, that it has high expectations for these corporate decision makers and their role in planning and overseeing the company's capital adequacy.[307]

Directors and officers of large BHCs also have regulatory responsibilities to ensure that the firm is sufficiently managing its liquidity risk. Under authority provided by Dodd-Frank,[308] the Federal Reserve has established liquidity risk management responsibilities for the directors and officers of BHCs with more than $50 billion in consolidated assets.[309] Directors of such firms are responsible for approving the firm's appropriate level of liquidity risk and periodically reviewing information provided by senior management related to the company's liquidity risk management.[310] The rule has more heightened responsibilities for senior managers, who are required to establish, develop, and implement liquidity risk management policies, including measurement and reporting systems, a review of significant or new products and business lines and their effects on the company's liquidity risk profile and its cash flow projections, among other things, and regular liquidity stress testing.[311]

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306. Capital Plans, 76 Fed. Reg. 74,631, 74,632 (Dec. 1, 2011) (codified at 12 C.F.R. § 225.8).

307. *See, e.g.*, BD. GOVERNORS FED. RESERVE SYS., SR 15-18, FEDERAL RESERVE SUPERVISORY ASSESSMENT OF CAPITAL PLANNING AND POSITIONS FOR LISCC FIRMS AND LARGE AND COMPLEX FIRMS 4–6 (Dec. 18, 2015) (describing the Federal Reserve Board's expectations of the board and senior management in developing and implementing capital and risk management policies and stating the Fed's view that the "board of directors is ultimately responsible and accountable for the firm's capital-related decisions and for capital planning").

308. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 165(b)(1)(A)(ii), 124 Stat. 1376, 1424 (2010) (codified as amended at 12 U.S.C. § 5365 (2019)).

309. Liquidity Risk-Management Requirements, 12 C.F.R. § 252.34 (2016).

310. § 252.34(a).

311. § 252.34(c).

As one observer has described, given the high priority that the Federal Reserve Board and other financial regulators have placed on liquidity risk management, "[r]igorous oversight of management's processes for liquidity risk management must thus be a high priority for the board of every large banking institution."[312]

c. Risk Committee Requirement

Dodd-Frank also directly impacts the board structure and governance of SIFIs, by directing the Federal Reserve Board to issue regulations requiring that all BHCs with consolidated assets of more than $10 billion and all nonbank SIFIs establish a risk committee that must include at least one risk management expert and which is responsible for overseeing the risk management practices of the entire company.[313] The Federal Reserve has created two risk committee standards, one for BHCs with more than $10 billion but less than $50 billion in consolidated assets,[314] and the other for BHCs with more than $50 billion in consolidated assets.[315]

BHCs with more than $10 billion in consolidated assets are required to maintain a risk committee,[316] chaired by an independent director and including at least one member with experience in risk management for large, complex firms.[317] This risk committee is responsible for, among other things, establishing a risk management framework including policies and procedures for the establishment, implementation and compliance with risk management governance.[318] A company must have a formal written charter approved by the company's board and must meet at least quarterly.[319]

A BHC with more than $50 billion in consolidated assets is subject to these same requirements,[320] but its risk committee must also be an independent, stand-alone committee whose sole and exclusive responsibility is overseeing the BHC's risk management practices, policies, and framework.[321] Furthermore, in addition to the requirement that the risk committee have an independent chair and a member who has experience in risk management for large, complex firms,[322] BHCs with

312. Lee, *supra* note 281, at 511.
313. Dodd-Frank § 165(h), 124 Stat. 1376.
314. Risk Committee Requirement for Publicly Traded Bank Holding Companies with Total Consolidated Assets of $10 Billion or More, 12 C.F.R. § 252.22 (2016).
315. Risk-Management and Risk Committee Requirements, 12 C.F.R. § 252.33 (2016).
316. 12 C.F.R. § 252.22(a).
317. § 252.22(d).
318. § 252.22(b).
319. § 252.22(c).
320. 12 C.F.R. § 252.33(a).
321. § 252.33(a)(3)(ii).
322. § 252.33(a)(4).

more than $50 billion in consolidated assets must also have a chief risk officer with risk management experience for large, complex firms.[323] This chief risk officer is responsible for overseeing the establishment of and compliance with risk limits across the company, and otherwise managing and overseeing the company's risk management practices, policies, and risk control framework.[324] The chief risk officer's compensation must be commensurate with her responsibilities and she should report directly to both the risk committee and chief executive officer of the company.[325]

5. Heightened Governance Standards for Holding Companies

In addition to the regulatory changes directly authorized under Dodd-Frank, financial regulators have utilized their existing authorities to adopt changes to their expectations for the directors and senior managers of large banking institutions. As described *supra* in Part I.C.4, the OCC promulgated new guidelines laying out its heightened expectations for corporate governance at large national banks.[326] The Federal Reserve recently issued similar guidance for the directors and officers of large complex BHCs as part of their overall examination process.[327]

Under the previous examination regime, dubbed RFI/C(D),[328] the Federal Reserve Board assigned each BHC and FHC a composite rating ("C"),[329] which was to be based on three essential component ratings:

> Risk management ("R"), which itself is made up of four subcomponents: (a) competence of the board of directors and senior management; (b) policies and procedures; (c) risk monitoring and management information systems; and (d) internal controls.[330]
>
> Financial condition of the holding company ("F"), to be assigned based on the Fed's evaluation of the financial strength of the consolidated organization, with support for this evaluation coming from four subcomponents collectively known as CAEL: (C) capital; A (asset quality); E (earnings); and L (liquidity).[331]
>
> Impact ("I") of the parent company and its nondepository subsidiaries on the strength of its depository institution subsidiaries.[332]

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323. § 252.33(b)(1).
324. § 252.33(b)(2).
325. § 252.33(b)(3).
326. *See supra* notes 127–30 and accompanying text.
327. Proposed Supervisory Guidance, 83 Fed. Reg. 1351, 1351 (Jan. 11, 2018).
328. Bank Holding Company Rating System, 69 Fed. Reg. 43,996, 43,997 (July 23, 2004).
329. *Id.* at 43,997.
330. *Id.* at 43,998.
331. *Id.* at 43,998–99.
332. *Id.* at 43,999. This component is meant to assess whether the holding company is able to serve as a source of strength for its depository institutions, as described *supra* in notes 264–82 and

An additional fourth rating, (Depository Institutions) ("D"), looks to the strength of the company's subsidiary depository institutions, as reflected by the examination ratings given by those institutions' primary regulators.[333]

In November 2018, the Federal Reserve Board issued a final rule replacing RFI/C(D) for large financial institutions, including bank holding companies with consolidated assets of more than $100 billion, with a new examinations approach.[334] This large financial institution (LFI) rating system eliminates the composite rating approach used under RFI/C(D) and replaces it with three component ratings: Capital Planning and Positions; Liquidity Risk Management and Positions; and Governance and Controls.[335] The Governance and Controls component rating evaluates the effectiveness of a firm's board of directors; its management of business lines and independent risk management and controls; and for a large systemically important firm, its recovery planning.[336] Directors are expected to closely oversee the firm's strategy and risk management, hold senior management accountable, support independent risk management and internal auditing, and maintain a capable board composition and governance structure.[337] Moreover, and in contrast with the previous RFI/C(D) regime, the Federal Reserve Board's LFI examinations framework does not simply confine regulatory assessments of the firm's management to a single component. For a firm to be considered "well managed" under the new LFI framework, it must receive satisfactory results for each of its three component ratings.[338]

In addition to the introduction of the LFI examination ratings system, the Fed also introduced a proposed guidance on supervisory expectations for boards of directors, which set forth expected attributes of an effective

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accompanying text, or whether it might have issues that could deteriorate the strength of these depository institutions. Satish M. Kini, *New Bank Holding Company Rating System Revises the Focus of the Federal Reserve's Supervisory Practices*, 121 BANKING L.J. 784, 788 (2004).

333. 69 Fed. Reg. at 44,000. This rating uses the CAMELS rating assigned by the institution's primary banking regulator, as described *infra*. RFI/C(D) itself replaced the "BOPEC" rating system that was previously utilized by the Federal Reserve Board. *See* Kini, *supra* note 332, at 784.

334. Large Financial Institution Rating System; Regulations K and LL, 83 Fed. Reg. 58,724, 58,724 (Nov. 21, 2018). The rating changes described in this rule also apply to non-insurance, non-commercial savings and loan holding companies with consolidated assets of $100 billion or more, and certain US intermediate holding companies of foreign banking organizations with total consolidated assets of $50 billion or more. *Id.*

335. 83 Fed. Reg. at 58,727.

336. *Id.* at 58,738.

337. *Id.*

338. *Id.* at 58,735. There are four ratings levels in the new LFI framework: "Broadly Meets Expectations," "Conditionally Meets Expectations," "Deficient-1," and "Deficient-2." For a firm to be considered "well managed," it must be rated Broadly Meets Expectations or Conditionally Meets Expectations for each of the three components. *Id.*

board of directors for LFIs.[339] While this proposed guidance has not yet been finalized, it nevertheless provides some important insight into the Federal Reserve Board's view of its ability to impact corporate governance at large financial institutions. The proposed guidance has three parts. The first part provides proposed guidance for LFI boards of directors, clearly distinguishing these expectations from those of senior management, and identifies five attributes that the Fed will use in assessing these boards.[340] The second part applies to directors of all BHCs and aims to revise and focus its guidance on supervisory expectations for boards of directors.[341] The third part would apply to all Fed-supervised institutions and aims to clarify the process that Fed examiners and supervisory staff should follow in communicating their findings to an institution's board of directors and senior management.[342] As with the new LFI examinations rating framework, the proposed supervisory expectations guidance illustrates the Fed's intention to become more deeply involved in the governance processes and expected goals of directors and senior officers of large financial institutions, and clearly highlights the Fed's belief that it has the authority to do so.

As this section describes, there are a number of regulatory tools that affect LFC governance either directly or by impacting the actions of directors and officers. But these do not directly affect fiduciary duties, nor do they aim to alter the primary goal that directors believe they must serve of maximizing shareholder wealth. Indeed, the Dodd-Frank Act explicitly states that it does not change director fiduciary duties in the context of changes to executive compensation.[343] That being said, existing regulatory authority does provide financial regulators with significant leeway to implement more direct steps to change LFC governance.

D. Implementing Federal Reforms to Banking Governance

If we accept the argument that federalization is the most efficient and appropriate pathway towards reforming banking governance, how might

339. Proposed Guidance on Supervisory Expectations for Boards of Directors, 82 Fed. Reg. 37,219 (Aug. 9, 2017).

340. *Id.* at 37,220. These attributes are: (1) Set clear, aligned, and consistent direction regarding the firm's strategy and risk tolerance; (2) actively manage information flow and board discussions; (3) hold senior management accountable; (4) support the independence and stature of independent risk management; and (5) maintain a capable board composition and governance structure. *Id.*

341. *Id.* at 37,220–22. Specifically, the goal of this part is to revise the outstanding Supervision and Regulation (SR) letters to eliminate confusing or contrary guidance and allow directors to better focus on the core responsibilities as articulated by the Fed. *Id.*

342. *Id.* at 37,222–23.

343. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 951, 124 Stat. 1376, 1900 (2010) (codified as amended in 15 U.S.C. § 78n–1 et seq. (2019)).

we best proceed in this regard, taking into account the federal authorities already in place? In this section, I outline the broad strokes of three pathways to implement changes to federal fiduciary duties. First, federal banking regulators, utilizing their existing regulatory powers, can insist on or incentivize changes in LFC governance priorities. Second, Congress could create a new governance regime directly impacting fiduciary duties or other aspects affecting LFC boards and senior management, preempting existing state laws in these areas. Finally, Congress could establish a federal charter for LFCs, akin to the charters that exist for national banks.

1. Changing Fiduciary Duties Through Existing Regulatory Authority

One potential pathway for changing LFC fiduciary duties is to exercise existing regulatory authorities to require or strongly encourage changes to governance incentives. As I have described above, financial regulators already have significant discretionary regulatory power over the institutions they regulate, a group which includes banks, bank holding companies, financial holding companies, and certain systemically important nonbank financial firms. Management and governance are already used by federal banking regulators as key criteria to assess the safety and soundness of these institutions. As such, changes in supervisory expectations that emphasize a more balanced approach to LFC governance could be implemented without new legislation and through a relatively simpler notice-and-comment process.

One mechanism by which governance changes could be encouraged is through changes to how regulators consider the soundness of a financial institution's management. As described previously, the CAMELS examination framework for banks,[344] the RFI/C(D) framework for BHCs with consolidated assets of $100 billion or less,[345] and the LFI framework for BHCs with more than $100 billion in consolidated assets[346] all already explicitly consider management in assessing the overall health of the regulated institution. Similarly, the requirement that FHCs (which is the organizational form for nearly all systemically important financial institutions) be "well managed"[347] also gives regulatory assessments of firm governance powerful sway. Given the arguments against an unmitigated shareholder wealth maximization paradigm in LFC governance, adjusting the factors by which management is assessed so that shareholder wealth maximization is de-emphasized could potentially have great impact on these firms' internal decision-making processes.

344. *See supra* notes 264–75 and accompanying text.
345. *See supra* notes 330–33 and accompanying text.
346. *See supra* notes 334–38 and accompanying text.
347. *See supra* notes 283–87 and accompanying text.

Indeed, it is possible that such regulatory changes could even spur changes to the fiduciary duties owed by LFC directors and officers under state law. Law professors Claire Hill and Richard Painter have proposed the negotiation and implementation of covenants between LFCs and their highly paid executives that would provide for a personal guarantee by these executives on losses incurred by the LFC in the event of insolvency.[348] The idea here is that private contracts could be used to better align the incentives of bankers with bank creditors.[349] And while the covenants proposed by Hill & Painter have a relatively narrow scope, limited to executive liability, one could imagine covenants being used to adopt more broad-based governance changes by creating express contracts with corporate stakeholders that expressly trump the default rules of corporate law. For example, a corporation might consider issuing classes of stock shares that contain express language specifying that the holders of those shares are not owed a fiduciary duty.

Another means by which financial institutions could implement governance changes is by incorporating as, or reincorporating as, a benefit corporation. The increasingly broad adoption of state benefit corporation laws provides another avenue through which shareholder wealth maximization could specifically be disclaimed as a guiding duty for LFC directors and officers.[350] Benefit corporations—or "B-corps" as they are often called—are organized as for-profit corporations that specifically call for the consideration of the interests of both non-shareholder stakeholders and shareholders by the board of directors.[351] B-corps and covenants between the corporation and its various stakeholders provide a potential vehicle for the express consideration of a leveraged financial company's safety and soundness, and the interests of its creditors.

As Hill & Painter note, it is not clear what motivation financial institutions would have to negotiate covenants of the kind they call for,[352] and a similar question exists for why any financial institution would

348. HILL & PAINTER, *supra* note 254, at 153–56.

349. *Id.* at 149.

350. *See* Michael B. Dorff, *Why Public Benefit Corporations?*, 42 DEL. J. CORP. L. 77, 79–80, 84 (2017) (noting that Delaware's adoption of a benefit corporation statute in 2013 made it the 14th state to do so, and also that as of November 2017, thirty-five states and the District of Columbia had enacted such statutes).

351. J. Haskell Murray, *Understanding and Improving Benefit Corporation Reporting*, BUS. L. TODAY, July 20, 2016, *available at* https://www.americanbar.org/groups/business_law/publications/blt/2016/07/04_murray/ [https://perma.cc/KUB7-X5VV]. *See also* Dorff, *supra* note 350, at 96–98, 109 (describing how Delaware's "Public Benefit Corporation" statute specifically requires a benefit corporation's board of directors to balance shareholder interests with "the best interests of those materially affected by the corporation's conduct, and the specific public benefit or public benefits identified in [the corporation's] certificate of incorporation").

352. HILL & PAINTER, *supra* note 254, at 164–65.

consider incorporating as a B-corp. But simple changes to the criteria by which banking regulators assess the management of their regulated institutions could potentially spur these types of governance changes. By expressly factoring in fiduciary duties—and negatively assessing an excessive fealty to shareholder wealth maximization—as part of their examinations processes, banking regulators may be able to encourage their regulated institutions to take affirmative steps to mitigate the shareholder primacy norm.

2. Federalizing Fiduciary Duties in Banking

While encouraging LFCs to adopt changes to their governance norms through regulatory pressure may be a worthwhile goal, this is unlikely to lead to any kind of wholesale adoption of changes in fiduciary duties. To achieve the types of systemic changes necessary to meaningfully address the governance problems in banking, some kind of mandatory solution that applies to all financial institutions (or some subset of them) is probably necessary. One obvious avenue is to enact legislation creating a federal regime for fiduciary duties of LFC directors and officers.

Such an approach would be consistent with our country's long history of maintaining a distinct and separate body of law outlining the responsibilities and duties of bank directors and officers.[353] As I described in Part I, to the extent that banking *activities* have been allowed to occur outside of regulated institutions with bank charters, this has been the result of regulatory arbitrage and historical happenstance and not based on any coherent policy rationale.[354] A federal regime for LFC fiduciary duties that deemphasized shareholder primacy norms and placed greater weight on safety and soundness would align the internal incentives of LFC decision makers with the broader regulatory goals of prudential oversight that we think are worthwhile for LFCs. If it makes sense to enact myriad bills to increase and improve the safety and soundness regulations imposed on leveraged financial institutions due to the systemic risk they pose, then it would seem to make just as much sense to adopt changes that would align the internal incentives of the directors and officers of those institutions with these same policy goals.

At the same time, Congress clearly has the power to create express laws that affect fiduciary duties. For example, Congress has created fiduciary duties for investment advisors under Section 206 of the Investment Advisers Act of 1940.[355] Section 206 prohibits investment advisers from employing or engaging in any action that operates as a

353. *See supra* Sections I.B–C (contrasting the limited liability of bank shareholders in Part I.B, with the fiduciary duties expected of directors and officers in Part I.C).

354. *See supra* Sections I.D–E.

355. Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2010).

fraud or deceit on a client, and also requires that investment advisers disclose any potential conflicts they may have in any transaction involving a client.[356] The Supreme Court has interpreted this language as imposing an affirmative duty of good faith and full and fair disclosure of all material facts, as well as an affirmative duty of reasonable care to avoid misleading the client.[357]

Finally, it is worth noting that Congressional legislation creating fiduciary duties for banks and other LFCs would restore the status quo that had long existed prior to Congress's enactment of FIRREA in 1989. Until that point, fiduciary duties for national bank directors were controlled by federal common law. As I describe in Part I.C. above, FIRREA Section 1821(k) effectively eliminated federal fiduciary duties for national banks and replaced these with state law. Reestablishing federal governance priorities for banks and other LFCs would, at least at a high level, simply reverse these changes.

3. A Federal Charter for LFCs

Finally, Congress could go further and establish a federal charter requirement, akin to the national banking charters issued by the OCC, for any business that was engaged in the "business of banking," utilizing an expansive view of this term to cover firms that have high leverage, which enjoy implicit government guarantees on their short term debt, and/or which pose a substantial risk to the broader financial system or macroeconomy. Such legislation would be consistent with the original and longstanding goals of US banking law, which has historically sought to segregate the formation and activities of banking firms into a separate and unique charter. It would also effectively reverse the regulatory arbitrage that has allowed so much of the "business of banking" to occur outside of the regulated firms we call banks.[358]

Once upon a time, bank charters were judiciously granted and only those firms with a charter were allowed to engage in the business of banking.[359] Banks themselves were prohibited from engaging in riskier activities, and this prohibition extended to the activities undertaken by their affiliates or their directors and officers.[360] But as I have described

356. *Id.*

357. Sec. & Exch. Comm'n v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963).

358. *See supra* Section I.E.

359. As described *supra* at notes 23–25 and accompanying text, Section 24 (Seventh) empowers nationally chartered banks to engage in the "business of banking." At the same time, Section 21 of the Glass Steagall Act prohibits securities firms from accepting deposits. Banking Act of 1933 § 21, 12 U.S.C. § 378 (2015).

360. Section 20 of the Glass Steagall Act prohibited nationally chartered banks from being affiliated with any firms that conducted securities activities. Banking Act of 1933 § 20,

in this Article, bank charters have become less and less important in the context of the banking system over time. Creating a new charter for firms that engage in banking would be consistent with the broader purposes of banking law and would help to reconcile the governance of banking firms with their external regulations.

E. Constructing a Federal Fiduciary Duty Framework

Regardless of how a federal fiduciary duty framework is created for banking firms, what should this framework look like? To achieve the goals for banking governance set forth in this Article, federal reforms of banking fiduciary duties should expressly embrace four principles. First, these reforms should reflect the view long held by federal banking regulators that bank directors and officers owe a duty of safety and soundness that must be emphasized above all other duties, including shareholder wealth maximization. Second, these duties should be expanded to include not only the directors and officers of banks—i.e., depository institutions—but also other financial institutions that share the characteristics (and thus systemic vulnerabilities) of banks, including high leverage, implied or express government guarantees on their short term debt, and the creation of negative externalities by their failures.[361] Third, to ensure that banking directors and officers are appropriately incentivized to prioritize safety and soundness, the standard of care should be one of simple negligence and not gross negligence. Finally, breaching these duties should not only subject directors and officers to liability from regulators but should also create a private right of action that can be asserted by depositors and other creditors holding short-term debt obligations issued by the LFC. I describe each of these principles in turn below.

1. Safety and Soundness Primacy

As described above, federal banking regulators have long asserted that directors and officers of banking institutions owe a duty of safety and soundness that supersedes other fiduciary duties.[362] While this assertion may be unsupported by state case law,[363] it is consistent with the goals of the significant body of federal safety and soundness law that seeks to

12 U.S.C. § 378 (1998) (repealed 1999). Section 32 of the Glass-Steagall Act prohibited "interlocking" between officers, directors, and employees of banks and securities firms. Banking Act of 1933 § 32, 12 U.S.C. § 377 (1998) (repealed 1999). Both of these sections were repealed by the Gramm-Leach Bliley Act of 1999. Financial Services Modernization Act of 1999 (popularly known as the Gramm-Leach-Bliley Act of 1999); Pub. L. No. 106-102, §§ 101-03, 113 Stat. 1338, 1341–51 (1999).

361. *See supra* Section I.B.

362. *See supra* notes 101–09 and accompanying text.

363. *See supra* note 97 and accompanying text.

reduce the risk of leveraged financial companies. Given the enormous costs of financial crises, including the 2007–08 financial crisis, which has cost every American $70,000 according to one recent study,[364] there is significant reason to think that increasing the safety and soundness of banking institutions should be a top policy priority. As I have argued above, shareholder primacy is inappropriate for banking firms for a number of reasons. Given the strong policy weight we have given to safety and soundness at banking firms, this policy goal should be reflected in the internal governance priorities of the firm. Any federal changes to the fiduciary duties of banking firms should reflect the long-held view of federal banking regulators and expressly state that LFC directors and officers owe a duty of safety and soundness that supersedes any other duties they might hold. This duty would be similar in some ways to the prohibitions on unsafe or unsound conduct described above in Part I.C.4, but would be expressly structured as a fiduciary duty, with open-ended liability as opposed to statutory penalties in the event of a breach of this duty.

2. Duty Extended to Other Leveraged Financial Companies

Importantly, for changes in banking governance to be effective, they must target not only the directors and officers of banks but also those of other banking institutions. As I have described, the divergence between bank governance and the prudential regulation that accompanies banking activities occurred through historical path dependency and regulatory arbitrage, not because of any well considered policy rationale. Given the enormous role that non-bank governance structures play in the banking system (both traditional banking and shadow banking today)—whether through bank holding companies or non-bank financial firms—for any governance reforms to be successful in complementing and not contradicting the broader policy goals of systemic safety and soundness, they must be extended beyond chartered banks and onto other financial firms that pose a systemic risk.

How broadly should governance reforms be applied? The easy answer is to simply apply any changes in banking fiduciary duties to all firms that are subject to safety and soundness oversight in the post-Dodd Frank financial regulatory framework, including banks, bank holding companies, and non-bank financial companies designated by the Financial Stability Oversight Council.[365] Such an approach would be

364. Regis Barnichon, Christian Matthes & Alexander Ziegenbein, *The Financial Crisis at 10: Will We Ever Recover?*, FED. RESERVE BANK S.F. (Aug. 13, 2018), https://www.frbsf.org/economic-research/publications/economic-letter/2018/august/financial-crisis-at-10-years-will-we-ever-recover/ [https://perma.cc/56ZP-WT3M].

365. *See supra* note 262.

consistent with the statutory framework for safety and soundness, as it would simply layer on fiduciary duty changes to financial firms that have already been identified as being appropriate subjects of such regulation by Congress. However, adopting this scope of financial firms covered by governance changes would also be potentially underinclusive insofar as it could exclude many firms for which the shareholder primacy norm is inappropriate.

A more suitable approach might be to target any financial institutions that raise the concerns identified in Part II.B, which obviate the traditional rationales for shareholder primacy. If a firm has high leverage (and thus relatively high creditor agency costs), enjoys explicit or implicit government guarantees on its debt (thus posing direct costs to taxpayers), and creates negative external costs through its failure (thus creating costs to the broader financial system and economy), it should be covered by any changes in fiduciary duties that are meant to improve the governance incentives of banks.

3. Simple Negligence Rule

As described above in Section I.C.1, prior to the New Deal-era reforms and the remarkable stability that they brought to the banking system, the courts were moving towards a simple negligence standard for bank director cases, curtailing the applicability of the business judgment rule. This trend was halted by the lack of bank liability cases during the mid-twentieth century, and it was reversed by the enactment of FIRREA Section 1821(k), which effectively established a gross negligence standard for all bank directors.[366]

Policy makers should consider a simple negligence standard for banking directors. As described above, banking firms are unique among business organizations insofar as they pose particular dangers to the financial system and broader economy. Given the critical importance of bank safety and soundness for our financial system and broader economy, it is worth adopting an approach that would more directly incentivize directors and officers to act in accordance with safety and soundness norms.

4. A Private Right of Action

Finally, to ensure that any duty of safety and soundness is appropriately enforced, a private right of action should be strongly considered. Recent experience has starkly illustrated that we cannot simply rely on the discretion of financial regulators who, depending on

366. *See supra* notes 64–70 and accompanying text (highlighting the power of shareholder rights, including the shareholder's power to bring a derivative suit).

the ideological bent of the United States president who appointed them, may or may not be inclined to exercise their regulatory authorities. As the Financial Crisis Inquiry Commission concluded in their definitive accounting of the 2007–08 financial crisis, regulators had "ample power" protect the financial system, but they chose not to exercise this authority.[367] The FCIC Report states unequivocally:

> In case after case after case, regulators continued to rate the institutions they oversaw as safe and sound even in the face of mounting troubles, often downgrading them just before their collapse. And where regulators lacked authority, they could have sought it. Too often, they lacked the political will—in a political and ideological environment that constrained it—as well as the fortitude to critically challenge the institutions and the entire system they were entrusted to oversee.[368]

To change the incentives of LFC directors and officers, these actors must believe that any breaches of a safety and soundness duty they might commit will actually and consistently be penalized. This cannot occur if federal regulators are the only actors with the ability to hold wayward directors and officers accountable. As we know from corporate law, a private right of action and its concomitant threat of litigation can be effective in policing the behavior of directors and officers.[369] Indeed, the Supreme Court has supported this idea in the context of shareholder suits alleging securities laws violations, stating: "Private enforcement of the proxy rules provides a necessary supplement to [SEC] action. . . the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements."[370]

But who should hold this private right of action to sue for breach of a duty of safety and soundness? Clearly, it should not be shareholders,

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367. FCIC REPORT, *supra* note 2, at xviii.

368. *Id.*

369. *See* C.N.V. Krishnan et al., *Shareholder Litigation in Mergers and Acquisitions*, 18 J. CORP. FIN. 1248, 1249 (2012) (finding that shareholder litigation challenging M&A deals as a breach of fiduciary duties leads to better offers for shareholders); James D. Cox & Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 EUR. COMPANY & FIN. L. REV. 164, 165–66 (2009) (describing how shareholder suits provide an important complement to government enforcement of laws, including of SEC disclosure violations); Donald E. Schwartz, *In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley*, 71 CORNELL L. REV. 322, 323 (1986) (concluding that shareholder litigation "profoundly affect[s] the conduct of corporate managers"). *But see* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 292 (1986) (concluding that the "widespread assumption" that shareholder derivative suits help to align the interests of corporate managers and shareholders is incorrect and "not supported by either the theory of liability rules, the available empirical evidence, or the structure of corporate law"). That being said, procedural barriers have limited the effectiveness of shareholder litigation as a policing mechanism, particularly in recent years. *See* Megan W. Shaner, *The (Un)Enforcement of Corporate Officers' Duties*, 48 U.C. DAVIS L. REV. 271, 313–14 (2014).

370. J.I. Case Co. v. Barak, 377 U.S. 426, 432 (1964).

since, as described above, shareholders may often have incentives to take on greater risk even if this is detrimental to the firm's safety and soundness. And while holders of short-term debt may be well positioned in many ways to care about safety and soundness, the fact that they are often insulated against credit losses, either via express government guarantees (such as federal deposit insurance) or bailouts to prevent contagion, makes them poorly situated as potential plaintiffs.

But uninsured creditors in intermediate-term LFC debt are well positioned to exercise a private right of action on breaches of a safety and soundness duty and can play an important role in holding directors and officers accountable. Indeed, there was a strong effort in the 1990s and 2000s to encourage the issuance of more subordinated bank debt based on the idea that creditors in this type of debt would be ideal monitors of bank risk and an important source of market discipline.[371] Because uninsured bank creditors have a fixed rate of return and are highly concerned with receiving back the entirety of their principal investment, and because, unlike insured depositors, they do not enjoy government guarantees on their investments, they have strong incentives to ensure that the bank avoids insolvency.[372]

To be fair, the *market* discipline provided by investors in subordinated bank debt has not been particularly effective in limiting bank risk taking.[373] In large part, the ineffectiveness of debt discipline has been due to the anemic and attenuated nature of the discipline being wielded. As a number of commentators have noted, debt discipline is necessarily ex post in nature, as it is a response to signals of rising risk rather than something exerted at the time that risk is being accrued.[374] Moreover, debt discipline does not directly impact directors and officers, operating instead by decreasing liquidity or raising the cost of funding provided to the banking firm.[375] That being said, I am more sanguine about the disciplinary effects of a private right of action arising out of a breach of a duty of safety and soundness. The possibility of personal liability arising from private litigation would have a much stronger effect on the decision making of LFC directors and officers than would the possibility of events that might harm the institution, due to the skin in the game involved. Indeed, increasing skin in the game for directors and officers

371. Min, *Market Discipline*, *supra* note 1, at 1437–38.

372. *See* Robert R. Bliss, *Market Discipline: Players, Processes, and Purposes*, *in* MARKET DISCIPLINE ACROSS COUNTRIES AND INDUSTRIES 37, 44 (Claudio Borio et al. eds., 2004).

373. Min, *Market Discipline*, *supra* note 1, at 1458–62.

374. Bliss, *supra* note 372, at 38–39; Mark J. Flannery, *The Faces of "Market Discipline"*, 20 J. FIN. SERV. RESEARCH 107, 114 (2001).

375. Min, *Market Discipline*, *supra* note 1, at 1439–40.

has been an important goal for bank governance in the post-Dodd-Frank regulatory environment.[376]

By empowering LFC creditors with a private right of action, lawmakers can help to ensure that there is a robust policing mechanism to keep directors and officers in line with changes to banking governance norms.

CONCLUSION

For too long, policy makers have blithely accepted the idea that the relationship between banking regulators and the directors and officers of banking firms must necessarily be an adversarial one. This has led to a "cat-and-mouse" dynamic in which federal regulators must affirmatively identify and address excessive risk, even as the directors and officers of the firms they oversee are incentivized to take on greater risk on behalf of their shareholders. As recent events have made clear, this dynamic is detrimental to the critical goals of macroprudential stability that are at the forefront of banking policy today.

Realigning the incentives of banking governance so that safety and soundness is expressly prioritized over other concerns would change the paradigm of banking and eliminate the adversarial relationship between banks and their regulators. While not a panacea for banking instability, such changes would go a long way towards improving overall financial stability.

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376. *See supra* notes 254–58 and accompanying text.