Balancing the Governance of Financial Institutions

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CONTENTS

INTRODUCTION

Banking regulation is first and foremost preoccupied with the problem of excessive risk-taking by banks and other leveraged financial intermediaries,[1] which can lead to bank runs and panics and their resulting

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1. The term "bank" is one that is used inconsistently. *See* David Min, *Understanding the Failures of Market Discipline*, 92 WASH. U. L. REV. 1421, 1424 n.7 (2015) [hereinafter *Market Discipline*] (explaining 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 to describe depository institutions, which rely on short-term

high economic costs.[2] In recent times, regulators have sought to curb bank risk-taking almost exclusively through external "safety and soundness" regulations,[3] which emphasize, among other things, capital requirements, disclosure, and an intensive examination process.[4] Modern banking regulation, both in the United States and abroad, has largely ignored the internal governance of banks.[5] Surprisingly, this is true even in the aftermath of the financial crisis, which seemed to illustrate the shortcomings of external regulatory restrictions. To the extent that policymakers consider bank governance issues, they typically defer to the corporate governance literature, which focuses on shareholder agency costs and generally promotes solutions that best align manager and shareholder interests, as I describe *infra* in Part I.A.

The Dodd-Frank Act of 2010 provides a good example of the short shrift that policymakers have paid to internal bank governance.[6] Dodd-Frank makes a number of important changes to bank safety and soundness regulation, particularly for so-called "systemically important financial institutions" (SIFIs).[7] Under the changes implemented by Dodd-Frank, SIFIs now face new consolidated capital and examination requirements and a newly created resolution regime called the "Orderly Liquidation Authority," intended to end the prospect of government bailouts of uninsured investors.[8] Dodd-Frank also implements new mortgage origination and securitization standards that banks must follow and creates a Consumer Financial Protection Bureau to promulgate and enforce consumer protection rules relating to bank loans and other

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(often demand) deposits to fund their investments in loans and other credit instruments. *Id.* With the rise of "shadow banking," which serves the same credit intermediation functions as traditional banking, the definitional lines around the term "bank" have become more blurred. *Id.* at 1449–52. In this Article, outside of Part I.A. and unless stated otherwise, the terms "bank" and "banking" are used to describe all leveraged financial intermediaries that rely heavily on short-term funding to finance their investments in credit instruments and thus are vulnerable to the problem of bank runs.

2. 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 Financial Crisis*, STAFF PAPERS (Fed Reserve Bank Dallas), July 2013, at 1–2. As Reinhart and 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).

3. Safety and soundness regulation is often referred to as "prudential regulation," and the two terms are frequently used interchangeably. *See, e.g.*, Frederic S. Mishkin, *Prudential Supervision: Why Is It Important and What Are the Issues?*, *in* PRUDENTIAL SUPERVISION: WHAT WORKS AND WHAT DOESN'T 1, 1 (Frederic S. Mishkin ed., 2001).

4. *Id.* at 8.

5. *See infra* Part I.A–I.B.

6. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank] (codified in scattered sections of 12 U.S.C.).

7. *Id.* § 115.

8. *Id.* §§ 202–210.

financial products.[9] Notably, almost all of these changes are external regulatory measures that outside regulators must monitor and enforce.

Dodd-Frank contemplates only a handful of minor changes to the internal corporate governance of banks, including provisions calling for: increased disclosures related to executive compensation (including any "golden parachutes");[10] a non-binding shareholder vote on executive compensation;[11] increased proxy access;[12] 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.[13] These measures all attempt to address managerial wrongdoing and more closely align the incentives of corporate executives and shareholders. In this regard, the reforms proposed by Dodd-Frank are consistent with the corporate governance literature, which generally focuses on shareholder–manager agency conflicts and plays up the importance of shareholder interests.[14] But as I discuss in Part I of this Article, banks are different from nonfinancial corporations in that there are strong reasons to believe that the prioritization of bank shareholder interests encourages greater risk-taking and thus works contrary to the purposes of banking regulators.

Part I briefly describes the traditional agency–cost approach to corporate governance and the rationale that is offered for elevating the agency–cost concerns of shareholders over those of other stakeholders (especially creditors). But as Part I goes on to argue, even if this justification for shareholder primacy is convincing in corporate governance generally (and there are many who do not find it so), several unique characteristics of banks obviate the reasoning behind shareholder primacy. Banks are highly leveraged, which exacerbates creditor–shareholder agency conflicts and places greater importance on the interests of creditors. Banks enjoy government guarantees, and thus their corporate governance (and allocation of gains and losses) is not merely a matter of private ordering, but one that implicates the public interest. And bank failures create massive negative social and economic costs not borne by bank investors, providing another key basis for rejecting shareholder primacy in bank governance.

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9. *Id.* §§ 1011–1029.

10. *Id.* §§ 951, 953.

11. *Id.* § 951.

12. *Id.* § 957. The SEC's rule implementing Dodd-Frank's Section 957 was famously vacated by the D.C. Circuit in its controversial decision, *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1156 (D.C. Cir. 2011). The D.C. Circuit found that the SEC had failed to adequately consider the economic consequences of its rule. *Bus. Roundtable*, 647 F.3d at 1148.

13. Dodd-Frank, *supra* note 6, § 954.

14. *See infra* Part I.B.

Part II provides an overview of the potential solutions for bank governance and argues that a realignment of bank governance priorities—specifically, deemphasizing shareholder primacy and expressly recognizing creditor interests—is likely to be most promising. Part II also briefly reviews the possibility of using existing laws—specifically, longstanding "commitment statutes" and the relatively recent phenomenon of statutes authorizing "benefit corporations"—as a means to help reorder bank governance.

I. THE CONFLICT BETWEEN SHAREHOLDER PRIMACY AND BANK SAFETY AND SOUNDNESS

While the financial crisis spurred some fairly significant regulatory changes, it has not yet led to significant changes in bank governance. Dodd-Frank contains only several small changes to bank governance,[15] and Basel III[16] does not look to change bank governance at all.[17] While some academics have begun to examine bank governance in the aftermath of the crisis,[18] regulators and policymakers have largely focused their efforts on creating and implementing new or revised external restrictions on risk-taking.[19] To the very limited extent that we have seen legal or regulatory changes to bank governance, they have tended to defer to the conventional wisdom espoused in the corporate governance literature, which seeks to more closely align the interests of bank managers with shareholders, as I describe above.[20]

But, as this Part describes, the shareholder primacy norm that dominates corporate law today is not necessarily well-suited for bank

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15. *See supra* notes 10–13 and accompanying text.

16. 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 Basel Committee*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/bcbs/about.htm [https://perma.cc/T89Y-C8KX]. 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, http://www.bis.org/bcbs/history.htm [https://perma.cc/2L6U-BBZ7]. "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.*

17. *See generally* BASEL COMM. ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS (2011).

18. *See, e.g.*, CLAIRE A. HILL & RICHARD W. PAINTER, BETTER BANKERS, BETTER BANKS: PROMOTING GOOD BUSINESS THROUGH CONTRACTUAL COMMITMENT (2015); John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANAL. 35 (2014); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010); Steven L. Schwarcz, *Misalignment: Corporate Risk-Taking and Public Duty*, 92 NOTRE DAME L. REV. 1 (2016).

19. For example, as described *supra* in notes 4–8 and accompanying text, Dodd-Frank focused almost entirely on extrinsic regulations.

20. *See supra* notes 10–13 and accompanying text.

governance.[21] Corporate governance elevates the interests of shareholders over other corporate stakeholders, based in large part on the normative claim that shareholder primacy is a more efficient state of corporate governance than the alternatives.[22] But even if we accept the validity of this argument, described below in Section A of this Part, there are several features unique to banks that present a strong case against shareholder primacy in bank governance. Banks are highly leveraged, which heightens the creditor–shareholder agency conflicts in bank governance and suggests that more weight should be given to bank creditor interests. The government insures (either explicitly or implicitly) the vast majority of bank creditors, which transforms these creditor–shareholder conflicts into public policy–shareholder conflicts. Additionally, bank failures create enormous negative externalities, which provide another compelling rationale for deemphasizing shareholder interests in bank governance.

A. Bank Governance

The United States has an unusual banking system in several regards. First, both the federal government and state governments issue bank charters.[23] This "dual banking" system is unique to the United States and is rooted in the struggle over states' rights that goes back to the nineteenth century.[24] Second, bank charters are distinct from the organizational charters for non-bank businesses, such as corporations and partnerships.[25] Banks do not need corporate charters, and corporations may not engage in the "business of banking."[26] Third, because of this legal distinction between bank and corporate charters, bank governance in the United States is, at least as a legal matter, distinct from corporate governance. Bank

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21. Of course, there are a number of well-respected critiques of shareholder primacy, including Margaret Blair and Lynn Stout's famous "team production theory" of the corporation, which argues that U.S. corporate law is best understood as an attempt to address the team production problems endemic to the corporate form. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248–54 (1999). Team production problems arise when a number of different groups must commit to making coordinated—and thus firm-specific—investments in the firm. *Id.* at 249. Under this account, corporate law solves the problem of how to divide up any rents created by team production by forcing all team production members under the authority of the corporate board of directors. *Id.* at 251–54. The board acts as a "mediating hierarchy" that fairly apportions economic surpluses generated by the firm among the different team members. *Id.* at 253–55. Under this account, any prioritization of shareholder interests unfairly and inefficiently empowers rent-seeking by shareholders. *Id.* at 256–57.

22. *See* David Min, *Corporate Political Activity and Non-Shareholder Agency Costs*, 33 YALE J. REG. 101, 131–32 (2016).

23. *See* Henry N. Butler & Jonathan R. Macey, *Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 681–83 (1988).

24. *See id.*

25. *See* Robert C. Hockett & Saule T. Omarova, *"Special," Vestigial, or Visionary? What Bank Regulation Tells Us About the Corporation—and Vice Versa*, 39 SEATTLE U. L. REV. 453, 474 (2016).

26. *Id.*

director fiduciary duties have developed separately in common law from corporate director duties.[27] Furthermore, bank regulators possess broad statutory enforcement powers to remove bank directors for unsafe or unsound banking practices, which effectively creates another duty of safety and soundness for bank directors.[28]

However, while these differences between bank governance and corporate governance are real, they are not particularly significant for several reasons. First, the common law development of bank governance largely disappeared for several decades following the enactment of the New Deal-era banking reforms, as there were virtually no bank failures between World War II and the 1970s.[29] Thus, even as the courts were dramatically shaping corporate law over this period, and as scholars were developing new theoretical and normative foundations of corporate law, there was a marked lack of development of bank governance law over the same period.[30] Because bank governance did not develop as a separate body of law during this time, the laws applicable to bank governance are quite similar to those for corporate governance. Bank shareholders enjoy the same limited liability as corporate shareholders,[31] bank directors have similar fiduciary duties to corporate directors,[32] and, just as in corporate law, these fiduciary duties are primarily owed to shareholders.[33]

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27. *See* Patricia A. McCoy, *A Political Economy of the Business Judgment Rule in Banking: Implications for Corporate Law*, 47 CASE W. RES. L. REV. 1 (1996); Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, 9 FED. RES. BANK N.Y. ECON. POL'Y REV. 91, 99 (2003).

28. *See* Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175, 188 (1995) (citing Banking Act of 1933, ch. 89, § 30, 48 Stat. 162, 193–94); Lawrence G. Baxter, *Fiduciary Issues in Federal Banking Regulation*, 56 LAW & CONTEMP. PROBS. 7, 13 (1993).

29. *See* Min, *Market Discipline*, *supra* note 1, at 1431–32.

30. McCoy, *A Political Economy of the Business Judgment Rule in Banking*, *supra* note 27, at 2, 22–25. *See also* Richard B. Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 343–44 (1965) (stating that claims against bank directors for governance failures almost entirely predated World War II).

31. *See* Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31, 38–39 (1992) (describing how bank shareholder liability has been equivalent to corporate shareholder liability since the 1940s).

32. *See* Ronald W. Stevens & Bruce H. Nielson, *The Standard of Care for Directors and Officers of Federally Chartered Depository Institutions: It's Gross Negligence Regardless of Whether Section 1821(k) Preempts Federal Common Law*, 13 ANN. REV. BANKING L. 169, 193–221 (1994) (noting that state laws governing bank director duties almost universally set forth a gross negligence standard that is analogous to that owed by corporate directors, either by common law or statute, and often in conjunction with the shield provided by the business judgment rule).

33. *See* Keith R. Fisher, *Nibbling on the Chancellor's Toesies: A "Roguish" Concurrence with Professor Baxter*, L534 ALI-ABA 397, 410–18 (1993); Baxter, *supra* note 28, at 15–31. There are a handful of scholars who claim that bank directors owe a fiduciary duty to depositors. *See, e.g.*, 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 . . . .") (citing Irving Bank Corp. v. Bd. of Governors of the Fed. Reserve Sys., 845 F.2d

Second, most banks are owned by a bank holding company (BHC), which is typically structured as a corporation. BHCs own about eighty percent of all banks[34] and control virtually all bank assets in the United States.[35] It is therefore accurate to state that most banks (and almost all bank activities) are controlled by holding companies governed by corporate boards, to which corporate law applies.

Third, banking regulation has increasingly become preoccupied with "shadow banking," which is loosely defined as the functional economic activity of banking taking place outside of the regulated depository institutions that we think of as banks. Shadow banking largely occurs in non-bank capital market firms, such as investment banks or hedge funds.[36] Thus, shadow banks are subject to corporate (or partnership) governance, not bank governance.

In the aggregate, then, while it is important to acknowledge differences exist between bank governance and corporate governance, these differences are largely insignificant for purposes of this Article. Bank governance and corporate governance share many of the same key features that create conflicts between shareholders and creditors, including limited liability for shareholders and similar fiduciary duties owed to shareholders. And to a large degree, bank governance has given way to corporate governance due to the outsized importance of BHCs and shadow banking. Banks are effectively governed under the same or similar laws as corporations, and banking scholars have long conceded the issue of

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1035, 1039 (D.C. Cir. 1988)); 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 . . . .") (citing *Irving Bank Corp*., 845 F.2d); 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/67LN-3SJX] ("There is some precedent for the proposition that 'it is well settled that the fiduciary duty of a bank officer or director is owed to the depositors and shareholders of the bank.'") (quoting Lane v. Chowning, 610 F.2d 1885, 1888–89 (8th Cir. 1979)). As I describe in greater detail in a forthcoming article, this claim is based on arguments made by the Office of Thrift Supervision and other regulators in the early 1990s, which were themselves based on exaggerated or incorrect readings of a handful of cases. This claim also ignores the overwhelming amount of case law that explicitly contradicts this claim of a duty to depositors. *See, e.g.*, 7 BUSINESS AND COMMERCIAL LITIGATION IN FEDERAL COURTS § 81:41 (3d ed.) (stating that "most courts have found that a bank does not owe a fiduciary duty to its depositors in the absence of special circumstances . . . [t]he relationship between a bank and a depositor is a contractual, rather than a fiduciary one") (citing a lengthy list of representative cases in support of this claim).

34. *See Percent of Banks Owned by BHCs*, FED. RES. (Dec. 2012) https://www.fedpartnership.gov/-/media/bank-life-cycle/charts/bank-ownership-by-bhcs.pdf?la=en [https://perma.cc/FWR5-JBF6].

35. *See* Dafna Avraham, Patricia Selvaggi & James Vickery, *A Structural View of U.S. Bank Holding Companies*, 18 FED. RES. BANK OF N.Y. ECON. POL'Y REV. 65, 66–67 (2012).

36. *See* Min, *Market Discipline*, *supra* note 1, at 1444–45.

governance to corporate law scholars. As I describe in the next several sections, corporate governance is not well suited for the unique problems posed by banks and other leveraged financial intermediaries.

B. Shareholder Primacy in Corporate Governance

For nearly a century, the primary focus of the corporate governance literature has been the agency cost problems that arise out of the corporate form and its separation of ownership and control.[37] Such scholarship predominantly focuses on the agency conflicts between shareholders and managers, due in large part to the ubiquity and dominance of the shareholder primacy norm.[38] But it has long been recognized that other agency conflicts, besides those between shareholders and managers, abound in the corporation. Michael Jensen and William Meckling famously argued in 1976 that the modern corporation was best understood as a "nexus of contracts" that served to minimize transaction costs between the corporation's different constituents, such as its investors, managers, directors, employees, and suppliers.[39] This "contractarian" account of the corporation has become the dominant theoretical framework used to explain and justify corporate law and its emphasis on shareholder interests. But as Jensen and Meckling themselves articulated, embedded in each of the different contractual (or quasi-contractual) relationships in the corporate "nexus of contracts" is an agency relationship, which gives rise to potential agency conflicts.[40] This is true not only for shareholders, but also for other corporate constituents.

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37. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 113–16 (10th prtg. 2009) (1932); Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 403–05 (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); *see also* Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 663 (2006) (stating that "[c]orporate law devotes its primary focus to the agency problems created by conflicts of interest—conflicts between shareholders and managers, between controlling and minority shareholders, and between shareholders and other stakeholders") (citing REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 2 (2004)).

38. Many scholars use the term "shareholder primacy" to refer to the norm or practice or legal requirement of prioritizing shareholder wealth maximization over other business interests. *See, e.g.*, Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 643 (2006). Stephen Bainbridge contrasts this "shareholder wealth maximization norm" with a broader definition of shareholder primacy, one in which shareholders are not merely the corporate stakeholders whose interests are prioritized, but also the parties that "exercise ultimate control of the corporate enterprise." Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 563 (2003). The terms "shareholder primacy" and "shareholder wealth maximization norm" are used interchangeably in this Article.

39. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305–10 (1976).

40. *Id.* at 310.

In order to justify shareholder primacy then, a normative argument must be made as to why shareholder interests should be prioritized over the interests of other stakeholders. Given that nonshareholders, such as employees and creditors, contribute valuable inputs to the corporation and face potentially steep agency costs arising out of their contractual relationships with the corporation, just as shareholders do, why should shareholder agency conflicts—and these alone—be given weight in corporate governance?

Two main justifications for shareholder primacy are typically given under the contractarian account. First, the residual claimant status of shareholders means that their interests are aligned with those of other stakeholders. Because shareholders are paid last and only after other stakeholders with fixed claims (such as suppliers, employees, or creditors) are paid in full, they possess the appropriate incentives to maximize firm value.[41] Second, it is argued that nonshareholders, who hold fixed claims on the assets of the corporation, are in a better position to protect their interests through contract. Because nonshareholders have fixed claims, which are discrete and limited, they can more easily write complete contracts to address any potential agency problems they may face, utilizing negative control provisions to limit potentially adverse behavior on the part of managers. Conversely, because shareholders hold residual and open-ended claims, any contract they might contemplate would invariably be incomplete, since shareholders essentially depend upon optimal wealth-maximizing behavior on the part of managers, which is difficult or impossible to dictate through contractual terms.[42]

C. The Conflict Between Shareholder Primacy and Bank Governance

While the normative arguments for shareholder primacy may be convincing in the case of corporate governance—and there are many who do not agree[43]—these arguments are far less compelling in the case of banks and other leveraged financial intermediaries for several reasons.

1. Creditor–Shareholder Agency Conflicts in Banking

To state the obvious, shareholder incentives are distinct from, and often opposed to, those of creditors. In general, shareholders prefer greater risk, because they have limited downside (the value of their initial investment) and unlimited upside, as the residual claimants. As Nobel

41. *See* Min, *supra* note 22, at 127–28.

42. *Id.* at 129–31.

43. *See, e.g.*, Blair & Stout, *A Team Production Theory of Corporate Law*, *supra* note 21, at 249; Charles W.L. Hill & Thomas M. Jones, *Stakeholder-Agency Theory*, 29 J. MGMT. STUD. 131, 132 (1992).

Prize winning economist Robert Merton illustrates, equity value is increased when firms invest in assets with higher volatility, even as this creates greater default risk—and thus lower expected value—for creditors.[44]

The schism between shareholder and creditor interests is particularly sharp in banks due to the high degree of leverage involved. Because banks rely disproportionately on debt to fund their business activities, the rewards associated with higher risk are potentially much greater for bank shareholders than they are for shareholders in other types of business corporations, as the potential rewards associated with risk-taking are greatly increased. To illustrate this proposition, let us imagine a nonfinancial business (Corporation 1) worth $200 million, funded 50-50 with equity and debt (pari passu, with a 5% promised interest rate), that is considering between two projects: Project A is a low-risk, low-return investment that costs $200 million and has a 100% probability of returning $220 million one year from today; Project B is a high-risk, high-return investment that costs $200 million, has a 50% chance of returning $300 million one year from today, and has a 50% chance of becoming completely worthless.

Here, Project B is much worse for creditors. Creditors who opt for Project B would suffer an expected loss of $47.5 million (-47.5%)[45] as compared to an expected return of $5 million with Project A.[46] Project B is also a bad deal for shareholders, who would suffer a net expected loss of $2.5 million,[47] as compared to an expected gain of $15 million from

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44. *See* Robert C. Merton, *On the Pricing of Corporate Debt: The Risk Structure of Interest Rates*, 29 J. FIN. 449, 455–62 (1974). *But see* Robert R. Bliss, *Market Discipline: Players, Processes and Purposes*, *in* MARKET DISCIPLINE ACROSS COUNTRIES AND INDUSTRIES 37, 43–44 (Claudio Borio et al. eds., 2004) (arguing that Merton's conclusion was flawed insofar as it failed to adequately consider the reduced value of future dividends and increased cost of funding that accompanies higher default risk).

45. There is a 50% chance that the creditors in this scenario would earn back their principal plus the promised 5% coupon (a total of $105 million) and a 50% chance that they would lose all of their promised principal and interest ($0). Thus, the creditors would expect to get back $52.5 million from Project B, which is $47.5 million less than the original $100 million they lent to Corporation 1.

46. There is a 100% chance that the creditors in this scenario would earn back their principal plus the promised 5% coupon, for a total of $105 million, which is $5 million greater than the $100 million they lent to Corporation 1.

47. There is a 50% chance that the shareholders in this scenario would have a stake worth $195 million ($300 million less the $105 million promised to the creditors) and a 50% chance that their investments would be worthless ($0). Thus, the expected equity value of Project B would be $97.5 million, which is $2.5 million less than the $100 million the shareholders invested in Corporation 1.

Project A.[48] Finally, Project B has a net expected loss of $50 million,[49] which is far worse than the net expected gain of $20 million associated with Project A.

Corporation 1 Example

	Project A	**Project B**
Net expected value	$220m - $200m = **$20m**	((50% * $0) + (50% * $300m)) - $200m = **- $50m**
Net expected creditor value	$105m - $100m (initial investment) = **$5m**	((50% * $0) + (50% * $105m)) - $100m = **- $47.5m**
Net expected SH value	$220m - $105m (payment to creditors) - $100m (initial investment) = **$15m**	((50% * $0) + (50% * ($300m - $105m (payment to creditors)) - $100m (initial investment) = **- $2.5m**

Now consider a $200 million financial company (Corporation 2) with leverage typical for a bank, funded 10% with equity ($20 million), and 90% with debt (pari passu, with a 5% interest rate) ($180 million) that is considering the same two projects described above. Again, Project B is much worse for creditors, with an expected loss of $85.5 million (-47.5%),[50] as compared to an expected return of $9 million from Project A.[51] But in this scenario, because of the high leverage, Project B would provide shareholders with an expected return of $35.5 million,[52] which is far better than the $11 million return they would receive from Project A.[53] Thus, while Project B is worse for creditors and for the corporation as a whole, it is preferable for shareholders.

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48. There is a 100% chance in this scenario that the shareholders would have a stake worth $115 million ($220 million less the $105 million promised to the creditors), which is $15 million greater than the $100 million they initially invested in Corporation 1.

49. There is a 50% chance that the company will be worth $300 million after one year and a 50% chance that the company will be worth $0. Thus, the expected value of the company would be $150 million, which is $50 million less than the $200 million invested into it.

50. There is a 50% chance that the creditors here would receive their promised principal plus interest (a total of $189 million) and a 50% chance they would receive nothing ($0). Thus, the creditors would expect to receive $94.5 million from Project B, which is $85.5 million less than the $180 million they lent to Corporation 2.

51. There is a 100% chance that the creditors here will receive $189 million, which is $9 million more than the $180 million they lent to Corporation 2.

52. There is a 50% chance that the shareholders here would have a stake worth $111 million ($300 million less the $189 million promised to the creditors) and a 50% chance that their stakes would be worthless ($0). Thus, the expected equity value of Project B is $55.5 million, which is $35.5 million more than the $20 million they invested in Corporation 2.

53. There is a 100% chance in this scenario that the shareholders would end up with a stake worth $31 million (a total firm value of $220 million less the $189 million owed to the creditors), which is $11 million greater than the $20 million they initially invested in Corporation 2.

Corporation 2 Example

	Project A	**Project B**
Total expected value	$220m - $200m = **$20m**	((50% * $0) + (50% * $300m)) - $200m = **- $50m**
Expected creditor value	$189m - $180m (initial investment) = **$9m**	((50% * $0) + (50% * $189m)) - $180m = **- $85.5m**
Expected SH value	$220m - $189m (payment to creditors) - $20m (initial investment) = **$11m**	((50% * $0) + (50% * ($300m - $189m (payment to creditors)) - $20m (initial investment) = **- $35.5m**

As the above examples show, the high leverage that is endemic to banks can steer shareholder incentives toward greater risk, even though this risk may run counter to the interests of creditors and society as a whole.

In addition to having a greater proclivity toward risk, bank shareholders also have strong incentives to delay or prevent the initiation of resolution[54] proceedings or mergers when the bank is insolvent (or near insolvency).[55] Because their equity value in insolvency is worth nothing, they have every incentive to want to keep the firm open and gamble on big bets that can restore the firm back to a state of positive value. The tension between bank shareholders and creditors is exacerbated by the fact that most investors in bank debt place an especially high premium on the safety, liquidity, and "moneyness" of their investments.[56] Because bank creditors tend to be more risk averse and place a greater value on protecting their principal than do other types of investors, any losses they

54. Ordinarily, insolvent companies are resolved in bankruptcy proceedings. But in the United States, federally insured depository institutions are resolved by the Federal Deposit Insurance Corporation, which is granted with special resolution privileges, including almost unilateral control over the failed bank's assets and limited judicial review. *See* Richard M. Hynes & Steven D. Walt, *Why Banks Are Not Allowed in Bankruptcy*, 67 WASH. & LEE L. REV. 985, 998–1000 (2010).

55. *See* Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31, 53 (1992).

56. *See, e.g.*, Gary Gorton & George Pennachi, *Financial Intermediaries and Liquidity Creation*, 45 J. FIN. 49 (1990); Morgan Ricks, *Regulating Money Creation After the Crisis*, 1 HARV. BUS. L. REV. 75, 76, 79–80 (2011); Jeremy C. Stein, *Monetary Policy as Financial Stability Regulation*, 127 Q.J. ECON. 57, 59–60 (2012); Adi Sunderam, *Money Creation and the Shadow Banking System*, 28 REV. FIN. STUD. 939, (2015); Gary Gorton, *The Development of Opacity in U.S. Banking* 10–13 (Nat'l Bureau of Econ. Research, Working Paper No. 19540, 2013); Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo* 10–12 (Nat'l Bureau of Econ. Research, Working Paper No. 15223, 2009).

may suffer are actually comparatively costlier than the above illustration indicates, since they are paying a premium for safety and liquidity.[57]

Of course, the interests of bank shareholders are not completely at odds with those of bank creditors. Shareholders want to increase the value of their equity stakes, and higher equity value means a larger buffer against losses to the creditors (assuming that returns on equity are retained and not returned to shareholders through capital distributions). Bank regulators have long emphasized earnings as an important barometer of bank stability. But the above hypotheticals demonstrate two points. First, shareholders tend to prefer projects with greater risk–reward tradeoffs than do creditors. Second, shareholders of highly leveraged corporations (such as banks and other financial institutions) prefer greater risk than do shareholders of less leveraged corporations (i.e., nonfinancial businesses).

It logically follows, then, that to the extent that shareholders control the corporation (or alternatively, that corporate managers emphasize shareholder interests), this presents a large agency cost problem for bank creditors, one which has been exacerbated by the strong emphasis on shareholder primacy that has taken over corporate boardrooms in recent decades. As Bratton and Wachter note, the stock markets strongly rewarded those financial firms that took on greater levels of risk 2003–2007.[58] This shareholder pressure caused bank managers to fall into line by taking on higher risk and higher growth strategies, including the origination of riskier loans, more investment in risky securitized assets, and the use of higher leverage.[59] These decisions to take on greater risk were, of course, to the detriment of creditor interests. In short, the high degree of leverage sharply increases the conflict between creditors and shareholders and undermines the argument for shareholder primacy in bank governance.

2. Government Guarantees in Banking Create Taxpayer–Shareholder Conflicts

Were the problem of bank governance merely a conflict between shareholder interests and creditor interests, it might be tempting to leave this issue for private ordering to resolve. But, because the federal government guarantees most of the debt obligations used to fund bank investment activities, as I describe below, the creditor–shareholder

57. Relative risk appetite is not the only issue upon which shareholders and creditors disagree. Capital distributions, such as dividends, are also an important area of conflict between bank shareholders and creditors, as a body of research has explored. *See, e.g.*, Laetitia Lepetit et al., Bank Dividends, Agency Costs and Shareholder and Creditor Rights (Apr. 28, 2016) (unpublished paper).

58. William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 719–21 (2010).

59. *Id.* at 720–21.

conflicts described in the previous section are transformed into taxpayer–shareholder conflicts, as taxpayers are the parties who ultimately suffer if shareholder preferences are actuated into greater bank risk-taking.

Bank deposits make up the vast majority of bank balance sheets, and these are explicitly insured by the Federal Deposit Insurance Corporation.[60] Additionally, most observers believe that many other bank obligations enjoy implicit guarantees of varying degrees against loss. Debt and mortgage-backed securities issued by the government-sponsored enterprises Fannie Mae and Freddie Mac are understood to benefit from very strong implicit government guarantees against credit losses.[61] Other debt instruments that are important to banking, such as senior debt obligations of systemically important financial institutions or uninsured bank deposits, also are thought to benefit from implicit government guarantees.[62]

The government backing of banking liabilities is important for two reasons for the purposes of this paper. First, because bank creditors are relieved of their downside risk, they lack the incentives to try to monitor and reduce bank risk-taking. In the aftermath of the crisis, there may be some reason to question whether bank creditors are effective at disciplining banks, even in the absence of any government guarantees, due to the fact that they are investing in money instruments specifically intended and designed to be insensitive to risk.[63] But, it is undisputed that when government guarantees come into play, any such creditor discipline dissipates. Thus, to the extent that advocates of the status quo in corporate governance rely on the assumption that self-interested creditors will

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60. As the Federal Reserve's Flow of Funds report indicates, insured bank deposits make up roughly two-thirds of all outstanding bank liabilities. *See* FED. RESERVE, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, tbl. L.111 (U.S. Chartered Depository Institutions) (2016) https://www.federalreserve.gov/releases/z1/current/z1.pdf.

61. *See* David Min, *How Government Guarantees Promote Housing Finance Stability*, 50 HARV. J. ON LEGIS. 437, 457 (2013) [hereinafter Min, *Housing Finance Stability*].

62. *See, e.g.*, GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 1 (2004) (stating that the term "too big to fail" describes "the receipt of discretionary government support by a bank's uninsured creditors who are not automatically entitled to government support"); João A. C. Santos, *Evidence from the Bond Market on Banks' "Too-Big-to-Fail" Subsidy*, 20 FED. RES. BANK N.Y. ECON. POL'Y REV. 29, 29–31 (2014) (reviewing the literature on too-big-to-fail implicit guarantees and summarizing the author's findings that the largest banks enjoy a subsidy of roughly 41 basis points by virtue of these implicit guarantees); Sebastian Schich & Sofia Lindh, *Implicit Guarantees for Bank Debt: Where Do We Stand?*, 2012 OECD J. 1, 2–4 (2012) (describing the implicit guarantees that accrue to "too big to fail" institutions, and the policy implications of these guarantees).

63. As I have described, creditors did not react to rising bank risk in the period immediately preceding the 2007–2008 financial crisis. This lack of reaction may be because banks are in the business of creating monetary instruments, which are necessarily designed to be risk-insensitive so that they can maintain their par value over time. *See generally* Min, *Market Discipline*, *supra* note 1.

monitor and enforce their own interests against greater risk-taking, it is clear that this assumption is ill-founded when it comes to banks.

Second, because these guarantees effectively place the costs of bank risk onto taxpayers, they transform a private ordering conflict into a public policy concern. It is taxpayers, not creditors, who may lose out due to the corporate governance structures in place for banks. Thus, bank governance presents a unique policy problem. The shareholder interests that are generally prioritized in corporate governance are potentially in conflict with the interests of taxpayers, who assume the losses of bank creditors by virtue of the federal government's role as deposit insurer and provider of implicit guarantees on senior debt.

3. Steep Negative Externalities in Banking

Why not simply unwind the government's role as deposit insurer? Why does the federal government guarantee bank creditors? The answer to this question presents another wrinkle in thinking about bank governance. Government guarantees are generally understood to exist for bank debt obligations because these obligations are highly vulnerable to the problem of runs and panics, which can create enormous social and economic costs not borne by bank investors ("negative externalities" in economic parlance).[64] Banking panics occur when a large number of bank runs[65] happen simultaneously, causing short-term liquidity to disappear and banks to forcefully liquidate their assets in a fire-sale environment. Banks are uniquely vulnerable to runs and panics because of several features specific to banking. First, banks are in the business of making idiosyncratic investments (loans), thus creating a steep informational mismatch between banks and their outside investors.[66] Second, banks, by their very nature, are highly leveraged, utilizing a large amount of debt (and very little equity) to finance their investment activities.[67] Finally, banks have a steep maturity mismatch between their assets (which are

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64. The term "negative externality" refers to a cost or loss created by an actor that is not borne ("internalized") by the actor. The concept (if not the term itself) was famously articulated by Ronald Coase in *The Problem of Social Cost*, as he focused on the problem of "those actions of business firms which have harmful effects on others." R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 1 (1960).

65. Bank runs are generally defined as a situation in which short-term creditors rush to redeem their invested funds (such as by withdrawing their demand deposits or by refusing to roll over short-term debt obligations), thus forcing the bank to sell illiquid assets to meet these redemptions. *See* Min, *Housing Finance Stability*, *supra* note 61, at 475–77 (citing Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 401 (1983)).

66. Min, *Market Discipline*, *supra* note 1, at 1428–29 (citing Ben Bernanke & Mark Gertler, *Banking in General Equilibrium* 1–2 (Nat'l Bureau of Econ. Research, Working Paper No. 1647, 1985)).

67. *Id.* at 1429.

long-dated) and their liabilities (which are very short-dated, often redeemable on demand).[68]

Collectively, these features render banks highly susceptible to the problem of bank runs (and thus bank panics). As I have previously described:

> 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.[69]

It is because of this confluence of factors that bank balance sheets are described as "fragile." Moreover, as Patricia McCoy has stated, "The unstable balance sheet of banks is not a quirk. Rather, it is inherent to a key economic function of banks, which is providing financial liquidity."[70] In other words, banking is thought to provide a fundamentally important and necessary public good—financial liquidity and credit intermediation—which is unfortunately accompanied by a small but potentially catastrophic risk of banking panics.

Were panics simply problems confined to the banking system, a large government role in the banking system might be unnecessary. But banking panics have typically led to major economic downturns, with major reductions in household wealth, the availability of credit, and economic growth.[71] On average, in the three years following financial crises, government debt increases an average of 86% due primarily to the sharp decline in tax receipts caused by economic stagnation.[72] Why exactly banking panics lead to such large negative economic consequences is a matter of some debate, but it is mostly undisputed that panics do lead to these high costs.[73]

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68. *Id.*

69. *Id.*

70. Patricia A. McCoy, The Moral Hazard Implications of Deposit Insurance: Theory and Practice 4 (Feb. 18, 2007) (unpublished manuscript prepared for presentation at Seminar on Current Developments in Monetary and Financial Law), https://works.bepress.com/patricia_mccoy1/18/.

71. *See generally* REINHART & ROGOFF, *supra* note 2.

72. REINHART & ROGOFF, *supra* note 2, at 142, 164.

73. Reinhart & Rogoff argue that financial crises are "an amplification mechanism" that severely exacerbate existing monetary shocks by reducing the stock of available credit. REINHART & ROGOFF,

To the extent that these massive economic costs are not borne by bank investors, the public policy priority of limiting bank risk gains even more importance, both practically and theoretically. Bank shareholders and creditors alike bear only a fraction of the potential costs of a bank failure (and resulting crisis).[74] Combined with the taxpayer's assumption of most banks' credit risk, described in the previous section, the large negative externalities associated with bank failures create a very sharp conflict between the interests of shareholders, who have a much higher preference for risk and the interests of public policy, which, for a multitude of reasons, seeks to maximize financial stability and minimize bank risk.

II. POTENTIAL SOLUTIONS TO BANK GOVERNANCE PROBLEMS

Having laid out the case that there are outsized conflicts between public policy and bank shareholder interests, the next question to address is how we should address these conflicts. As described previously, external restrictions on risk-taking, such as capital or liquidity requirements, are most heavily relied upon to limit bank risk-taking.[75] But these types of external regulations are inherently adversarial and require regulators to play a cat and mouse game with the regulated financial institutions.[76] As the 2007–2008 financial crisis showed us, this type of approach may fail, with catastrophic consequences. Thus, it is worth thinking through how we might better align the governance of financial institutions with the public policy goals that animate our external regulation of these firms.

There have been a number of different substantive proposals offered to try to address bank governance issues. Many, like the incremental bank

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supra note 2, at 145. Bernanke has hypothesized that this amplification mechanism exacerbates problems in the real economy by sparking a reduction in household consumption. Ben S. Bernanke, Chairman, Fed. Reserve Bd., The Financial Accelerator and the Credit Channel, Remarks at the Credit Channel of Monetary Policy in the Twenty-First Century Conference, Fed. Reserve Bank of Atlanta (June 15, 2007), https://www.federalreserve.gov/newsevents/speech/bernanke20070615a.html [https://perma.cc/J88Z-Z3RA]. Along the same lines as Bernanke, others have asserted that the massive economic downturns following banking crises are due to a "vicious circle" or "paradox of thrift" effect, in which deleveraging causes a reduction in asset values, which leads to greater consumption declines, which then beget further deleveraging. *See, e.g.*, Paul Krugman, *The Paradox of Thrift—for Real*, *The Conscience of a Liberal*, N.Y. TIMES: KRUGMAN (July 7, 2009, 8:48 AM), http://krugman.blogs.nytimes.com/2009/07/07/the-paradox-of-thrift-for-real/?_r=0; Irving Fisher, *The Debt-Deflation Theory of the Great Depression*, 1 ECONOMETRICA 337, 337 (1933).

74. *See supra* notes 65–73 and accompanying text.

75. *See supra* notes 3–15 and accompanying text.

76. *See* Stanley Fischer, Vice Chair, Fed. Reserve Bd., The Importance of the Nonbank Financial Sector, Speech at the Debt and Financial Stability—Regulatory Challenges Conference (Mar. 27, 2015), https://www.federalreserve.gov/newsevents/speech/fischer20150327a.htm (stating that prudential regulation is a "cat and mouse game").

governance reforms advanced in Dodd-Frank,[77] have sought to more closely align the incentives of bank managers with the interests of bank shareholders.[78] As described above in Part I.C, this shareholder-centric approach to governance reform may be inappropriate for banks and other leveraged financial institutions. But there has been a small but growing number of scholars who have recognized the conflict between existing governance norms and public policy aims when it comes to banks and have proposed reforms to help ameliorate these conflicts. I describe several of the leading proposals below, including one offered by Professor Steven Schwarcz to create a "public governance" duty for bank directors. While I think Professor Schwarcz's idea is more promising than the other approaches offered to date, there are some potential issues with it, including that the public governance duty may be too vague to be practicable and that it faces significant hurdles to implementation.

A. Realigning the Incentives of Bank Managers

One avenue towards narrowing the conflict between shareholders and public policy objectives is simply to bypass shareholder control and create greater incentives for bank managers to act in the best interests of creditors, regulators, or both. This can either be done through a stick or carrot approach. Proposals in the first category have largely involved imposing personal liability on bank executives in the event of bank losses. Dodd-Frank § 954 provides one example of this type of approach, requiring corporations to develop and implement "claw backs" that take back a certain amount of incentive-based compensation from bank executives in the event of an accounting restatement.[79] In a similar vein, Claire Hill and Richard Painter have called for imposing personal liability on highly paid bank executives, up to a certain set amount (say all but $2 million of the banker's assets), in the event of the bank's insolvency.[80]

Alternatively, there are some proposals that seek to alter the compensation structure of bank executives' pay in ways that better align their incentives with those of creditors, the public, or both. Some have called for deferring a portion of bank executives' compensation, to be paid

77. *See supra* notes 6–13 and accompanying text.

78. *See, e.g.*, SIR DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES—FINAL RECOMMENDATIONS 68–89 (2009) (recommending steps to facilitate greater engagement by shareholders); Lucian Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1784 (2006) (calling for relaxations on limitations on shareholder power). A subset of these proposals seeking to more closely align bank managerial interests with shareholder interests view the problem as one of short-termism, and have consequently sought to maximize long-term shareholder value.

79. Dodd-Frank, *supra* note 6, § 954.

80. HILL & PAINTER, *supra* note 18, at 149–51.

out after some set period (say five years later) if the bank has not received a government bailout or declared bankruptcy.[81] Others have called for including a significant debt component in bankers' compensation packages.[82] The reasoning behind these proposals is similar to the reasoning behind the punitive measures offered under Dodd-Frank § 954's claw-back measures and Hill and Painter's personal liability—to incentivize bank executives to seek less risk.

This general approach of targeting the incentive structures of bank managers is promising but insufficient and, I think, unlikely to be successful. While these proposals, either individually or in the aggregate, may influence managerial behavior to some degree by affecting personal incentives, the problem is that bank executives, and the directors who oversee them, still owe fiduciary duties to shareholders. Bank executives and directors can be fired or removed for failing to maximize shareholder wealth, and they may be subject to shareholder lawsuits as well.[83] Thus, even if bank executive compensation is structured to emphasize the interests of financial stability, it is important to recognize that bank executives face powerful countervailing financial incentives.

B. Increased Liability for Bank Shareholders

Several scholars have argued for changing the incentives of bank *shareholders*, rather than bank managers. One recent such proposal has been offered by Richard Ridyard, who channels earlier pre-crisis papers written by Jonathan Macey and Geoffrey Miller,[84] as well as Richard

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81. KENNETH R. FRENCH ET AL., THE SQUAM LAKE REPORT: FIXING THE FINANCIAL SYSTEM 50–51 (2010).

82. *See* Bebchuk & Spamann, *supra* note 18, at 253 (calling for bank executive pay to be tied to a set percentage of the aggregate value of common shares, preferred shares, and bonds issued by the bank or bank holding company); Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 15 NW. U. L. REV. 1205, 1207 (2011) (suggesting that bank executives be compensated in part with subordinated debt securities); Wulf A. Kaal, *Contingent Capital in Executive Compensation*, 69 WASH. & LEE L. REV. 1821, 1850–72 (2012).

83. As I discuss *supra* in Part I.A, the governance of financial institutions is somewhat more complicated than the governance of corporations, insofar as bank governance and corporate governance are slightly distinct. But bank directors still owe fiduciary duties to shareholders. *See* Macey & O'Hara, *supra* note 27, at 99 (noting that bank directors owe a duty of care to shareholders). *See also* OFFICE OF THE COMPTROLLER OF THE CURRENCY, THE ROLE OF A NATIONAL BANK DIRECTOR: THE DIRECTOR'S BOOK 78 (Washington, DC, 2010) (describing how bank directors owe a "duty of loyalty" which requires that they "exercise their powers in the interest of the organization and its stockholders" rather than in their own personal interest). Moreover, officers and directors of bank holding companies or non-bank financial companies, like other corporate officers and directors, owe the traditional corporate fiduciary duty to shareholders. *See* AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(a) (1994) (stating that corporations must be managed "with a view to enhancing corporate profit and shareholder gain").

84. Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31 (1992).

Grossman,[85] who argue for reinstating some form of the double par liability that was once ubiquitous in U.S. banking prior to the 1930s.[86]

These proposals aim to better align the interests of shareholders, who are seen as the drivers of bank governance and its preference for excessive risktaking, with those of policy makers. But while these solutions are intriguing, I tend to think they suffer from two related concerns about implementation and practicability. First, it is unclear how and to what extent shareholders would be liable. Ridyard's double par liability proposal acknowledges that the double liability imposed upon banks in the U.S. in the pre-1930s era was based on the par value of the stock, which constituted effectively all of the value of the stock, because there was limited or no secondary market trading of this bank stock.[87] Of course, bank equity today is widely traded in secondary markets, and such trading is encouraged by regulators, as it helps to ensure that there is sufficient equity capital for banks. But, this secondary market trading means that double liability based on par value is largely meaningless, and there are equitable and distributional questions around how double liability might be levied against shareholders who purchased their shares in the secondary market.[88] Perhaps more importantly, these types of proposals may cause secondary market trading in bank equity shares to tumble, particularly during periods of financial or economic distress. This in turn would invariably impact the valuation of bank shares, creating a potential trade-off between imposing shareholder liability and reducing bank capital.

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85. Richard S. Grossman, *Double Liability and Bank Risk Taking*, 33 J. MONEY, CREDIT & BANKING 143 (2001).

86. Richard Ridyard, *Toward a Bank Shareholder-Orientated Model: Using Double Liability to Mitigate Excessive Risk-Taking*, 2 UCL J.L. & JURIS. 141, 141 (2013). Peter Conti-Brown offers a more aggressive and more expansive version of this approach, proposing unlimited shareholder liability for certain banks. Peter Conti-Brown, *Elective Shareholder Liability*, 64 STAN. L. REV. 409, 428–41 (2011).

87. *See generally* Ridyard, *supra* note 86.

88. For example, one way to calculate double liability might be on the average market value of the shares over some discrete time period, such as during the last calendar year. However, this could raise fairness issues. For example, imagine that the average market value was $30.00. Shareholder A had purchased her shares at their low point, say for $10.00 a share, and Shareholder B had purchased his shares at their high point, say for $40.00 a share. Both Shareholder A and Shareholder B could raise fairness concerns. A paid only $10/share for these, so why should she now be liable for an additional $30 per share? At the same time, B paid $40/share, so he has already absorbed a heftier loss than other shareholders and is now being asked to pay up an additional $30/share on top of that. In addition to these equitable concerns, it seems likely that increasing liability to shareholders beyond what they paid may have severe deleterious effects on the liquidity of bank shares, particularly during periods of financial or economic turmoil, which may exacerbate the procyclicality of bank credit cycles.

C. Public Governance Duty

What has been largely absent from the nascent conversation over how to best resolve the governance issues in banking is any mention of changes to the fiduciary duties owed by bank directors and officers. Professor Steven Schwarcz recently authored an excellent and intriguing paper arguing for a change in fiduciary duties owed by bank directors, one which would create an additional "public governance" duty that would apply to directors at systemically important financial institutions.[89] One advantage of targeting director duties is that it creates flexibility to adopt various changes to improve bank governance. If it was determined that claw backs and changes to managerial liability were the most effective means of fulfilling these fiduciary duties, then directors could adopt these measures. But if these measures proved less than effective, directors could adopt many other measures to try to fulfill this fiduciary duty. At the same time, applying a public governance duty to directors would have the advantage of directly aligning the incentives of directors with public policy priorities.

But while I think this general strategy of targeting director duties has significant promise, I believe there are still some potential roadblocks to Professor Schwarcz's specific proposal. First, Professor Schwarcz would limit his proposed public governance duty to SIFIs.[90] But the conflicts inherent to bank governance are not limited to SIFIs, nor are the steep negative externalities associated with banking panics confined to SIFIs. Thus, this proposal seems too narrow in the classes of institutions it targets.

Second, the public governance duty may be too vaguely defined. What does a public governance duty entail? Professor Schwarcz describes it as "a duty not to engage in excessive risk-taking that could systemically harm the public"[91]—essentially, a duty of safety and soundness. But it is unclear what this duty would entail, how it would differ from the existing statutory duty to refrain from unsafe or unsound conduct, and how it might be balanced against the traditional duty that officers and directors owe to shareholders. Nor does it respond to the critique, made by Bainbridge and others, that imposing a dual fiduciary duty effectively nullifies any fiduciary duty and provides management with a broader shield against misconduct, as they can pursue their own interests and play each constituency off of one another.[92]

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89. Schwarcz, *supra* note 18.
90. *Id.* at 30.
91. *Id.* at 36.
92. Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1435–40 (1993).

Third, and I think most importantly, it is unclear how this duty would be effectively enforced. Professor Schwarcz avoids spelling out many of the details, as he describes his proposal as "primarily normative," emphasizing the question of "whether the duty should be imposed, not how it might be imposed."[93] But the mechanisms by which such a duty would be imposed matter, because this gets to the question of what type of pressure would be levied upon bank directors. One problem with a general public governance duty is that it has no natural self-interested constituency—other than perhaps the FDIC and other bank regulators—invested in ensuring compliance. Thus, this duty, even if formulated as a fiduciary duty, would, in practice, potentially be redundant of existing bank regulatory powers, because it relies on federal regulators for its enforcement.

CONCLUSION

As I hope I have illustrated in this symposium Article, it is clear that internal governance reforms can help bolster the prudential regulatory aims of public policy makers. There have been a number of promising proposals made to help align bank governance incentives with those of prudential regulators, but these do not appear sufficient. I aim to develop these themes and my proposed solutions for the potential conflicts between bank governance and systemic risk regulation in future work.

93. Schwarcz, *supra* note 18, at 37.