The Role of Corporate Law in Preventing a Financial Crisis: Reflections on In re Citigroup Inc. Shareholder Derivative Litigation

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The Role of Corporate Law in Preventing a Financial Crisis: Reflections on *In re Citigroup Inc. Shareholder Derivative Litigation*

Franklin A. Gevurtz*

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ABSTRACT

This Article uses recent events and litigation involving Citigroup to ask whether corporate law as created and enforced by state legislatures and courts—such as the legislature and courts of the State of Delaware—is capable of reducing the possibility of a replay of the recent financial

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crisis. Specifically, after presenting the events at Citigroup as a case study demonstrating the excessive risk-taking activities of financial institutions, this Article outlines generally the tools available to the law to limit the sort of excessive risk-taking that occurred at Citigroup and elsewhere. These tools include regulation of business activities, capital requirements, rules for executive compensation, imposing liability on directors and officers for unreasonable risks, and rules governing the selection of directors and officers. This Article then divides these tools into those addressed by banking law (regulation of business activities and capital requirements), and those for which state corporate law plays a role (compensation limits, personal liability for unreasonable risks, and director and officer selection). This Article then uses the results from the recent Citigroup litigation as a case study in the limited willingness of state legislatures and courts to use the important tools allocated, at least in part, to corporate law to curb excessive risk-taking by financial institutions. Specifically, the article contrasts the weaker standards and application for finding directors and officers liable for their inattention to risk in Citigroup with the probable analysis under a banking law or other regulatory regime. This Article also explains why this result is inherent in a regime in which directors and shareholders select which state's corporate law will govern. The article concludes with a discussion of normative implications.

I. INTRODUCTION

As we survey the wreck of the economy left in the wake of the recent financial crisis, the question inevitably becomes what to do in order to prevent another such meltdown. This question, in turn, divides into two subsidiary inquiries: (1) What substantive rules are necessary to prevent another crisis; and (2) Who should impose such rules? Consistent with the focus of the symposium of which this article forms a part, this article looks at one aspect of the latter question.

The debates over who should impose rules to prevent another financial crisis tend to focus on agencies that regulate financial institutions (e.g., bank regulators) and agencies that regulate financial markets (e.g., securities regulators). Commentators have given less attention to the role of government bodies that create and enforce corporate law more generally. The lack of attention given to those responsible for enforcing corporate laws in preventing a future financial crisis seems surprising. After all, one would not assume a priori that corporate law is irrelevant to preventing a crisis involving the collapse or


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bailout of major corporations. Indeed, among the potentially more significant legal actions to date from the recent crisis has been a shareholder derivative lawsuit seeking to hold the directors of the mega financial firm, Citigroup, liable under Delaware corporate law for the massive losses suffered by the firm.2

This Article seeks to fill the gap. Specifically, it looks at the role of state legislatures and courts—such as those of the State of Delaware—which are the governmental bodies primarily responsible for creating and enforcing corporate law in the United States. The question is whether these organs of state government are institutionally capable of deploying corporate laws—the laws governing the internal affairs of business corporations—to reduce the possibility of a replay of the recent financial crisis.

The discussion will proceed through a blending of the particular and the general. Specifically, Part II of this Article will use a review of the activities within Citigroup as a case study in excessive risk-taking by financial institutions that led to the recent financial crisis. Part III of this Article will outline generally the tools available to the law to limit the sort of excessive risk-taking that occurred at Citigroup and other financial institutions. It will then divide these tools into those addressed by banking law and those for which state corporate law may play a role. We will see that tools given in whole or in part to corporate law constitute potentially important mechanisms in the toolbox available to the law to curb excessive risk-taking by financial institutions. Part IV will use the results in the Citigroup litigation as a case study in the limited willingness of state legislatures and courts to use the tools allocated to corporate law to curb excessive risk-taking by financial institutions. It will explain why the results in Citigroup are inherent in the structural underpinnings of state-created and enforced corporate law. The normative implication of this analysis is that, regrettably, one cannot look to state-created and enforced corporate law—as opposed to aggressive use of all available tools by banking authorities—to limit excessive risk-taking by financial institutions.

II. CITIGROUP AS A CASE STUDY IN EXCESSIVE RISK-TAKING

The financial crisis climaxing in late 2008 had a number of causes—ranging from macro-economic conditions of excessive liquidity stemming from low interest rates and saving imbalances between the United States and Asia, which, in turn, fueled a bubble in housing prices in the United States;3 to micro-economic factors of risky borrowing against residential real estate through


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subprime loans; to conflicts of interest afflicting key gatekeepers, especially credit rating agencies; to legal factors flowing from a pervasive deregulatory philosophy. No doubt the relative significance of each of these and other factors will be debated for some time. For purposes of an article focused on the role of corporate law in preventing a financial crisis, however, the factor of concern is excessive risk-taking within financial corporations. Rather than discuss such risk-taking in the abstract, it may be useful to describe briefly the events at one company. Citigroup provides a convenient example.

Citigroup is a bank holding company that operates, through its subsidiaries, both banking and non-banking financial services businesses—at one time being the world’s largest bank. In late 2007 and 2008, Citigroup suffered more than $65 billion worth of losses, which, coupled with the fear of further losses, threatened Citigroup’s survival. Concerned with damage to the broader economy from the collapse of such a massive financial institution, the federal government agreed to a bail-out plan in November 2008. Under the plan, the federal government invested $20 billion in Citigroup, and also agreed to absorb 90 percent of the losses, beyond the first $29 billion, if Citigroup suffered further losses in its portfolio of approximately $306 billion in residential and commercial real estate loans, as well as other assets. To cover these losses, if necessary, the Treasury Department would use $5 billion of its bailout fund, the FDIC would cover the next $10 billion, and the Federal Reserve would guarantee the rest. In exchange, the federal government received preferred stock.

While Citigroup’s losses flowed from a number of sources, for present purposes it is enough to focus on the largest source: mortgage-related securities

4. E.g., Jon Hilsenrath & Luca Di Leo, Fed Chief Edges Closer to Using Rates to Pop Bubbles, WALL ST. J., Jan. 4, 2010, at A3, available at http://online.wsj.com/article/SB126253288955613905.html. (Federal Reserve Chairman Ben Bernanke, in an address to the American Economic Association, blamed the real estate bubble on mortgages that should not have been extended).


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involved with Citigroup’s operations in collateralized debt obligations. Collateralized debt obligations (often referred to as CDOs) are created by packaging together various secured obligations, such as home loans secured by mortgages, and then selling rights to the cash flows from the pooled secured obligations in classes, or tranches. Some of these tranches possess a senior right to be paid (thereby having less risk of default), while the subordinated tranches receive a greater interest rate in exchange for taking the greater risk of non-payment. The prevailing view was that one could create tranches which, because of their senior position, justifiably could claim even extremely low investment-grade (such as AAA) levels of risk despite the underlying assets in the pool being more risky home loans, including subprime loans.\textsuperscript{11}

Citigroup engaged in packaging and selling CDOs using not only home loans it originated, but also home loans it purchased from other lenders, as well as other secured obligations. Following Charles Prince (who later became Citigroup’s CEO) taking charge of Citigroup’s corporate and investment bank in 2002, Citigroup ramped up its CDO operation so that by the middle of the decade it became one of the biggest players in generating and selling CDOs. This produced considerable income for Citigroup, which charged fees for managing the CDOs.\textsuperscript{12}

This operation not only increased Citigroup’s earnings, it also increased its risks. In part, this was because Citigroup itself invested in CDOs. In part, however, Citigroup was creating an inventory risk; in other words, the risk that, if the market for CDOs dried up, Citigroup would be stuck with not only the CDOs it was creating for sale but also with the various secured obligations, such as mortgage-backed home loans, that it was generating or buying to package into CDOs.\textsuperscript{13} Moreover, among the secured obligations Citigroup purchased for packaging into CDOs, which consequently added to its inventory risk, were CDOs Citigroup issued earlier.\textsuperscript{14} Compounding the inventory risk to an even greater degree, Citigroup included a “liquidity put”—an option allowing purchasers of the CDOs to sell them back to Citigroup at original value—along with the CDOs it created.\textsuperscript{15}

The risk Citigroup faced from holding an inventory of CDOs and securities for packaging into CDOs, as well as from the obligation to repurchase CDOs sold

\begin{footnotesize}
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  \item[12.] E.g., Dash & Creswell, supra note 9.
  \item[13.] E.g., Citigroup, 964 A.2d at 113 (for example, Citigroup, in a couple major transactions in 2007, acquired billions of dollars worth of subprime loans from financially troubled subprime lenders to package into CDOs).
  \item[14.] E.g., Martin & Morgenson, supra note 8 (referring to allegations in a class action lawsuit that Citigroup recycled older CDOs into new CDOs because it could not find buyers for the old CDOs).
  \item[15.] E.g., Citigroup, 964 A.2d at 113 (it appears from the plaintiffs’ complaint in Citigroup that a staggering $25 billion face value of CDOs—around half of the CDO inventory upon which Citigroup incurred losses—came from CDOs returned to Citigroup under liquidity puts. In re Citigroup Inc. Shareholder Derivative Litig., Second Amended Complaint, para. 68).
\end{itemize}
\end{footnotesize}
with liquidity puts, came home to roost in 2007 and 2008 when the housing price bubble, which peaked in 2006, burst completely; whereupon subprime home loan defaults accelerated and the market prices for CDOs collapsed. In stages, Citigroup was forced to recognize losses by writing down the value of its one-time $50 billion plus inventory of CDOs and subprime mortgage-backed home loans, in many cases to between twenty-one and forty-one cents on the dollar.\(^\text{16}\)

While Citigroup's losses came from risks taken on the assets side (CDOs and subprime loans), liabilities incurred to finance the CDOs and subprime loans also created risks which came back to bite Citigroup. Specifically, Citigroup established so-called Special Investment Vehicles ("SIV"), which issued commercial paper—very short-term notes—the proceeds of which were used to fund subprime loans and CDOs. The risk thereby created was that very short-term borrowing was funding long-term investments, which was acceptable so long as the investments were safe and liquid. When these investments became devalued and illiquid, the SIVs could not repay the commercial paper. While Citigroup claimed it was not legally obligated to do so, it nevertheless made emergency transfers of funds into the SIVs and ultimately assumed the assets and liabilities of the SIVs.\(^\text{17}\)

The fact that Citigroup took business risks in search of profits, and that those business risks led to losses, would be unexceptional—except perhaps for the magnitude of the misadventure. What is important is whether there are facts to suggest that persons within Citigroup acted unreasonably, even without the benefit of twenty-twenty hindsight, in incurring these risks. If so, then it becomes useful to discuss how the law might seek to prevent persons from taking unreasonable risks.

Based upon reports of investigative journalists and review by regulators, there are grounds to believe that Citigroup's misfortune was not simply the result of bad luck following the pursuit of reasonable business risks. Specifically, Citigroup had risk management systems in place designed to prevent its executives—including the executives who allowed the dangerous build-up in its inventory of CDOs and subprime loans to occur—from taking unreasonably dangerous risks. However, a serious flaw apparently in Citigroup's risk management systems was a lack of independence of the risk managers from the executives whom the risk managers were supposed to monitor, both because of long standing personal connections\(^\text{18}\) and because of lines of authority under

\(^{16}\) E.g., Dash & Creswell, supra note 9.

\(^{17}\) E.g., Citigroup, 964 A.2d at 113.

\(^{18}\) For example, the senior risk officer at Citigroup who was responsible for overseeing risks involved in Citigroup's CDO operations had long-standing friendships both with the head of the division undertaking the CDO operation and with the Citigroup executive who oversaw the build-up in Citigroup's inventory of CDOs and related securities. This relationship, according to accounts, raised eyebrows of those concerned about risk controls at Citigroup and it was said that Citigroup traders who wanted to undertake profitable but risky deals could take advantage of this relationship to convince the senior risk officer that the risk was worth taking. E.g., Dash & Creswell, supra note 9.
which risk managers reported to the person with an interest in promoting the activities they were monitoring. Further, as discussed above, Citigroup’s biggest risk came, not so much from individual risky transactions, as it did from a buildup in its overall inventory of CDOs and subprime securities; these became particularly dangerous the minute there were signs of a slow down in the real estate market. Citigroup officials do not seem to have accompanied this dangerous buildup with any independent assessment of the risk it entailed, but simply relied blindly on favorable credit ratings given to CDOs. Potentially embarrassing along this line, reports surfaced that the most senior officers and directors at Citigroup may not have been informed enough to be aware of the magnitude of the risk Citigroup was running in its CDO operations. Regulatory actions give credibility to the press reports of Citigroup’s risk management failings. Complaints by foreign regulators that Citigroup’s risk management practices were dangerously lax led the Federal Reserve to bar Citigroup from making any acquisitions of other financial companies for twelve months between the spring of 2005 and 2006. In 2008, Federal Reserve examiners apparently gave Citigroup a scathing confidential review of its risk management practices.

Citigroup’s losses seem to have resulted not only from a lack of brakes (as in a well-functioning risk management system) but also from too much steam in the engine (as in the focus on profits and bonuses). This ran from former Clinton Administration Treasury Secretary, Robert Rubin, who, as Chairman of the Citigroup Board of Directors’ Executive Committee, urged engagement in greater risks for greater profits; to Charles Prince, who pushed the expansion of the CDO operation to gain increased profits; to the persons running Citigroup’s CDO trading operations, who, because of bonuses geared to profits, became among Citigroup’s highest paid employees. According to some at Citigroup, this created a culture in which those worried about the buildup of risk kept quiet.

19. At one point, the risk managers not only reported to the senior risk officer, but also reported to the head of the division undertaking the CDO operation—which placed the risk managers in the awkward position of reporting to the person whose division’s risk-taking they were supposed to be keeping in check. Keep in mind that the purpose for having risk managers is because traders and the manager of their division have an incentive to take excessive risk. Id.

20. E.g., Dash & Creswell, supra note 9.

21. E.g., Id (Citigroup CEO Charles Prince never questioned the risk entailed in Citigroup’s CDO operation before an emergency meeting when it was too late to avoid huge losses, because no one had warned him); Eric Dash, Citigroup Director Expected to Quit Key Committee, N.Y. TIMES, Apr. 8, 2008 (reporting on pressure for the chairman of the Audit and Risk Management Committee of Citigroup’s board of directors to resign for failing of oversee Citigroup’s risk management practices, and that, according to people familiar with the matter, some Citigroup directors were not aware of Citigroup’s CDO loss exposure until huge write-downs started piling up).

22. E.g., Martin & Morgenson, supra note 8.

23. E.g., Dash & Creswell, supra note 9.

24. Id.
III. TOOLS FOR CURBING EXCESSIVE RISK-TAKING AND THE ROLE OF CORPORATE LAW

A. The Tools for Curbing Excessive Risk-Taking

To explore the potential role for corporate law in curbing excessive risk-taking, such as occurred at Citigroup, it is useful to step back and take an inventory of the key mechanisms available to the law to address the problem. There are at least five basic approaches.

1. Regulation of Business Activities

The most obvious approach for the law to take to limit excessive risk-taking by financial institutions is to enact and enforce rules regulating the activities whereby financial companies incur risk. For example, to limit the risk that the failure of one borrower would ruin a bank, banking law prohibits a bank from lending more than a certain percentage of its assets to a single borrower.25 For many years, concerns about the risks banks would face if engaged in securities transactions led Congress, in the Glass-Steagall Act, to limit the ability of banks to engage in the securities business.26 This limit on potential risk substantially departed the scene in a much-noted symptom of increasing deregulation.27 An obvious lesson from the role of “no-doc loans” in the recent financial crisis is the need to enforce rules requiring adequate documentation of the borrower’s earnings capability before making a home loan.28 A more controversial lesson from the recent crisis could be the need to limit the use of certain derivative contracts, such as credit default swaps.29 Regulation of business activities to curb excessive risk-taking can preclude the firm from engaging in certain risky activities; it can alternately leave decisions to the firm but mandate certain processes, such as the establishment of risk management committees, designed to avoid ill-considered risks.30


Since the purpose of this Article is to look at the role of corporate law in preventing a financial crisis, it is not necessary to go beyond these few examples and delve into extensive details on the regulation of business activities of financial firms. Such regulation, however, raises a couple of broad questions that are important to answer in order to consider the role of corporate law in this realm.

To begin with, it is useful to ask what justifies the regulation of the business activities of banks and other financial firms so as to limit their risk. After all, in seeking to prevent the sort of excessive risk-taking that might cause the failure of regulated financial institutions, these regulations seem quite different than most regulations the government imposes on business entities. Specifically, when dealing with worker health and safety, consumer protection, environmental regulations, and the like, it is easy to imagine that if left unregulated, business entities would happily sacrifice the interests of their employees, customers and the environment to make extra profit for the owners. By contrast, when the law acts to prevent a financial institution from taking excessive risk, it seeks to prevent actions that could wipe out the owners’ interests in the firm. Of course, the law is not trying to protect the owners. Rather it is trying to protect depositors, or the taxpayers in the case of deposit insurance, or the broader economy from the injury resulting from the collapse of financial institutions. Yet, this does not answer the question of why the self-interest of the owners in avoiding failure does not provide adequate protection.

There are a couple of answers to this question. To begin with, the owners (the shareholders in a corporation) are not commonly the persons making the decisions regarding risk-taking. Particularly in the widely held company, managers, over whom shareholders may have limited practical influence, will be making the decisions. Concededly, managers may have strong incentives to avoid business failure—depending particularly on their prospects for alternate employment and how much of their personal wealth is tied up in the company’s stock. Nevertheless, there is no reason to assume that the managers’ precise calculus of costs and gains from risk-taking matches either the shareholders’ or those of the broader society.

More fundamentally, there are very strong reasons to question whether the shareholders’ views of acceptable risk match what is socially optimal. In fact, an examination of the stock market performance of shares in financial companies in the years leading up to the recent financial crisis shows that the stock market

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32. This observation is commonly known as the “Berle-Means thesis” after the authors of the classic work which pointed out the phenomenon. See ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).
34. Id. at 265-267.
rewarded the shares of banks and financial firms, including Citigroup, that took what turned out to be excessive risks, while punishing the shares of more prudent institutions. The existence of bank regulation is based upon the recognition of the moral hazard that inflicts a business whose essence is making money by risking other peoples' (depositors') money. While bank shareholders do not want their firms to fail, taking a risk in search of higher profits can make sense for the shareholders even when the risk no longer makes economic sense once one factors in the greater amount of depositors' money potentially lost. Moreover, a highly significant (as illustrated by recent events) externality, presumably ignored by shareholders, is the systemic damage caused to the broader economy by the failure of large banks.

Moving beyond the question of whether regulation is necessary, we must ask whether regulation of business activities by financial institutions is a sufficient legal tool to curb excessive risk-taking by financial institutions. If so, then there is little need for corporate law to play a role in seeking to avoid a financial crisis. Noted economist, Joseph Stiglitz, has provided insights into the limits of regulation as a tool to control negative corporate impacts on society. He begins by asking why governments, including the United States' government, are concerned about sovereign investment funds (funds investing on behalf of foreign governments) acquiring controlling interests in corporations operating businesses in sensitive fields. If regulation of corporations is sufficient to ensure companies refrain from actions that create negative impacts, then corporate ownership and control, including by other countries, should not matter. The answer, Stiglitz concludes, is that governments recognize that ownership and control matter despite regulation. This is because regulation can never be complete. Those in charge of the corporation invariably have some freedom of action due to inevitable gaps in the regulations, or because the regulator cannot be present at all times. This means those in control of corporations can take actions that create negative consequences despite the best regulation.

36. E.g., Bebchuk & Spamann, supra note 33, at 256-73.
37. E.g., Richard A. Posner, Capitalism in Crisis, WALL ST. J., May 7, 2009, at A17, available at http://online.wsj.com/article/SB124165301306893763.html. One might also ask whether the self-interest of the financial institution’s creditors will lead creditors to prevent the institution from taking excessive risk. Writers sometimes blame deposit insurance for creating moral hazard by removing the insured depositors' incentive to monitor banks against dangerous risk-taking. E.g., Jonathan R. Macey & Maureen O'Hara, The Corporate Governance of Banks, 9 FRBNY Econ. Pol'y Rev. 91, 98 (2003) available at http://www.newyorkfed.org/research/epr/03v09n1/0304mace.html. The problem, of course, is that the threat of a bank run by ill-informed depositors, who might be reacting as much to the danger of the run as they are to poor investments of the bank, seems a crude tool to discourage excessive risk-taking that the depositors will be the last people to discover. E.g., Peter O. Müller, Corporate Governance of Banks 10, 13 (ECGI - Law Working Paper No.130, 2009), http://ssrn.com/abstract=1448118. For an explanation as to why bondholders in the bank lack sufficient incentives to address excessive risk-taking, see Bebchuk & Spamann, supra note 33, at 268-71.
2. Capital Requirements

A second type of law aimed at curbing excessive risk imposes capital requirements on financial institutions. In this context, and simplifying a great deal, the law defines a basket of items—such as the amount received for common and preferred stock, certain retained earnings and reserves, as well as the amount received for some types of debt instruments—as capital. The law then demands that capital constitute a percentage—which depends upon the nature of the capital and of the firm’s assets—of the financial firm’s total assets.\(^4\)

Capital requirements provide a cushion to help ensure that a financial institution can still meet its obligation to depositors despite losses in its investment and lending portfolio.\(^4\) This affect of capital, however, mitigates the consequences of excessive risk-taking; it does not curb it. The way in which capital serves to curb excessive risk-taking is by addressing the moral hazard that results if shareholders can make money by risking the depositors’ money without suffering the consequences of any losses.\(^4\) By ensuring that shareholders have some “skin in the game,” capital seeks to alleviate the moral hazard.

As with regulation of business activities, the question arises whether capital requirements in banking law can be sufficient in themselves to curb excessive risk-taking, thereby precluding the need for corporate law to play a role. There are several reasons to conclude capital requirements are not sufficient. To begin with, capital requirements work on the incentives of shareholders, but, as discussed above, managers make decisions regarding risk-taking.

More fundamentally, capital requirements have had limited success in forcing the shareholders to focus on excessive risk to a socially optimal level—as illustrated in the earlier discussion of the stock performance of banking and

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39. General corporate law has some, largely minimal, capital rules. See infra note 83.
40. \textit{E.g.,} ALFRED M. POLLARD \& JOSEPH P. DALY, BANKING LAW IN THE UNITED STATES § 11.02 (3rd ed. 2009).
41. \textit{E.g.,} Joseph Jude Norton, Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?, 49 OHIO ST. L.J. 1299, 1313 (1989). By contrast, reserve requirements—in other words, the requirement that some portion of the bank’s assets from deposits or capital be held and not loaned out—serve somewhat different functions. One is a matter of monetary policy as such reserves reduce the amount of money in circulation. The other is to address a timing problem. Banking involves a mismatch between the bank’s assets in the form of long-term loans, and the bank’s obligations in the form of short-term deposits. Reserves provide a cushion to help ensure banks can cover withdrawals of short term deposits despite the delays entailed in waiting for payments on their long-term loans. \textit{E.g.,} Pollard \& Daly, supra note 40, at § 11.03. None of this, however, is really relevant to the general riskiness of the financial institution’s investments and lending.
42. \textit{E.g.,} Franklin Allen, Elena Carletti \& Robert Marquez, Credit Market Competition and Capital Regulation, HARY. L. SCH. FORUM ON CORPORATE GOVERNANCE AND FIN. REGULATION, Sept. 9, 2009, http://blogs.law.harvard.edu/corpgov/2009/12/11/credit-market-competition-and-capital-regulation/#more-5965. The impact of capital requirements on moral hazard may be particularly important given the presence of deposit insurance, since the existence of such insurance may allow banks with little or no capital—where the moral hazard problem is the greatest—to still attract deposits. \textit{E.g.} Macey \& O’Hara, supra note 37, at 98.
financial companies in the years leading up to the recent panic. Several factors may account for this.

For one, capital rules involve an inherent complexity which undercuts their effectiveness. A key purpose of the capital requirement is to deal with the prospect that bad loans and investments will mean that the institution’s assets are not worth what was thought; yet central to applying the capital requirement is the value of the institution’s assets. The effort to square this circle—for instance, by making the required capital depend upon the riskiness of the assets held by the bank—may lead to gaming and unintended consequences. For example, the presumably less risk entailed with AAA rated securitized investments, as opposed to individual mortgage backed home loans, has meant a lower capital requirement for banks that hold more of their assets in AAA rated securitized investments than that required for banks holding more of their assets in the form of individual home loans. This, in turn, may have led banks to place a premium on holding AAA rated senior tranches of CDOs rather than individual home loans. As discussed earlier, these CDOs turned out to be a major source of Citigroup’s multi-billion dollar losses; indeed, the added complexities of valuing and dealing with these securitized instruments in a collapsing housing market may have added a significant element of unexpected riskiness over individual mortgage-backed home loans.

Capital requirements may also create a perverse effect. Since the shareholders have a greater investment, return on the investment will go down unless loans and other investments give a greater return. This may produce an incentive to take greater risks.

Finally, the effectiveness of the shareholders’ capital investment in curbing the shareholders’ appetite for excessive risk depends upon forcing the shareholders to internalize the societal cost of the financial institution’s failure. One problem here is that this depends upon the shareholders’ planning horizons. Despite capital requirements, shareholders with only a short-term planning horizon—in other words, shareholders only focused on near-term corporate profit performance—may be favorably disposed toward excessively risky behavior by financial firms when the likely positive result is near-term and the possible negative consequences are of sufficiently small probability that they are unlikely to occur within the planning horizon (the so-called black swan event). Such

43. E.g., Scott, supra note 3, at 20.
44. E.g., MICHAEL P. MALLOY, BANKING LAW AND REGULATION § 5.3.3.4.2 (Supp. 2009).
45. E.g., Bebchuk & Spamann, supra note 33, at 286-87.
46. E.g., Scott, supra note 3, at 20.
48. E.g., Scott, supra note 3, at 10-11, 16.
49. E.g., Norton, supra note 41, at 1313; Mülbret, supra note 37 at 14. Adjusting the capital requirements for the riskiness of the bank’s assets should decrease this incentive (id)—albeit, this increases the complexity problem with capital requirements.
short-term planning horizons exist among many institutional investors (e.g., mutual funds) in substantial part because the actual decision-makers in such investors are managers whose compensation may depend more on the short-term performance of individual portfolio companies than on the long-term.\textsuperscript{50} Beyond the timing issue, there is the inherently large difference in the magnitude of what shareholders have to lose and the losses faced by depositors despite any reasonable capital requirement. The mathematics of banking are such that, unless one makes the capital requirement so large as to undercut the banking function altogether, investments that are not in the interests of depositors still could make sense for the shareholders despite the risk to their capital.\textsuperscript{51} Compounding this problem, the cost of a bank’s collapse may be the systemic damage caused to the broader economy, which could even exceed the depositors’ losses.\textsuperscript{52}

3. Compensation Rules

Sources from politicians to academic commentators have given considerable attention to the possible role of executive compensation in encouraging excessive risk-taking by financial institutions.\textsuperscript{53} The large size of executive compensation at financial firms has caught the public’s attention,\textsuperscript{54} but this, in itself, is not the concern when it comes to excessive risk. The fact that executives who brought their firms to collapse nevertheless received such compensation begins to get to the problem, but we need to be more precise. The question is: What incentives does compensation create for executives as they make decisions through which the financial institution incurs risks as it seeks profits?

The very fact that executives, who so miserably failed, nevertheless received rewards presumably has some affect on incentives. Yet, while such a no-fault system provides little carrot for good performance, it would not seem, at least on its own, to promote the pursuit of excessive risk. One possible exception would be when the laxity, potentially encouraged by such a compensation scheme, applies to persons (say members of the risk management department or of the board of directors) whose essential role lies in monitoring risk-taking by others. Still, this has not been the central focus of concern.


\textsuperscript{51} E.g., Bebchuk & Spamann, supra note 33, at 256-63 (giving examples).

\textsuperscript{52} See supra note 37.


Much of the expressed concern has focused on the skewed incentives created by the timing structure common to executive compensation schemes, which grant rewards based upon earnings performance during a relatively short time (such as a year or a quarter). The simple bonus based on earnings during a given accounting period creates the incentive to increase earnings during this period. Stock option plans add to the bonus incentive—to the extent the amount of the option grant depends on reported earnings—the additional incentive to increase earnings during current accounting periods because the market price of stock upon which the value of the option depends is highly responsive to near-term reported earnings. The corporate scandals of 2001-2002 involving accounting fraud at Enron, Worldcom and the like illustrated the incentives this system creates for gaming reported earnings during a given accounting period. The financial panic of 2008 may illustrate the incentive this system creates for improving earnings during a given accounting period by way of decisions involving unreasonably high levels of risk.

The problem is not simply that executives have the firm incur risk in order to achieve earnings—this is what such schemes hope to achieve. Rather, the problem is that such schemes create asymmetric incentives under which the executives take unreasonable risk because they gain benefit from increased reported earnings during the given accounting period yet do not suffer equal consequences from losses. The asymmetry results from the fact that there is no negative bonus or stock option under which the executive must pay the company for accounting periods in which there are losses. This “heads-I-win, tails-who-cares” approach makes it rational to place a bet even if the odds of winning, or the payoff if one wins, would not make this a worthwhile bet with one’s own money. This becomes even worse if the loss event has very low probability—a black swan event—in which case, the executive might figure that the odds of such an event occurring within the period of time the executive cares about (say, before he or she moves on to another position) is so small as to ignore. Yet, as recent events show, even the risk of a black swan event can be excessive if the magnitude of harm is great enough.

59. E.g., Mülbert, supra note 37 at 13; E.g., Posner, supra note 55, at 1026. It is also worth noting that the opaque quality of a bank’s assets can render it difficult for those outside management to judge the degree to which increased earnings reported by management seeking a bonus simply resulted from increasing the risk profile of the assets, as opposed to superior acumen.
60. See, e.g., Stiglitz, supra note 38, at 49-50.
While most attention has focused on this timing issue, Professors Lucian Bebchek and Holger Spamann have noted an additional incentive problem regarding the encouragement of excessive risk that may arise from the compensation of financial firm executives.\textsuperscript{61} As discussed above, shareholders of financial firms have an incentive to take excessive risks insofar as most of the loss falls on depositors. Hence, executive compensation schemes—such as ones that pay in part with stock or stock options—designed to align executive interests with those of the shareholders may contribute to the incentives of executives taking excessive risks. Indeed, to the extent stock options allow executives to enjoy the upside potential of gains for the stockholders without the downside risks of holding stock, they further skew the incentives of executives toward excessive risk.

There are those who have challenged the thesis that incentives based upon executive compensation increased the danger to financial firms.\textsuperscript{62} Correlation studies comparing forms of compensation and how financial firms fared in the crisis have provided ammunition for both sides.\textsuperscript{63} Resolving who has the better of the argument, however, is well beyond the scope of this Article.

If, in fact, certain forms of executive compensation have encouraged excessive risk-taking, then rules limiting the use of these forms of executive compensation become a useful tool in curbing excessive risk-taking. However, as conceded by the advocates of such rules,\textsuperscript{64} this approach is unlikely to be sufficient, standing alone, to curb excessive risk-taking.

4. Liability for Unreasonable Risks

Imposing liability to pay the damages resulting from unreasonable risks is a conventional tool in the law to deter creating such risks. Indeed, this concept is a pillar of tort law. While one goal of tort recovery for negligence (taking unreasonable risks) is compensation for injured parties, another goal is to deter negligent conduct.\textsuperscript{65}

Interestingly, there do not appear to be many empirical studies on the degree to which fear of liability for unreasonable risk has changed the conduct of corporate directors and executives. Nevertheless, those in the field operate on the assumption that such an impact exists. Indeed, as expressed in \textit{Citigroup}, as well as

\textsuperscript{61} Bebchuk & Spamann, supra note 33, at 264-65.

\textsuperscript{62} E.g., Friedman, supra note 47.

\textsuperscript{63} For a description of the major studies that potentially cast doubt on the impact of executive compensation in leading to excessive risk-taking by financial firms, see Bhagat & Romano, supra note 53, at n.3; Friedman, supra note 47. For a contrary view of the significance of these studies, see Bebchuk & Spamann, supra note 33, at 270-72.

\textsuperscript{64} E.g., Bebchuk & Spamann, supra note 33, at 293.

\textsuperscript{65} DAN B. DOBBS, THE LAW OF TORTS § 11 (2000).
as numerous other court opinions and academic commentary, the fear is that legal liability may overly deter risk-taking by directors and executives.

Of course, by definition, imposition of liability for taking unreasonable risks should not create liability for those who only create reasonable risks; therefore, as a first approximation, liability should not deter reasonable risk. Hence, the concern about over-deterrence is based on either a supposition that there will be erroneous determinations of liability or the hypothesis that executives will avoid even reasonable risk for fear of erroneous determination of liability, or just to avoid the burden of being sued. It is useful to note, however, that this over-deterrence concern raises a challenge to the wisdom of much of tort law, and not just to liability for risk-taking by financial firm executives. Still, as discussed later, in reaction to the concern of over-deterring business risk-taking, corporate law commonly requires greater culpability than simply unreasonable conduct before finding liability—a doctrine referred to as the business judgment rule.

In any event, the impact of monetary liability is, to some extent, the flip side of the impact of compensation schemes that reward profit creation. If compensation based on company profits may encourage excessive risk, then paying damages in the event of losses from unreasonable actions should discourage excessive risk-taking. The degree to which the possible imposition of liability deters risk depends upon well-established factors: the magnitude of liability and the probability of its imposition. These, in turn, depend upon both the substantive standards for imposing liability and the procedural rules that may facilitate or hinder prosecution of the claim. So, for example, procedural rules that facilitate private actions may increase deterrence by increasing the probability of sanction. Finally, it should be noted that liability for unreasonable risks may fall on both those who unreasonably decided to take the risk and upon those whose job it was to prevent engagement in unreasonable

68. Applying Judge Hand's famous formula from *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947), adjusted for investments rather than accident avoidance, if the magnitude of gain expected from an investment decision multiplied by its probability of occurring exceeds the magnitude of loss risked by the investment decision multiplied by its probability of occurring than the investment is reasonable (ignoring the opportunity costs of competing investments).
72. See, e.g., J.I. Case Co. v. Borak, 377 U.S. 426, 430-33 (1964) (court implied a private right of action for violation of SEC rule against false statements in proxy solicitation, in part, to aid enforcement by catching violations the SEC lacks the resources to detect).
risks but unreasonably allowed the risk to be taken. The events at Citigroup, discussed above, seemingly illustrate both types of conduct.

5. **Selection of Management (Rules of Corporate Governance)**

Rules impacting selection of corporate management may also provide a means to curb excessive risk-taking. Here, we are concerned with rules affecting the selection of those who decide whether the financial company will incur risks, the selection of those who supervise those who decide whether the financial company will incur risks, and even the selection of those who choose those who have these other roles. Such rules may help if they are able to address a couple of ways selection can either limit or foster excessive risk-taking.

Selection can influence excessive risk-taking to the extent such risk-taking results from incompetence (as opposed to rational responses to bad incentives). In fact, there is some reason to believe that lack of financial competence played a role in the financial crisis. A study of German state-owned banks by Professor Harald Hau found a statistically significant inverse correlation between the financial sophistication possessed by members of the bank supervisory boards and how poorly the banks did during the recent financial crisis; in other words, the less financial sophistication (as measured by various criteria) members of the board possessed, the worse the bank generally fared. On a more anecdotal level, references to the lack of knowledge in the field of CDOs possessed by Charles Prince, the Citigroup senior executive and then CEO who pushed Citigroup’s unfortunate lunge into such investments, raise the question as to what role lack of competence may have played in Citigroup’s problems.

The other impact of selection on risk-taking involves incentives. Desire for advancement or fear of firing can discourage excessive risk-taking if executives perceive that those controlling appointments and removal will hold losses against the executives. On the other hand, desire for advancement or fear of firing can encourage excessive risk-taking if executives perceive that those controlling appointments and removal are more concerned with earnings than risk. This prospect, in turn, ties into the discussion of the incentives of bank shareholders—who elect the directors. As explained above, shareholders have incentives to favor excessive risk-taking.

This discussion suggests that rules setting qualifications of financial competence for election to the board or appointment as an executive, or allowing

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74. Dash & Creswell, supra note 9 (quoting a former Citigroup executive as saying that Charles Prince “didn’t know a CDO from a grocery list”).

removal and a bar from future service in case of incompetence, might limit excessive risk-taking. Rules mandating disclosure of financial qualifications of candidates to the board might also promote competence—assuming disclosure actually affects either voting or nominations. More controversially, the discussion above suggests that rules limiting the effectiveness of the shareholder electoral franchise might reduce excessive risk-taking. For example, as a radical thought, one might consider giving other stakeholders in the bank—those possessing a greater interest in prudence than do the shareholders—some portion of the right to elect directors.

B. Dividing the Tools Between Banking and Corporate Law

Having taken an inventory of basic approaches to curb excessive risk-taking, we now must ask which approaches lie entirely within the domain of banking law, and in which approaches might corporate law play a role. An initial problem with this task is that banking law and corporate law are loose concepts rather than precisely defined terms. After admitting the term is amorphous, one treatise describes banking law as covering the corporate operation and establishment of banks as well as the regulation of the financial and related services provided by a bank. A basic working definition of corporate law would be the law governing the internal affairs of corporations. This includes the powers and duties of directors and officers and the rights and liabilities of shareholders. Just from these definitions one sees an immediate overlap between banking and corporate law when it comes to financial firms: Specifically, since banks are organized as corporations, is the law governing the internal affairs of banks banking law or corporate law?

Rather than answer this question in the abstract, we can take a more pragmatic approach. As stated in the introduction, this Article fits within the broader inquiry of who should impose the rules necessary to prevent another financial crisis. More precisely, the question is whether state legislatures and state courts, when creating and enforcing laws for all business corporations (rather than just for banks), are up to the task of employing such laws in a way to prevent another financial crisis. Using this as a guidepost, banking law then becomes laws enacted as part of legislation—be it state or, increasingly, federal—as well as the actions of regulatory agencies, which focus on banks or financial companies rather than business corporations more generally.

76. POLLARD & DALY, supra note 40, at § 1.01.
77. See, e.g., McDermott Inc. v. Lewis, 531 A.2d 206, 215 (Del. 1987) (defining the scope of the internal affairs doctrine, under which the state of incorporation provides the governing corporate law rules, as covering the relationships inter se of the corporation, its directors, officers and shareholders).
We also can use the Citigroup example to help sort things out. Citigroup is a bank holding company; it has subsidiaries organized under banking laws rather than incorporated under general state corporate laws.\(^9\) Citigroup, itself, is incorporated under the General Business Corporation Law of Delaware.\(^8\) As such, Citigroup illustrates the interplay of banking law and corporate law with respect to the various tools to curb excessive risk-taking by financial firms.

The two easy tools to categorize are regulation of business activities and capital requirements. Both clearly fall within banking law as they come from legislation directed at banks and are enforced by regulatory agencies concerned with banks, rather than corporations generally. Indeed, regulation of a firm’s business activities is not the sort of thing one considers to be internal affairs, even if one were dealing with general corporations rather than firms incorporated under banking laws.\(^8\) Admittedly, general corporate laws address capital requirements; but, especially in the United States,\(^3\) capital rules found in general corporate laws have become little more than a minimal prohibition on those distributions to shareholders that would leave insufficient assets to cover debts and liquidation preferences.\(^3\)

Looking at Citigroup, agencies concerned with banking regulate the banking activities Citigroup conducts through its banking subsidiaries—the Federal Reserve having approved Citigroup’s acquisition of these subsidiaries.\(^4\) The mix of agencies regulating the subsidiaries depends upon whether they are national or state banks,\(^5\) ignoring any overseas banking subsidiaries. The fact that the Federal Deposit Insurance Corporation (FDIC) insures deposits in the banking subsidiaries, however, means there will be extensive federal regulation over both the subsidiaries and Citigroup in any event.\(^6\) Citigroup’s banking subsidiaries and Citigroup are also subject to capital requirements imposed by federal banking regulators.\(^7\)

\(^{79}\) CITIGROUP'S 2008 ANNUAL REPORT ON FORM 10K 2 (2009).

\(^{80}\) Id.

\(^{81}\) See McDermott, 531 A.2d at 215.

\(^{82}\) Many other nations, especially those following civil law traditions, provide some minimum capital, and sometimes even capital maintenance, requirements in their general company laws. E.g., FRANKLIN A. GEVURTZ, GLOBAL ISSUES IN CORPORATE LAW 35-38 (2006).

\(^{83}\) E.g., Model Business Corporation Act §§ 6.21 (no capital requirements in issuing shares), 6.40 (2003) (prohibiting distributions that leave assets less than debts and liquidation preferences of senior shares, or the corporation unable to pay it bills as due). Traditional statutes, as in Delaware, complicate things with references to par value of stock as a minimum price for shares upon issuance by the corporation and a constraint on dividends; but par is simply a number in the certificate of incorporation subject to reduction or elimination by amendment of the certificate. Delaware General Corporation Law §§ 102(a)(4), 153, 154, 170, 242(a)(3).


\(^{85}\) E.g., Felsenfeld, supra note 25, at 5-9.

\(^{86}\) E.g., 12 U.S.C. § 1831p-1 (2006) (authorizing federal regulatory agencies to promulgate regulations for safety and soundness of FDIC insured depository institutions). See also 12 U.S.C. § 1818(b)(3) (2008) (authorizing Federal Reserve Board to issue cease-and-desist orders against bank holding companies engaged in unsafe or unsound practices on the same basis as applied to state banks that are members of the Federal Reserve System and have federally insured deposits).

Things become more complicated concerning the regulation of compensation, the imposition of liability for taking excessive risks, and the supervision of management selection. As a Delaware corporation, Citigroup is subject to the corporate law of that state when it comes to rules governing compensation of Citigroup directors and officers; imposing liability on Citigroup directors and officers for damages incurred due to unreasonable risk-taking; and regulating the election and appointment of Citigroup directors and officers—as these are each, normally, a matter of internal affairs and state general corporate law. This explains why Citigroup shareholders brought a derivative lawsuit against directors and officers of Citigroup in the Delaware Chancery Court to recover losses the company sustained from its dealings in CDOs, as well as the compensation it paid its ex-CEO, and why the court resolved this suit through the application of Delaware corporate law. Given the widespread use of bank holding companies, this shows the potential significance of state general corporate law with respect to the tools for curbing excessive risk-taking by financial firms.

On the other hand, what about Citigroup's banking subsidiaries? Because these companies are organized under banking statutes, the issues of compensation, liability for excessive risks, and management selection would all seem to be banking law, even if they are the internal affairs of the banking subsidiaries. Yet, this does not mean that state general corporate law would necessarily be inapplicable. This is because provisions in the banking statute, judicial decisions, or actions by the banking regulatory agency might call for the application of the state's general corporate law on the issue. This is best seen regarding liability for excessive risks. For decades, state and federal courts have held that bank directors are subject to common law fiduciary duties—including a duty of care to avoid damage to the company—the parameters of which courts often find in general corporate law. For state banks,

88. E.g., Citigroup, 964 A.2d at 118 (liability for excessive risk and claims based upon excessive compensation resolved by Delaware law for Delaware corporation); McDermott, 531 A.2d 206 (issue of who can vote to elect directors resolved by law of state of incorporation).

89. Delaware courts do not have exclusive jurisdiction in cases involving the internal affairs of Delaware corporations, and, indeed, a securities fraud action pending in New York also asserted claims for breach of fiduciary duty against Citigroup directors and officers based upon the CDO losses. Nevertheless, the Delaware Chancery Court in Citigroup refused to stay the Delaware action, in part because Delaware law would control. Citigroup, 964 A.2d at 115-119.

90. E.g., Bebchuk & Spamann, supra note 33, at 259-260 (the biggest banks in the United States are not stand alone banks, but subsidiaries of bank holding companies and major strategic decisions are taken at the holding company level).

91. E.g., 12 C.F.R. § 7.2014 (1996) (replaced former 12 C.F.R. § 7.5217(a)) (Office of the Comptroller of the Currency regulation allowing national banks to include indemnification provisions in their articles if the provisions substantially reflect general standards of law as evidenced by the law of the state in which the bank is headquartered, the law of the state in which the bank's holding company is incorporated, or else the relevant provisions of the Model Business Corporation Act).

92. E.g., MALLOY, supra note 44, at § 3.2.6.1.
courts presumably look to the common law of the bank’s state, while pre-Erie, federal courts applied a federal common law to national banks. In 1997, however, the United States Supreme Court held that, even as to national banks, state corporate law (presumably of the state in which the national bank has its headquarters) dictates the contents of this duty.

With the background of the savings and loan crisis, and dissatisfied with the developments in state law that made it more difficult to bring claims for breach of the duty of care, Congress intervened. In the Financial Institutions Reform, Recovery, and Enforcement Act (“FIRREA”), Congress added Section 1821(k) to Title 12 of the United States Code. Section 1821(k) allows the FDIC to pursue claims against directors and officers of insured banks in receivership (or that accept FDIC assistance to avoid receivership). This section establishes the federal standard to impose liability as gross negligence or worse; albeit, it leaves open the possibility of recovery under state law standards that would impose liability for conduct not as culpable as gross negligence, such as ordinary negligence.

An obvious gap in Section 1821(k) is that it only kicks in upon the bank’s failure (or the use of FDIC funds to avoid failure). To deter misconduct short of bank failure, the FIRREA also added a three-tier set of monetary penalties for, among others, officers and directors of banks with deposits insured by the FDIC, as well as officers and directors of their holding companies. The application of these penalties to unreasonable risks, however, is not entirely clear. The section penalizes engaging in unsafe or unsound practices, which would seem to include execution of unreasonable risks. However, this only encompasses reckless or knowing acts. While the section also reaches breach of fiduciary duties, it is unclear if this encompasses negligence or gross negligence, or whether it requires some greater degree of culpability.

97. Id at 228 (Congress enacted Section 1821(k) against a background of failing savings and loan associations, large federal payments to insured depositors, and recent changes to state law designed to limit preexisting director and officer liability).
98. Id at 227.
100. Id. at (b)(3)(treating a holding company like a state FDIC insured bank for purposes of section 1818(i)).
103. E.g., II KENNETH M. LAPINE, DENNIS LASSILA, BURTON V. MCCULLOUGH, PAUL S. PILECKI & HAROLD WEISBLATT, BANKING LAW § 45.08(2) (Supp. 2008).
All told, legal liability upon bank directors and officers for excessive risk involves a blending of rules specifically directed at banks, together with general corporate law applied by analogy. With executive compensation, too, use of general corporate law fiduciary duty rules applied by analogy mix with explicit banking law rules. Indeed, in the FDIC Improvement Act of 1991, Congress specifically identified compensation as one of the areas for banking agencies to address in regulations creating standards for safety and soundness of insured banks and their holding companies. In October 2009, responding to concerns about the incentives for excessive risk-taking resulting from some forms of compensation, the Federal Reserve proposed incentive compensation policies for all banking organizations subject to its supervision, including member banks and bank holding companies. The policies are designed to prevent incentive compensation from encouraging excessive risk-taking.

Finally, a blended system also exists with respect to management selection. Banking statutes codify general corporate law principles under which the shareholders elect the directors and the directors appoint the officers for banks. Moving beyond common norms of general corporate law, banking statutes grant regulatory agencies the power to remove directors, officers, and other affiliated parties of insured banks—and even of bank holding companies—for various misdeeds, and to prevent their further employment by any financial institution. The impact of the removal power on excessive risk-taking is somewhat muted, however. Among conduct that can produce removal is participation in unsafe or unsound banking practices, or breach of fiduciary duty. Yet, the conduct must demonstrate willful or continuing disregard for the institution’s safety (or else personal dishonesty) in order to warrant removal.

Banking law can also curb the effectiveness of the shareholder voting franchise. Specifically, as stated above, acquisition by one corporation of sufficient shares in a banking corporation to make the acquiring corporation a bank holding company requires approval by the Federal Reserve. Acquisition of a controlling amount of shares in an FDIC insured bank or a bank holding company by any person—whether or not the acquirer is a corporation—is subject

108. 12 U.S.C. § 1818(b)(3) (2008) (treating a holding company like a state insured bank for purposes of Section 1818(e)).
to disapproval by banking authorities under the Change in Bank Control Act.\textsuperscript{112} The significance of this veto over bank acquisitions should not be underestimated since the significance of the shareholder voting franchise in a widely held corporation often lies primarily in the prospect of a hostile tender offer.\textsuperscript{113} Still, the impact of these provisions on the pressure to increase reported earnings because of the market for corporate control is attenuated by the fact that the acquisition of a bank with lower earnings by an institution with higher earnings, in and of itself, would not seem to be grounds for disapproval.\textsuperscript{114}

IV. WHY IT MATTERS: \textit{CITIGROUP AS AN ILLUSTRATION OF THE LIMITATIONS OF STATE CORPORATE LAW}

In many instances, disputes over whether a particular tool of regulation belongs to one field of law or another seem to involve little more than tacky turf wars—whether that is between agencies and their legislative oversight committees or between professors carving up the law school curriculum. When asking whether the tools for limiting risk involve banking law or corporate law, however, something more important is at stake. This is because the two laws involve fundamentally different structural and philosophical underpinnings, which impact their effectiveness in employing the tools they possess to limit excessive risk-taking.

At its core, banking regulation is largely national and mandatory. Of course, this is an oversimplification. For example, the United States has a dual banking system with national banks chartered and regulated by the federal government through the Comptroller of the Currency, and state banks chartered and regulated by state banking agencies.\textsuperscript{115} This has allowed a certain degree of regulatory arbitrage as banks jump between federal and state charters to gain some advantage under the system.\textsuperscript{116} Moreover, the narrative of the last couple of decades in banking law has been one of deregulation, as banks have been allowed to engage in practices (such as the securities business) previously barred to them.\textsuperscript{117} Yet, it is important not to let the details obscure the central core. Despite the existence of state chartered banks, banking law has essentially become national. This is because virtually all state chartered banks have opted for FDIC insurance, and in doing so, they become subject to extensive federal

\textsuperscript{113} \textit{E.g.}, Henry G. Manne, \textit{Mergers and the Market for Corporate Control}, 73 J. POL. ECON. 110 (1965).
\textsuperscript{114} \textit{E.g.}, JULIE L. WILLIAMS, SAVINGS INSTITUTIONS: MERGERS, ACQUISITIONS AND CONVERSION, § 4.02(5)(a)(i) (Scott Zesch, ed., 2009).
\textsuperscript{115} \textit{E.g.}, Atherton, 519 U.S. at 220-21.
\textsuperscript{116} \textit{E.g.}, FELSENFELD, supra note 25, at 28-29.
\textsuperscript{117} \textit{E.g.}, \textit{id.} at 88-110 (decline in regulation of interest rates on deposit accounts), 145-202 (liberalization of activities for bank holding companies), 225-234 (allowing inter-state banking), 245-302 (allowing holding companies to engage in securities business).
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regulation. Also, despite liberalization, banking law is essentially mandatory. By and large, banking regulations are not default rules which the owners of the business can contract around. This is because, as discussed earlier, the essence of banking is the effort by the business’ owners (shareholders), or managers working on the owners’ behalf, to make money by risking the money of other persons—depositors, or the taxpayers in the case of deposit insurance—who are not in a position to contractually limit risk-taking by owners or managers. Under these circumstances, even before the most recent misadventure in finance, policy makers recognized the inherent temptation (or moral hazard) to engage in unreasonably dangerous risk-taking, as well as the externalities produced when the owners or managers succumb to this temptation. Accordingly, the law imposes mandatory limits on risky activities by a bank.

By contrast, at its core, corporate law is state law and permissive. This difference in the source and underlying philosophy of corporate law limits its ability to utilize the tools available to it as an effective control on excessive risk-taking by financial institutions. To illustrate the point, we look to the Citigroup decision.

A. Citigroup As a Case Study In Weak Corporate Law

1. Overview

In Citigroup, shareholders of the company brought a derivative action against current and former directors and officers of Citigroup, alleging that the directors and officers breached their fiduciary duties by failing to properly monitor and manage the risks Citigroup faced in its dealings in CDOs and the subprime mortgage lending market. Specifically, the plaintiff shareholders alleged that the directors and officers ignored extensive “red flags” of the problems that were brewing in the real estate and credit markets. The shareholders also complained about the board’s failure to disclose to the shareholders the risks faced by the company and about certain board decisions; specifically those that increased Citigroup’s exposure to risks from subprime loans, that repurchased Citigroup stock at high prices, and that gave generous compensation to the outgoing CEO upon his removal because of Citigroup’s massive losses.

As mentioned earlier, imposing liability for taking unreasonable risk involves both substantive and procedural standards and rules. Citigroup serves as a good illustration. A derivative suit is a procedural mechanism for enforcing fiduciary

118. E.g., Michael P. Malloy, Seeing the Light: Savings Association Conversions and Federal Regulatory Realignment, 10 ANN. REV. BANKING L. 189, 223-24 (1991) (arguing that prevalence of FDIC insured institutions combined with federal regulation of such institutions has substantially federalized bank regulation).

119. See, e.g., 12 U.S.C. § 1831p-1 (authorizing federal regulatory agencies to promulgate regulations for safety and soundness of insured depository institutions, with no indication that such regulations are optional for the bank’s owners).
duties owed to the corporation by allowing a shareholder of the company to bring a suit seeking recovery for the company rather than for the shareholder. Because such a suit removes the board’s normal control over corporate decisions—in this instance, whether to bring a lawsuit on behalf of the company—derivative suits face a special pleading requirement designed to establish that the board is not the appropriate body to decide whether to bring the lawsuit in question. Specifically, the plaintiff must plead with particularity either that the plaintiff has made a demand for action upon the board and a reason why the court should ignore the board’s rejection of the plaintiff’s demand, or a good excuse for not making such a demand. In most jurisdictions, including Delaware, a good excuse for not making a demand is that demand would be futile because we know, even before the demand is made, that the court will ignore the directors’ rejection of demand. The plaintiff establishes this by pleading with particularity that most of the board members breached their duty and should be sued by the corporation, or that most of the board members are under the control of a party who should be sued by the corporation; meaning, in either event, that most of the board members are not the parties who should decide whether the company should sue.

The Citigroup opinion arose from a motion to dismiss the complaint for failure to make such a demand or plead an adequate excuse. In response, the Delaware Chancery (trial) Court had to assess whether the plaintiffs had successfully pled, with particularity, an excuse—in this case, the plaintiffs’ excuse being that most of Citigroup’s current directors had breached their fiduciary duty. With one exception, the court in Citigroup concluded that the plaintiffs had not succeeded in this task. In particular, the court rejected the plaintiffs’ allegations that the directors had breached their duty by ignoring red flags warning of trouble; as well as allegations that the directors breached their duty regarding either disclosure or decisions the directors made that exposed Citigroup to risks in the subprime market and that had the company repurchasing its stock when the price was high. The only claim which survived the court’s scrutiny was the allegation that the compensation awarded to the fired CEO constituted waste.

Of course, the Chancery Court’s dismissal of the excessive risk-taking claims, in itself, does not establish that either Delaware corporate law liability rules or their application are necessarily weaker than one might expect from rules or application under a different regime. Instead, we must examine more carefully the basis for the Delaware court’s decision and compare the critical steps with the closest analogy arising under banking or other regulatory statutes. In this

120. E.g. FRANKLIN A. GEVERTZ, CORPORATION LAW § 4.3 (2000).
123. E.g., Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).
discussion, it is important to keep in mind that the goal is not to criticize the *Citigroup* decision from a doctrinal, or even, at this point, from a policy standpoint. Rather, the point is simply comparative: *Citigroup* illustrates that corporate law is weaker (in the sense of being less likely to produce liability) than banking law or other regulatory regimes are likely to be. In turn, as discussed earlier, there is less deterrence of excessive risk-taking.

2. The Standard

We begin with the standard for imposing liability applied by the court. The court’s opinion in *Citigroup* is littered with references to the business judgment rule; so much so that a casual reading might lead one to assume that this rule provided the standard against which the court assessed liability. The business judgment rule means different things to different courts, all of which center on the notion that courts should be reticent to impose liability based upon, or otherwise second guess, decisions by corporate directors. In Delaware, the rule requires the plaintiff to establish that disinterested directors are guilty of gross, rather than just ordinary, negligence in order to prove a breach of the directors’ duty of care in making a decision. The business judgment rule, however, did not provide the relevant standard in *Citigroup*. For one thing, the plaintiffs’ chief complaint was not about a decision by Citigroup’s board of directors. Rather, they largely complained about the failure of the Citigroup board to act, despite warning signs of excessive risk. Such a seemingly unconsidered failure to act does not invoke the protection of the business judgment rule, as this rule protects the board from claims it made poor decisions, rather than from claims it was not paying sufficient attention.

While the *Citigroup* plaintiffs’ focus on claims involving inattention should have lowered the culpability standard the plaintiffs faced, a more important fact in the case significantly raised the standard the plaintiffs needed to overcome. Citigroup, as is typical of Delaware corporations, has a provision in its certificate of incorporation permitted by Section 102(b)(7) of the Delaware General Corporation Law. Section 102(b)(7) allows a certificate of incorporation to contain a provision waiving damage claims against directors for breach of fiduciary duty unless the breach involves certain categories of conduct; for example, the section prohibits waiver of damages for acts not in good faith. Hence, to prevail, the plaintiffs in *Citigroup* had to establish that the directors failed to act in good faith.

Analytically, the question of how to apply the test of good faith to a case claiming director inattention is not straightforward. After all, traditionally one
thinks of good faith as meaning that the directors subjectively thought their action was in the best interest of the corporation. 128 This works for a board decision—which is why courts commonly mention good faith in the context of the business judgment rule 129—but seems less relevant in the context of an inattention case where, presumably, directors did not notice the danger to the corporation and the question is whether there was a reason for them to have done so. Nevertheless, beginning with dicta in the landmark Caremark opinion 130 and culminating in a holding by the Delaware Supreme Court in Stone v. Ritter, 131 Delaware courts have applied good faith to inattention claims. Specifically, Delaware courts have explained that if the plaintiff showed not only that the directors breached their duty of care due to inattention, but also showed the directors knew they were breaching their duty, then the directors would not be acting in good faith. 132 The problem, however, is to prove the directors actually knew they were breaching their duty when they failed to act. Instead of demanding direct proof of subjective knowledge, Delaware courts appear to allow a sort of indirect proof by a showing of a sufficiently egregious case of inattention. Specifically, a sustained or systematic failure to exercise oversight, such as utterly failing to implement any reporting system or consciously failing to monitor the operation of such a system, will establish a lack of good faith. 133 It was this standard of good faith that the court applied in Citigroup.

How does this good faith standard compare to a standard for imposing liability that we might expect to find in a national banking law? We need not guess, because we know. Recall the earlier discussion of 12 U.S.C. Section 1821(k), enacted as part of the FIRREA. As explained earlier, this section allows the FDIC to pursue claims against directors and officers of insured banks in receivership. Section 1821(k) establishes gross negligence as the standard for finding liability. Is this the same as a lack of good faith, as Delaware courts have interpreted the terms? The answer, as the Delaware Supreme Court pointed out in its Disney decision, 134 is no. After all, equating gross negligence with a lack of good faith would render Section 102(b)(7) illusory in the context it was meant to address, since, as stated above, without gross negligence there is no liability to waive under Delaware’s version of the business judgment rule. Indeed, it was a decision finding liability based upon gross negligence in making a business decision 135 which provoked the enactment of Section 102(b)(7). 136 Hence, by

128. E.g., Aronson, 473 A.2d 805 at 812.
129. E.g., Brehm, 746 A.2d at 263 n. 66.
131. 911 A.2d 362, 369 (Del. 2006).
132. Id.
133. Id.
135. Van Gorkom, 488 A.2d 858.
136. E.g., James J. Hanks, Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification, 43 BUS. LAW. 1207 (1988).
allowing directors to escape liability unless plaintiffs can demonstrate the directors' lack of good faith, the Section 102(b)(7) waiver raises the barrier for imposing liability from the gross negligence standard called for in the case of an FDIC action on behalf of a failed bank under Section 1821(k).137

3. Application

Ultimately, the significance of a standard for imposing liability comes in its application. Looking at the application of the standard in Citigroup, it is helpful to note that there are two types of inattention cases. There are the cases in which senior officers or directors ignore warning signs of employee misdeeds or other problems within the corporation.138 Such warning signs are often, as in Citibank, referred to as “red flags.” Other cases, by contrast, involve claims that the directors failed to implement adequate systems to discover misdeeds or other problems without waiting for warning signs of particular trouble.139 To use a metaphor, the first sort of cases involves situations in which the directors smelled smoke, but did not investigate to see if there was a fire; while the second sort of cases involves situations in which the claim is that the directors failed either to install or maintain smoke detectors.

The Citigroup complaint seems to have given limited attention to possible claims based upon the inadequacy of Citibank’s monitoring systems (smoke detectors), in this case to monitor for excessive risk. Indeed, while the complaint quotes some newspaper stories that speak of poor risk management, and the plaintiffs’ reply brief in opposition to the motion to dismiss introduces the more detailed news reports concerning the flaws in Citigroup’s risk management, the Chancery Court treats the complaint as virtually conceding the monitoring systems issue by making reference to the Audit and Risk Management Committee of Citigroup’s board, which was charged with oversight of the firm’s risk management system and met eleven or twelve times a year in the years most relevant. The plaintiffs’ failure to make more out of the structural problems in Citigroup’s risk management systems that were discussed earlier seems perplexing. Of immediate relevance to the comparison between banking law and

137. Admittedly, as discussed earlier, Section 1818(i) imposes a more demanding standard of culpability (reckless or knowing) before imposing financial penalties on officers or directors who engage in unsafe or unsound banking practices in a bank that does not fail. This, however, seems to reflect the difference between what Congress viewed as a tort-like recovery provision (Section 1821(k)) and what Congress viewed as a criminal like penal provision (Section 1818(i)). Specifically, 1821(k) provides recovery for losses suffered by the bank (and, therefore, the FDIC), whereas 1818(i) provides a flat fine for each day of continuing violation. Most significantly, however, it was 1821(k), not 1818(i), that Congress enacted because of its dissatisfaction with state law developments, along the lines of Section 102(b)(7) of the Delaware General Corporation Law, which made it more difficult to recover against grossly negligent bank corporation directors. See supra text accompanying note 97.

138. E.g., Bates v. Dresser, 251 U.S. 524 (1920) (bank president ignored a number of warnings of bookkeeper’s dishonesty).

state corporate law standards, neither the plaintiffs nor the court seem concerned
that federal regulatory officials had condemned Citigroup's risk management
practices. Perhaps this simply reflects the competence of the plaintiffs' attorneys. Yet, it probably did not matter. Given the Delaware Supreme Court's 2006 *Stone v. Ritter* decision, so long as there is some system in place, complaints about the inadequacies of the system would not meet Delaware corporate law standards for imposing liability, even when inadequacy in the system is documented by federal regulatory findings.

In fact, *Stone* provides a telling example of the disparity between banking standards and the standards for imposing liability under Delaware corporate law. In *Stone*, the plaintiff shareholders alleged that the directors of a bank breached their duty by failing to ensure that the bank's employees complied with federal law requiring the filing of suspicious activity reports. The employees' non-compliance allowed the bank to be used in a Ponzi scheme and resulted in federal banking authorities imposing $50 million in fines and penalties on the bank. Notably, in assessing these fines, federal banking officials found that the Bank Secrecy Act compliance program at the bank lacked adequate board and management oversight. However, the Delaware Supreme Court in *Stone* affirmed the dismissal of the shareholders' complaint against the directors. How could the court do so in the face of federal regulatory findings of inadequate oversight by the bank's board? The answer is that the bank's certificate of incorporation contained a waiver of liability under Section 102(b)(7), meaning the directors could only be liable to the bank for their inattention if they failed to act in good faith. Since the plaintiffs' allegations in *Stone* admitted that the board had instituted an extensive reporting system on employee regulatory compliance—even if one that the federal banking authorities ultimately found to be seriously inadequate—the plaintiffs' allegations were insufficient to establish the sort of sustained or systematic failure to monitor necessary to establish a lack of good faith.

Having eschewed much of a claim based upon inadequate monitoring systems, the *Citigroup* plaintiffs alleged that the directors ignored red flags of dangerous risk stemming from Citigroup's huge positions in subprime mortgages and subprime mortgage-based securities (CDOs). These red flags ranged from a 2005 article in the New York Times by economist (later to win the Nobel Prize) Paul Krugman, which warned that America's housing market was approaching "the final, feverish stages of a speculative bubble;" to various public events in 2006 and 2007, including bankruptcies and credit rating downgrades, which demonstrated problems both in the subprime market and in CDOs based upon subprime mortgages. To the court, however, such public red flags established nothing since they did not warn of wrongdoing at Citigroup.

There are a couple of different ways one could interpret the court's reaction in this regard. In part, this could be harkening back to a discussion in the court's opinion in which the court suggested that claims in Delaware based on inattention (so-called *Caremark* claims) might be limited to the failure to detect
illegal actions or other specific wrongdoing by employees in the corporation—as in Caremark140 and Stone—rather than the failure to detect and prevent excessive, but legal, business risks by company employees. Invoking the policies underlying the business judgment rule, the court expressed concern that a duty to monitor for business risk, as opposed to misconduct, could discourage the sort of risk-taking which is necessary in business. The court also used this distinction to explain the success of a recent derivative lawsuit against directors of A.I.G.141— noting that in the A.I.G. case the complaint alleged that directors failed to exercise oversight to prevent pervasive fraudulent and criminal conduct, rather than prevent excessive business risk-taking.

One could argue about whether the Chancery Court's views in regard to monitoring for business risk are an accurate reflection of Delaware corporate law.142 Moreover, one might ask what the Chancery Court would have done in a pair of overseas proceedings brought in the 1990s against directors of the Diaw143 and Barings144 banks after the directors failed to prevent unauthorized securities trading, costing each firm over a billion dollars. Presumably, directors should have a duty to ensure employees not only act legally but also stay within their authority, as there is no reason to encourage risk-taking by persons acting contrary to their instructions. Yet, if the court says the directors have a duty to monitor because unauthorized actions are employee misconduct and not just business risk, and at the same time the court refuses to find any duty to monitor authorized risk-taking, the result could create the perverse incentive of tempting directors to remove limits on the authority of lower level employees, thereby lessening the possibility of liability from failing to monitor against unauthorized acts—hardly the desired result. Hence, it is difficult to see how one can hold the line the Chancery Court attempted to draw between misconduct and business risks.

In any event, the critical point for present purposes is that there seems little basis, if one were applying banking law, for the Chancery Court's possible rejection of a duty to monitor for business risks. Rather, it seems evident that bank directors are supposed to monitor for business risks and not just against wrongdoing.145

140. In Caremark, the claim involved the board's failure to detect and prevent violations by employees of Medicare rules limiting the payment of referral fees.
142. E.g., Stephen M. Bainbridge, Caremark and Enterprise Risk Management, 34 J. CORP. L. 967, 988-989 (2009) (arguing that Citigroup is inconsistent with Caremark and Delaware law in possibly rejecting a duty to monitor business risks as opposed to just for misconduct).
144. In re Barings Plc (No. 6), [1999] 1 B.C.L.C. 433 (Ch. Div. Companies Court) (Eng.).
145. E.g., Hoye v. Meek, 795 F.2d 893 (10th Cir. 1986); BASEL COMMITTEE ON BANKING SUPERVISION, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANIZATIONS 4-5 (2006).
Alternately, perhaps the court could not accept the idea that public information ever constitutes a red flag. After all, by the very nature of the fact that the "red flags" were public, we know that Citigroup's directors were hardly alone in missing the warnings about the existence of a housing bubble and the early signs of demise in the subprime market. Again, we must ask whether those enforcing a banking law or another regulatory regime would see things differently. Here, there is an informative comparison to be found in a decision applying federal securities law.

One of the lawsuits resulting from the spectacular collapse of Worldcom, Inc. in 2002 was a securities fraud class action brought by purchasers of bonds, which Worldcom sold to the public in 2000 and 2001. Among the purchasers' causes of action was a claim under Section 11 of the 1933 Securities Act against the underwriters in these bond offerings (who included, interestingly enough, a company absorbed by Citigroup). The 1933 Act requires filing a registration statement with the Securities Exchange Commission before one may sell securities to the public. To deter making false or misleading statements in this document, Section 11 of the Act grants persons purchasing securities sold under a registration statement containing a false or misleading statement a claim for damages against a number of parties, including the underwriter. The registration statements for Worldcom's bond offerings incorporated by reference Worldcom financial statements, audited by the Arthur Andersen accounting firm, which improperly treated almost $4 billion worth of payments by Worldcom as capital expenditures rather than current expenses. The result was to report net income during a period in which Worldcom actually lost money.

Section 11 creates a defense for underwriters with respect to portions of the registration statement prepared on the authority of an expert (such as the financial statements audited by Arthur Andersen) if the underwriters can establish they did not believe, and had no reasonable grounds to believe, the statements were false. This, in turn, raised the issue as to whether there were any "red flags" that gave the underwriters reasonable grounds to believe the audited financial statements might have a problem. The plaintiffs argued there was such a red flag; an important component of Worldcom's expenses as reported in the audited financial statements was better than its competitors. This, the plaintiffs argued, should not have been an expected result in a highly competitive industry in which competitors could not survive with significantly higher costs than one another; hence, it should have led one to question Worldcom's expense numbers.

In response, the underwriters pointed out that the audited Worldcom financial statements in question came from earlier filings Worldcom made with the Securities Exchange Commission, meaning the public had been aware of the cost comparison for some time. Yet, none of the investment analysts that followed

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Worldcom stock, nor anyone else, had noticed the implications of the cost comparison argued by the plaintiffs. Nevertheless, the court rejected the argument that, because everyone else missed the significance of a publicly known fact, such a fact cannot constitute a red flag the defendant should have noticed. The moral is that the answer to the question of what is a red flag may vary depending upon whether we are dealing with a regulatory regime imposing rigorous gate-keeping responsibilities, such as securities law imposes upon underwriters in a public offering, or whether we are dealing with the willingness of those enforcing ordinary corporate law to impose liability upon directors.

Finally, putting aside the questions of whether either public warnings, or warning of general business risk rather than misconduct can constitute red flags, the court in *Citigroup* faulted gaps in the plaintiffs’ pleading on the claim that the directors ignored the red flags. Specifically, the complaint left unanswered such questions as what exactly the directors did upon learning of the so-called red flags, and what exactly the plaintiffs claimed the directors should have done. Had the rules of ordinary notice pleading applied, such gaps probably would not have mattered. However, the plaintiffs faced the requirement that, in order to excuse demand, they must plead “with particularity” their claim against most of the current board. The problem the plaintiffs faced in pleading such detail was that they had not had the opportunity to take discovery during which they might investigate exactly what the directors’ reactions were to the alleged red flags.

Once again, the question arises: Would the situation have been different in an action to enforce banking law or another regulatory scheme? Because the heightened pleading standard facing the plaintiffs in *Citigroup* is a product of the derivative suit mechanism used to enforce fiduciary duties owed to the corporation under corporate law, it would not have applied had there been an action, for instance, by the FDIC under Section 1821(k) of the FIRREA on behalf of a financial firm in receivership.

### 4. The Waste Claim

The *Citigroup* opinion showed much greater sympathy toward the plaintiffs’ claim challenging the compensation awarded to Citigroup’s outgoing CEO, Charles Prince. Here, the plaintiffs’ complaint incorporated a letter agreement entered into between Citigroup and Prince upon Prince’s removal, under which Prince received $68 million—including bonus, salary, and accumulated stockholdings. In exchange, the letter agreement contemplated that Prince would sign a non-compete agreement, a non-disparagement agreement, a non-

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148. See, e.g., Unisuper Ltd. v. News Corp., 2005 WL 3529317 (Del. Ch. Dec. 20, 2005) (held that a complaint for breach of an oral agreement was adequate under notice pleading standard despite the lack of details regarding the contract).

149. See, e.g., F.D.I.C. v. McSweeney, 976 F.2d 532, 536 (9th Cir. 1992) (action brought by F.D.I.C. without anyone arguing that demand was required).
solicitation agreement, and a release of any claims he might have against Citigroup.

Since the directors approving this agreement were not parties to it, the plaintiffs could only prevail in challenging the merits of this decision if, at the very least, they established that the agreement constituted "waste." Waste is a transaction so unbalanced that no reasonable person would conclude the corporation received the equivalent to what it gave up in the deal. In this instance, there were a couple of key facts unknown from the complaint that prevented the court from determining whether the letter agreement was sufficiently one-sided to constitute waste. To begin with, it was uncertain how much additional compensation the letter agreement actually provided over and above what Prince was already entitled to under his employment contract (keeping in mind that, under the letter agreement, Prince would be relinquishing anything still owed under his existing employment contract). Also indeterminate was the value of the rest of the promises made by Prince in the letter agreement. Given these open questions, the court decided that the case should go forward.

The court's analysis of the "compensation equals waste" claim seems inconsistent with the approach of the rest of the opinion. To begin with, what happened to the good faith standard resulting from the Section 102(b)(7) provision in Citigroup's certificate of incorporation—i.e., why is the court now applying a waste, rather than a good faith, standard? The answer must be that the court is treating waste as establishing a lack of good faith. One rationale for this result would be the assertion that directors who enter a transaction so unbalanced that no reasonable business person would say the corporation received the equivalent to what it gave must not have acted in the good faith belief they were benefitting the corporation.

There may also be another reason to treat waste as establishing the failure to act in good faith for purposes of Section 102(b)(7) waivers. A transaction amounting to waste is one that even an affirmative vote by the majority of shareholders cannot save over the objection of any minority shareholders. While there may be greater freedom of action for provisions in the certificate of incorporation on the ground that all shareholders have bought into the contract represented by the corporate charter, a court may nevertheless be tempted to interpret the limits on the claims shareholders can waive ex ante—through a provision allowed by Section 102(b)(7)—to parallel the limits on the transactions a majority of the shareholders can save ex post by a vote of approval.

The greater inconsistency in the court's opinion comes in its attitude toward unanswered questions left after reading the plaintiffs' complaint. Addressing the

150. E.g., Brehm, 746 A.2d at 262 (applying waste standard to compensation approved by disinterested directors); Beard v. Elster, 160 A.2d 731, 738-39 (Del. Ch. 1960) (compensation approved by disinterested directors entitled to deference under the business judgment rule).
152. Id. at 219.
compensation claim, the court resolved the two critical uncertainties in what Citigroup received under the letter agreement in the plaintiffs' favor, by making those the grounds for denying the motion to dismiss the complaint. In contrast, as discussed above regarding the red flags claim, when dealing with other claims in the complaint, the court pointed to critical gaps in its knowledge left by the plaintiffs' complaint as reasons why the complaint failed to meet the pleading standard for excusing demand.

In fact, the Citigroup court's liberality in dealing with the plaintiffs' pleadings when it came to the compensation claim appears to be inconsistent with other Delaware cases dealing with claims of waste in decisions to pay compensation. For example, in the leading Aronson decision, the Delaware Supreme Court followed a more typical approach in dismissing a complaint because it contained insufficient details in alleging waste.

Aronson was a derivative action in which the plaintiff alleged that the directors had breached their duty by approving an employment contract between the corporation and one member of the board, Leo Fink, who also happened to own forty-seven percent of the corporation's outstanding stock. Fink, who was seventy-five years old, had retired under a pre-existing employment contract and was receiving consulting fees. The new contract reinstated Fink’s employment, but provided that Fink could retire again at any time, after which he would again become a consultant to the corporation. Critically, the new contract also provided that Fink was entitled to receive compensation even if he was unable to perform services for the corporation, which the plaintiff alleged amounted to waste. Pointing to a lack of any allegations that Fink was in poor health—or presumably otherwise planned to take advantage of the provision allowing compensation without work—the court held the allegation insufficient to establish that the board had breached its duty in approving the contract, thereby excusing demand.

Still, one should not assume that the Citigroup opinion marks a significant stiffening of the Delaware courts' collective spine when it comes to compensation challenges. In fact, we have been down this road in Delaware before with complaints challenging compensation packages whose magnitude and circumstances have caught media attention. Most notably, in the Disney litigation, the Delaware courts faced a challenge to a compensation package under which Michael Ovitz received roughly $140 million upon his termination after an unsuccessful year as the number two senior executive at Disney. This inspired considerable media attention and shareholder litigation.

Initially in the Disney litigation, the Delaware Chancery Court dismissed the plaintiffs' complaint, viewing the situation as an unremarkable exercise of business judgment. On appeal, however, the Delaware Supreme Court, cognizant

of the case's notoriety, showed more concern. It expressed the view that the sloppy processes allegedly followed by Disney's board, and the sheer size of the payout to Ovitz, rendered this "a close case." In the end, the Supreme Court affirmed the dismissal of the plaintiffs' complaint due to its "deficient pleading," but, in an important post-script, instructed the Chancery Court to grant the plaintiffs leave to amend.

After following the Supreme Court's advice to seek more facts through the exercise of shareholder inspection rights, the Disney plaintiffs returned with an amended complaint. The new complaint turned out to be enough for the Chancery Court—whose attitude toward the case seemed to have undergone a shift (as evident in the Court's critical asides about the possible impact of the friendship between Disney's CEO, Michael Eisner, and Ovitz on the favorable treatment that Ovitz received). Still, the net upshot of the Chancery Court's new decision was simply to postpone the day of reckoning for the Disney plaintiffs. After several years and a long trial, the Chancery Court, while remaining critical of the Disney directors—particularly Eisner—nevertheless gave judgment for the defendants, concluding that the directors' conduct was not so bad as to fall outside the protections of the business judgment rule. On appeal, the Delaware Supreme Court affirmed. Whether a similar fate awaits the claim regarding Prince's compensation in Citigroup remains to be seen.

In fact, judging from the track record of Delaware cases dealing with waste, the odds are extraordinarily slim that the Citigroup plaintiffs will ultimately succeed at trial in their claim based on Prince's compensation. As put by a highly regarded Delaware Chancery Court judge, Delaware cases in which courts, after a trial, actually concluded there was waste might be as difficult to find as the Loch Ness Monster. Hence, this part of the Citigroup opinion may be bluff and bluster.

In any event, neither the waste standard itself nor the application of this standard when dealing with Prince's termination package suggests much focus on the possible affect of compensation in encouraging excessive risk-taking. The inquiry is a crude one of whether the corporation received so little in exchange for the compensation that no reasonable business person would say the corporation got anything equal to what it paid. Consistent with this, the two unanswered questions about the letter agreement in Citigroup simply went to measuring the value of what Citigroup received for the $68 million. The court does not engage in the more subtle inquiry of whether Prince's compensation package, by cushioning the impact of his dismissal, may encourage excessive risk-taking by other Citigroup executives in the future. Indeed, in the Disney

156. In re Walt Disney Co. Derivative Litig., 906 A.2d 27.
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litigation, arguments that the Ovitz contract constituted waste because of its incentive impact received little sympathy.\textsuperscript{158}

B. The Structural Underpinnings of Weak Corporate Law

\textit{Citigroup} illustrates that results under Delaware corporate law are weaker in imposing liability upon directors and officers who take unreasonable risks than what we might expect from banking or other regulatory law. This leads one to ask what produces this outcome. Specifically, is there something structural acting upon the legislatures and courts which create and enforce corporate law that leads it to be inherently weaker than banking or other regulatory law?

1. Who Picked the Delaware Legislature and Courts to Make the Rules for \textit{Citigroup}?

As previously stated, whereas banking law has become essentially federal, corporate law in the United States is, for the most part,\textsuperscript{159} state law. Yet, this sentence understates the difference in a key way: It ignores the degree to which the state law regime in corporate law consists of a supermarket where those operating corporations can shop for the law they desire.

Corporate law in the United States follows what is known as the incorporation doctrine, under which persons can form corporations in states (such as the state of Delaware) other than one in which the company will conduct operations.\textsuperscript{160} What makes this significant is another doctrine generally followed

\begin{itemize}
\item \textsuperscript{158} The plaintiffs noted that, under the contract, Ovitz would actually do better financially by being terminated, so long as it was not for cause, than he would by staying on the job. The court responded that Ovitz hardly appeared to be trying to get himself dismissed but without giving cause within the meaning of the contract. The more subtle incentive problem—that such a contract gave Ovitz little incentive to provide optimum performance—is not an argument the court even recognized. \textit{In re Walt Disney Co. Derivative Litig.}, 906 A.2d 27.

\item \textsuperscript{159} Federal statutes have effectively nationalized various aspects of corporate law for public companies. For example, the Sarbanes-Oxley Act imposes requirements with respect to the audit committees of public companies. 15 U.S.C. § 78j-1 (2002) (amending Section 10A of the Securities Exchange Act). Despite these inroads, however, corporate law is predominately state law, particularly in the areas—liability for excessive risk-taking, limits on compensation, and selection of directors and officers—relevant to curbing excessive risk. E.g., \textit{Santa Fe Indus., Inc. v. Green}, 430 U.S. 462 (1977). The primary exceptions of relevance relate to the selection of directors. Here, there is federal regulation of proxy solicitations for public corporations under Section 14(a), and federal regulation of tender offers under Section 14(d) and (e), of the 1934 Securities Exchange Act. Indeed, pursuant to its authority to regulate the solicitation of proxies, the Securities Exchange Commission recently responded to the financial crisis by proposing to require companies provide greater disclosures about their risk oversight practices, including information as to the board’s role in risk management and the qualifications and experiences of directors and director nominees. E.g., Lipton, supra note 30. Whether such disclosure will actually change who gets elected to the board or the risk practices of the board, however, is another matter—and beyond the power of the Securities Exchange Commission under Section 14(a).

\item \textsuperscript{160} See, e.g., \textit{Model Business Corporations Act} § 3.02(10) (2003); \textit{Del. Code Ann. tit. 8, §§ 101(a), 102(a)(2) (1998). By contrast, many continental European nations traditionally operated under the view that corporations must be formed in the nation in which the company had its headquarters—variously called the

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in the United States, known as the internal affairs rule. Under the internal affairs rule, courts, for the most part, apply the law of the state of incorporation when it comes to issues of corporate law. The combination of the incorporation doctrine and the internal affairs rule means that parties forming a corporation can select which state’s corporate law they wish to govern their corporation largely unencumbered by concerns about where the company actually intends to conduct business.

The result of parties’ ability to choose their state of incorporation for its law has resulted in what Justice Brandeis famously labeled, a “race . . . not of diligence but of laxity.” Specifically, he noted how a number of smaller states had enacted less restrictive corporate laws in order to gain revenues from incorporation fees and franchise taxes. New Jersey was a pioneer in this endeavor, but after it retrenched under the reform leadership of then-governor Woodrow Wilson, Delaware became the leading state in attracting incorporation through so-called liberal corporation laws.

Of course, persons might choose to set up their banks in jurisdictions with less regulation. Indeed, this has become a concern with national, as opposed to international, bank regulation, in an era of increasing global finance. Moreover, to the extent that moving bank operations to avoid regulation has a significant impact on jobs and the like, jurisdictions may be more susceptible to engage in a race to the bottom than in corporate law, where the impact is largely limited to franchise fees and the like. This said, however, there presumably are much greater constraints on a firm’s willingness to attempt regulatory arbitrage when it must move actual banking operations to a potentially less desirable business location.

The focus of Justice Brandeis’ famous quote was on the demise of corporate size and activity limits, a subject which is now the concern of antitrust rather than corporate law. In more recent decades, the concern about Delaware and the race to the bottom has focused instead on the notion that the Delaware legislature and courts have sought to appeal to those who plan to be directors or controlling shareholders—who normally choose where to incorporate—by watering down

siege social, siege real, or seat theory. Under this view, a nation would reject the effort to incorporate under its law if the corporate headquarters would be in another nation, and a nation in which a firm had its headquarters would refuse to recognize the firm as a corporation—meaning, for example, the firm would lack the capacity to sue in this nation’s courts and its owners might face personal liability—unless the firm incorporated under this nation’s, rather than another nation’s, laws. E.g., Wulf-Henning Roth, From Centros to Uberseering: Free Movement of Companies, Private International Law, and Company Law, 52 INT’L & COMP. L.Q. 177, 180-85 (2003).


164. E.g., Posner supra note 37.
regulation on such persons. One example relevant to this Article is to reduce the prospects that directors will be held liable for breaching their duty of care to the corporation.

Commentators point to a number of constraints on Delaware’s ability to attract corporations by watering down regulations on corporate directors and controlling shareholders to an undesirable degree. One cynical theory postulates that Delaware has an interest in providing minority shareholder protections because the resulting litigation and extra planning creates work for the state’s corporate bar.

Another theory holds that the Delaware legislature and courts are limited in their protection of corporate directors and controlling shareholders by their concern that a backlash could provoke Congress to adopt federal standards. Under this view, it is no coincidence that the 2003 Chancery Court decision in Disney—which allowed continuation of the highly publicized litigation—followed both the corporate scandals at Enron, Worldcom and other companies in 2001 and 2002 and the Congressional reaction to those scandals with the enactment of the Sarbanes-Oxley Act in 2002. Indeed, as previously suggested, the one partial victory for the plaintiffs in Citigroup may be understood in this light. Specifically, this decision coincides with widespread public disgust at the large pay packages awarded to managers, like Charles Prince, whose actions led to bailouts at financial institutions.

The most important constraint from a normative standpoint, however, lies in the theory that the reticence of shareholders to invest in corporations formed under state laws that provide inadequate protection of their interest will deter companies from incorporating in states with suboptimal corporate laws. What is also important for purposes of this Article is that this theory largely focuses on protecting minority shareholders, rather than other parties who may be injured by management decisions. This, in turn, brings us to the ability of corporate law to protect non-shareholder interests injured by directors, including by the directors’ failure to prevent excessive risk-taking.


166. *Id.* at 683-84 (pointing to the Delaware Supreme Court’s decision refusing to find liability upon inattentive directors in *Graham v. Allis Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963), as evidence of the Delaware Supreme Court’s seeking to attract corporate charters).


172. *Id.*

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2. Shareholder Primacy

Debates over whether the purpose of a business corporation is to maximize shareholder wealth (within the limits of the law), or to advance the interests of all stakeholders in the firm (including creditors, employees and the broader community), often occur at such a level of abstraction as to make one wonder if there is any real legal impact. Even when the debate turns to the concrete question of whether directors breach their duty toward shareholders by acting to advance the interest of other stakeholders—the issue in the classic *Dodge* case— the board’s vast discretion under the business judgment rule removes much of the practical importance of the question. Nevertheless, the role of shareholder interests is so central to the structural and philosophical underpinnings of corporate law that it produces a real impact on the ability of corporate law to protect the interests of other stakeholders in the corporation.

The primacy of shareholder interests in corporate law manifests itself in a variety of critical ways when it comes to the tools for curbing excessive risk-taking. Short of insolvency, courts generally hold that directors lack any duty in corporate law to look out for the interests of other stakeholders in the corporation. Reinforcing this narrow view of duty, the law grants to shareholders, and not to other stakeholders, standing to sue for breach of duties under corporate law—at least unless the corporation is insolvent. Also, shareholder approval can significantly lower the degree of scrutiny applied by the court to the compensation of directors. Last, but certainly not least, corporate law places the power to select the directors in the hands of the shareholders.

This is not to say that those creating corporate law think corporations and their managers should run roughshod over the interests of others impacted by corporate actions. Instead, the issue is whether these are problems that corporate law should address, rather than problems for other laws to handle. Pervasive in corporate law is the notion that, except for certain abuses of limited liability, the protection of other stakeholders is the job of other laws. Hence, the

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177. *E.g.*, Michelson v. Duncan, 407 A.2d 211 (Del. 1979) (shareholder approval of compensation reduces review to the waste standard).

178. *See note 75 supra.*


overriding view of those creating and enforcing corporate law is to leave it to employment, labor, and occupational safety laws to protect workers; to consumer protection and contract laws to protect customers; to environmental and other laws to protect the community; and to banking law to protect depositors.

Indeed, given the free choice regime for state corporate law, it is difficult to see how the system could be otherwise. After all, who chooses the state of incorporation? While directors may desire a state law regime that grants them discretion to consider the interests of stakeholders beyond the shareholders, directors are unlikely to favor a regime which increases their potential problems by adding to those who might sue directors for breach of duty or might claim the right to vote on their removal.

Moreover, to the extent corporate law protects anyone other than directors in the decision of where to incorporate through the right to vote, or to vote with one’s feet, it is the shareholders. In the case of a reincorporation of a firm incorporated in one state to become a corporation organized under the laws of another state—a common route by which Delaware corporations are formed when companies go public, or later—it is the shareholders, not other stakeholders, who get a vote. It is the prospective shareholders who can refuse to invest based upon undesirable corporate law—a prospect arguably made realistic, even for the prospective shareholder ignorant of the intricacies of various state corporate law rules, by the impounding of the expected impact of these rules into the price of shares traded on efficient markets. Hence, state corporate law inexorably must focus on shareholder interests to the extent it does not bow before management interests.

All of this produces a system in which corporate law rules are permissive in the sense that they become viewed largely as default rules that shareholders can contract around. Section 102(b)(7) of Delaware’s General Corporation Law is a good example. As discussed above, this provision played a critical role in the dismissal in Citigroup, and provides a much weaker approach to liability for inattention than found in banking law. It became the governing law for Citigroup because the shareholders of Citigroup (or its predecessors) voted to amend its certificate to add a waiver allowed by Section 102(b)(7) or bought into a corporation with this in its charter. Yet, before the shareholders could make this

see Macey & O’Hara, supra note 37, at 102 (advocating a different rule for banks under which bank directors would have a fiduciary duty toward fixed claimants, such as depositors).


182. See, e.g., Bebchuk, supra note 171, at n. 143.

183. E.g., Winter, supra note 170, at 277. Perhaps publicly traded bonds might have a similar effect, but such an impact seems less plausible as one starts dealing with bank depositors.

choice, they made another: They either voted to become a Delaware corporation or bought into a Delaware corporation. Section 102(b)(7) stems from a third choice as well: Knowing that shareholders and those who would be directors decide where to incorporate, the Delaware state legislature voted to amend the state’s corporate law to add Section 102(b)(7).

Of course, Section 102(b)(7) is not without limits. Shareholders cannot waive claims for breach of the duty of loyalty or for acts not in good faith. On the other hand, one strongly suspects that shareholders who agree to waive liability for actions in which directors acted disloyally or in bad faith must not have understood the impact of the waiver. Hence, this limit may be little more than the corporate law equivalent to the notion that commercially unreasonable terms buried in the fine print of an adhesion contract that no one read may not be enforceable.\(^\text{185}\) Also, Section 102(b)(7) excludes claims for excessive dividends and the Delaware Supreme Court has stated that knowingly approving illegal conduct by the corporation violates the duty to act in good faith\(^\text{186}\)—both of which establish some protection of non-shareholder interests through corporate law that shareholders cannot waive. The instance of excessive dividends, however, is an elementary abuse of limited liability and it is presumably not worth the political capital to lobby for shareholders to possess the ability to waive corporate claims against directors who get caught engaged in illegal actions.

The various manifestations of shareholder primacy relevant to the tools of limiting excessive risk would be well and good if we assume that shareholder interests with respect to acceptable risk in a financial institution are consistent with societal interests. This, however, brings us back to the earlier discussion of the necessity for regulation of banks and other financial firms rather than relying on the shareholders’ self-interest in avoiding failure as sufficient protection against excessive risk. As discussed previously, underlying the existence of banking and other financial firm regulation is recognition of disconnects between shareholder and societal interests with respect to acceptable risks.

V. CONCLUSION

In comparing state created and enforced corporate law with banking and other national regulatory regimes, it is important not to fall victim to a “nirvana fallacy” of assuming the other system is always better. In fact, banking and financial regulatory regimes performed poorly in the years leading up to the financial crisis\(^\text{187}\) and some of this failure, no doubt, reflects structural weaknesses. Specifically, banking and other regulatory regimes are subject to

\(^{185}\) E.g., HOWARD J. ALPERIN & ROLAND F. CHASE, CONSUMER LAW SALES PRACTICE AND CREDIT REGULATION § 191 (2009).

\(^{186}\) In re Walt Disney Co. Derivative Litig., 906 A.2d at 67.

industry capture resulting, among other factors, from the revolving door phenomenon of individuals moving from the regulated private sector to regulatory agencies and back to the regulated private sector again, and from campaign contributions to elected officials from the regulated firms. More fundamentally, it may be asking too much for regulatory agencies, whose heads are political appointees, and whose budgets are subject to political process, to maintain rigorous enforcement in the face of a pervasive deregulatory philosophy among elected officials and the electorate at large.

Perhaps the ultimate conclusion is that there are structural weaknesses in both state corporate law as well as banking and regulatory regimes that render each a poor reed on which to prevent excessive risk-taking by financial firms. If so, then the conclusion may simply be that societies are doomed to endlessly repeat the cycle of excessive risk-taking and financial panic that stretches back at least eight hundred years. In that event, the contribution of this Article is entirely academic, but not unimportant, one of contributing to our understanding of the inherent limits of the law.

On the other hand, the traditions of this form of scholarship demand a normative proposal rather than simply a depressing pathology. Therefore, let us assume that changes can be made in order to avoid excessive risk-taking so that next time will be different. The question then becomes which law provides a better platform on which to work to make such changes. Put differently, in which law, corporate or banking, are the problems less structural and the necessary changes less difficult, and with less potential for unintended consequences?

There have been proposals in the past to end the “race to the bottom” in corporate law by enacting a national corporate law regime. There also have been proposals to change the shareholder focus of corporate law by establishing duties toward other stakeholders in the company. This could change the underlying structure of corporate law, which currently renders it inherently weak in using available tools to curb excessive risk-taking by financial firms. On the other hand, there are strong arguments against adopting such proposals for

189. E.g., Frank Rich, Op-Ed., Hollywood’s Brilliant Coda to America’s Dark Year, N.Y. TIMES, Dec. 13, 2009, at WK9 (observing that financial reform has been embattled on Capitol Hill, where the financial industry has spent $344 million on lobbying in the first three quarters of 2009).
190. Wayne Strumpfer, Address at the University of the Pacific, McGeorge School of Law Symposium: Local to Global: Rethinking Spheres of Authority after a World Financial Crisis (Oct. 16-17, 2009).
corporations generally. While the exploration of these arguments is well beyond the scope of this Article, their existence seemingly counsels for a more focused approach: If the problem lies with financial firms, then a solution limited to financial firms (in other words using banking law) seems wise.

By contrast, while also getting well beyond the scope of this Article, the problems of regulatory capture might be addressed, for example, by greater limitations on revolving door regulator-to-regulated employment, by an overlap of regulatory jurisdiction, or even by borrowing a page from corporate and securities law and facilitating private enforcement actions. Of course, these actions might have unintended negative consequences, but the question is a relative one of whether the potential untoward consequences are less than those possible from upending the key traditions of general corporate law for all companies.

Moreover, having banking law use all the available tools to curb excessive risk-taking, because state general corporate law is inherently weak, does not mean that banking law must provide the exclusive source of law. One could, as Congress did in enacting Section 1821(k), leave corporate law in play for those cases in which, perhaps, corporate law is more aggressive in curbing excessive risk than the banking law.

The bottom line is that banking legislation and banking regulators should move aggressively to use all the tools to curb excessive risk-taking, rather than rely on state general corporate law. To see how this might play out in concrete examples, we return one last time to Citigroup.

Beginning with compensation that promotes excessive risk-taking, cynics might suspect that the Delaware Chancery Court in Citigroup had in the back of its mind forestalling federal action in the area when it allowed the claim to proceed on the ex-CEO’s termination package. Regardless, the lesson of this Article is that the Federal Reserve was wise, in its recent proposal to regulate compensation, not to wait on state corporate law to address the problem.

Turning to the subject of liability for unreasonable risking taking, Congress already moved to a fair extent in this area in Section 1821(k) of the FIRREA. As discussed above, this section creates a minimum national standard for imposing liability on grossly negligent directors in actions brought by the FDIC on behalf

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194. E.g., ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 9 (1993) (arguing that the ability to chose corporate law through incorporating in Delaware has benefitted shareholders); Comm. On Corporate Laws, Am. Bar Ass’n, Other Constituencies Statutes: Potential for Confusion, 45 BUS. LAW. 2253, 2269 (1990) (discussing problems with extending directors’ fiduciary duty to benefit constituencies other than the shareholders).

195. E.g., Boone & Johnson, supra note 188.

196. E.g., James D. Cox, Professor of Law, Duke Univ. Sch. of Law, Address at the University of the Pacific, McGeorge School of Law Symposium: Local to Global: Rethinking Spheres of Authority after a World Financial Crisis (Oct. 16-17, 2009).

of failed banks. Significantly, part of the motivation for this provision lay in Congress' concern about states watering down liability standards in the wave of state corporate law legislation of which Section 102(b)(7) of the Delaware General Corporation Law was a part. The problem is that Section 1821(k) does not go far enough. It leaves the matter with state corporate law until the FDIC asserts an action in the right of a receiver of a failed bank or when FDIC money is used to save the bank. Even putting aside liability for directors and officers of a holding company (as in Citigroup) rather than a bank, by waiting to trigger the federal standard until the bank fails or the FDIC saves the bank, the statute leaves a gaping hole when a financial firm is bailed out by the Treasury Department or the Federal Reserve (rather than the FDIC) on the grounds it is "too big to fail." Indeed, this avoidance of more liability-conducive federal standards may compound the moral hazard problem in the too big to fail notion.

Finally, and most radically, perhaps it is necessary to rethink the importation for financial corporations of the corporate law norm that shareholders possess the exclusive power to elect directors. Germany and some other nations use a system in which employees have the right to elect a certain number of directors to the board. Perhaps a system in which bondholders, depositors, or the like, can elect a certain number of directors could temper the moral hazard afflicting financial corporations.

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198. E.g., F.D.I.C. v. McSweeney, 976 F.2d 532, 537-38 (9th Cir. 1992) (discussing legislative history of Section 1821(k)).

199. As discussed earlier, the tiered financing of the Citigroup bailout meant that the use of FDIC money depended on depth of Citigroup's losses.

200. E.g., Gevurtz, supra note 82, at 63-65.

201 See, e.g., 4 IND. LAW ENCYCL. BUILDING AND LOAN ASSOCIATIONS § 8 (2009) (discussing election of directors by depositors in mutual building and loan associations).