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The Corporate Governance of Banks

1. Introduction

Few public policy issues have moved from the wings to center stage as quickly and decisively as corporate governance.[1] Virtually every major industrialized country as well as the Organisation for Economic Co-operation and Development and the World Bank has made efforts in recent years to refine their views on how large industrial corporations should be organized and governed. Academics in both law and economics have also been intensely focused on corporate governance.[2] Oddly enough, despite the general focus on this topic, very little attention has been paid to the corporate governance of banks. This is particularly strange in light of the fact that a significant amount of attention has been paid to the role that the banks themselves play in the governance of other sorts of firms.[3] In this paper, we explain the role that corporate governance plays in corporate performance and argue that commercial banks pose unique corporate governance problems for managers and regulators, as well as for claimants on the firms' cash flows such as investors and depositors.

The intellectual debate in corporate governance has focused on two very different issues. The first concerns whether corporate governance should focus exclusively on protecting the interests of equity claimants in the corporation, or whether corporate governance should instead expand its focus to deal with the problems of other groups, called "stakeholders" or nonshareholder constituencies. The second issue of importance to corporate governance scholars begins with the assumption that corporate governance should concern itself exclusively with the challenge of protecting equity claimants, and attempts to specify ways in which the corporation can better safeguard those interests.

The Anglo-American model of corporate governance differs from the Franco-German model of corporate governance in its treatment of both issues. The Anglo-American model takes the view that the exclusive focus of corporate governance should be to maximize shareholder value. To the extent that shareholder wealth maximization conflicts with the interests of other corporate constituencies, those other interests should be ignored, unless management is legally required to take those other interests into account. The Franco-German approach to corporate governance, by contrast, considers corporations to be "industrial partnerships" in which the interests of long-term stakeholders—particularly banks and employee groups—should be accorded at least the same amount of respect as those of shareholders.[4] The Anglo-American model of corporate governance also differs from the Franco-German model in its choice of preferred solutions to the core problems of governance. Specifically, the market for corporate control lies at the heart of the Anglo-American system of corporate governance, while the salutary role of nonshareholder

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constituencies, particularly banks and workers, is central to the Franco-German governance model.

At the outset, we note that it is strange that paradigms of corporate governance differ on the basis of national boundaries rather than on the basis of the indigenous characteristics of the firms being governed. Of course, the extent to which either the Anglo-American model or the Franco-German model of corporate governance exists as more than theoretical constructs is a matter of debate. There is doubt about the extent to which the European system really protects the interests of nonshareholder constituencies, just as there is debate over whether the interests of U.S. management are as closely aligned with those of shareholders as is generally claimed. However, differences in corporate governance systems do exist. Moreover, the distinctions between these two paradigms of corporate governance are quite useful in framing the analysis in this paper.

We begin with an overview of the topic of corporate governance and proceed to a discussion of the particular corporate governance problems of banks. We embrace the view that a corporation is best defined as a complex web or "nexus" of contractual relationships among the various claimants to the cash flows of the enterprise.[5] The defining principle of American corporate governance is that an implicit term of the contract between shareholders and the firm is that the duty of managers and directors is to maximize firm value for shareholders. The legal manifestations of these contracts are the fiduciary duties of care and loyalty that officers and directors owe to shareholders.

Although we support the general principle that fiduciary duties should be owed exclusively to shareholders, we believe that the scope of the duties and obligations of corporate officers and directors should be expanded in the special case of banks. Specifically, directors and officers of banks should be charged with a heightened duty to ensure the safety and soundness of these enterprises. Their duties should not run exclusively to shareholders. Thus, we support a hybrid approach to corporate governance in which most firms are governed according to the U.S. model, while banks are governed according to a variant of the Franco-German paradigm. Our variant calls for bank directors to expand the scope of their fiduciary duties beyond shareholders to include creditors. In particular, we call on bank directors to take solvency risk explicitly and systematically into account when making decisions, or else face personal liability for failure to do so.

2. The Nature and Purpose of Corporate Governance

2.1 The Corporation as a Contract

The dominant model of corporate governance in law and economics is that the corporation is a "complex set of explicit and implicit contracts." In other words, one should view the corporation as nothing more (or less) than a set of contractual arrangements among the various claimants to the products and earnings generated by the business. The group of claimants includes not only shareholders, but also creditors, employee-managers, the local communities in which the firm operates, suppliers, and, of course, customers. In the case of banks, these claimants also include the regulators in their roles as insurers of deposits and lenders of last resort and in their capacity as agents of other claimants.

As Hart (1989, pp. 1757, 1764) observes, every business organization, including the corporation, "represents nothing more than a particular 'standard form' contract." The very justification for having different types of business organizations is to permit investors, entrepreneurs, and other participants in the corporate enterprise to select the organizational design they prefer from a menu of standard-form contracts. The virtue of the standard-form arrangement characteristic of modern corporate law is that it reduces transaction costs by allowing the participants in the corporate enterprise to take advantage of an arrangement that suits the needs of investors and entrepreneurs in a wide variety of situations.

The nexus-of-contracts approach implies that no particular set of contractual outcomes is ideal for every firm. Because contracts define each participant's rights, benefits, duties, and obligations in the corporate endeavor, there is no necessary presumption that any one class of claimants has preference over any other. Instead, each claimant or group of claimants deserves to receive only the exact benefits of the particular bargain that it has struck with the firm, no more and no less. What claimants have bargained for, however, may differ enormously from firm to firm, depending on a complex set of exigencies.[6] As we discuss below, the notion that no class of claimants should have preference over another is fundamentally at odds with the notion that shareholders and shareholders alone should benefit from fiduciary duties.

2.2 The Economic Nature and Purpose of Fiduciary Duties

On a theoretical level, the problems of corporate governance result from the existence of incomplete contracts. The rules of corporate governance are aimed at resolving the gaps left in these contracts in ways consistent with maximizing the value of the firm. In the case of shareholders' contingent contracts in the United States, these background rules are called fiduciary duties.

The economic justification for having fiduciary duties is straightforward: "Fiduciary duties are the mechanism invented by the legal system for filling in the unspecified terms of shareholders' contingent [contracts]."[7] The creation of a contract covering all possible contingencies is impossible between shareholders and boards of directors. Relying only on an incomplete contract to define the relationship between shareholders and directors would lead to unacceptably high monitoring costs on both sides. The presence of fiduciary duties attempts to address these contingencies. In this gap-filling role, fiduciary duties essentially call on directors to work hard and to promote the interests of shareholders above their own.

We argue that, to the extent that fiduciary duties lower agency costs by reducing the freedom of management to act in its own unconstrained self-interest, such duties will be especially valuable devices in the banking context because of the inherent difficulties in monitoring banks. Not only are bank balance sheets notoriously opaque, but as Furfine (2001) points out, "rapid developments in technology and increased financial sophistication have challenged the ability of traditional regulation and supervision to foster a safe and sound banking system."

Under Delaware law, directors are charged with the responsibility of managing and supervising the business and affairs of the corporation. "In discharging this function, the directors owe fiduciary duties . . . to the corporation and its shareholders."[8] These duties include the duty of care and the duty of loyalty. If these duties are breached, directors may be held personally liable for any damages caused by the breach.

The duty of care requires that directors exercise reasonable care, prudence, and diligence in the management of the corporation. Director liability for a breach of the duty of care may arise in two discrete contexts. First, liability may flow from "ill advised or negligent" decisionmaking. Second, liability may be the result of failure of the board to monitor in "circumstances in which due attention would, arguably, have prevented the loss." [9] Significantly, in both classes of cases, directors are entitled to rely on information, reports, statements, and opinions prepared by the company's officers and directors as well as outside consultants. However, the ability of directors to rely on others does not absolve them of their responsibility to make independent business decisions; directors are only "entitled to good faith, not blind, reliance" on experts.[10]

The danger inherent in the first class of cases is that directors may be held liable for "honest but mistaken judgment calls"[11] when their decisions are judged in hindsight. This would result in an unacceptable intrusion on directors' anonymity. Courts have long recognized the risks associated with judging directors' decisions retrospectively. The courts have responded by developing what is known as the Business Judgment Rule.

Under the Business Judgment Rule, courts presume that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company."[12] When the Business Judgment Rule applies, the plaintiff carries the burden of rebutting the presumption in favor of sound business judgments by showing that the directors were not sufficiently well informed, the directors could not rationally believe that the decision was in the best interest of the shareholders, or the decision was not made in good faith.

Courts examine the process by which the decision was made and not the end result of the particular decision. In other words, "even though a decision made or a result reached is not that of the hypothetical ordinary prudent person, no liability will attach as long as the decision-making process meets the [appropriate] standard."[13] The "business judgment" of a majority of the directors "will not be disturbed if they can be attributed to any rational business purpose"[14] and absent fraud, illegality, or a conflict of interest. Accordingly, the Business Judgment Rule substantially reduces the risk that directors will be held liable for simple mistakes of judgment.

Along with adopting the Business Judgment Rule, many states have rejected the simple negligence standard of care. For example, provided that the decision was made in good faith, Delaware courts do not allow plaintiffs to recover unless they can show that a director acted with gross negligence. In this context, "gross negligence would appear to mean, 'reckless indifference to or a deliberate disregard of the stockholders,'[15] or actions which are 'without the bounds of reason.'[16] These articulations arguably provide a higher threshold for liability than does the definition of gross negligence in general tort law."

The second context in which directors can find themselves liable for breach of the duty of care involves "circumstances in which a loss eventuates not from a decision but, from unconsidered inaction." In other words, the duty of care not only requires directors to make careful decisions, it also requires them to take affirmative steps toward monitoring the operations of the firm.[17] In *In re Caremark International Inc. Derivative Litigation*, a Delaware court considered a claim involving the misfeasance of directors and the extent of directors' duty to monitor the ongoing operations of the firm's business and performance. The original complaint in *Caremark* alleged in part "that Caremark's directors breached their duty of care by failing adequately to supervise the conduct of Caremark employees, or institute corrective measures, thereby exposing Caremark to fines and liability."

The court first noted that "absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf." The court went on to reason that it is an "elementary fact that relevant and timely information is an essential predicate for satisfaction of the board's supervisory and monitoring role" of the Delaware law. Thus, the court held that the duty of care imposes an ongoing responsibility on directors to monitor a firm's compliance with the law as well as its business performance. Specifically, corporate boards must implement and maintain information and reporting systems reasonably designed to provide timely and accurate information to allow the board to reach informed decisions.

Interestingly, the level of detail required for an information and reporting system is a matter of business judgment, and so the Business Judgment Rule protects directors' decisions regarding the specific design and implementation of a firm's information and reporting system. The court also recognized that no system completely eliminates the possibility of wrongdoing or violations of the law. Directors are simply required to exercise a good-faith judgment in deciding what sort of oversight is appropriate for their firm. Thus, "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."

A board of directors also owes a fiduciary duty of loyalty to the corporation and its shareholders. The Delaware Supreme Court has characterized the duty of loyalty as "the rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest." [18] Until the last part of the nineteenth century, the "undivided and unselfish loyalty" mandated by the duty of loyalty meant that, upon the insistence of the shareholders or the corporation, any business transaction involving a director and the corporation was automatically voidable, regardless of the fairness of the transaction. Today, however, this is no longer the case.

In recognition of the fact that self-interested transactions between board members and a corporation are often advantageous to the corporation and its shareholders, courts generally allow for such transactions under limited circumstances. For instance, in Delaware, the common law requires the application of an intrinsic fairness test. In *Marciano v Nakash*, the court held that an interested director transaction must be upheld when the transaction is intrinsically fair. This test takes into account the interests of the corporation and its shareholders as well as the motives of the director for entering into the transaction.

Prior to this paper, no attempt has been made to determine whether this solution applies with equal force to all sorts of firms. We argue that the case for making shareholders the exclusive beneficiaries of directors' fiduciary duties is particularly weak in the context of banks.

2.3 To Whom Should Fiduciary Duties Be Owed?

The standard law and economics view regarding fiduciary duties is that corporations and their directors owe fiduciary duties to shareholders and to shareholders alone. There has been much debate over the issue of whether shareholders should be the exclusive beneficiaries of directors' fiduciary duties. The dominant view in the United States is that needless complexity would result if corporations were required to serve the interests of groups other than shareholders. Specifically, corporate practitioners point out that if directors must serve constituencies other than shareholders:

> The confusion of . . . trying to . . . require directors to balance the interests of various constituencies without according primacy to shareholder interests would be profoundly troubling. Even under existing law, particularly where directors must act quickly, it is often difficult for directors acting in good faith to divine what is in the best interests of shareholders and the corporation. If directors are required to consider other interests as well, the decision-making process will become a balancing act or search for compromise. When directors must not only decide what their duty of loyalty mandates, but also to whom their duty of loyalty runs (and in what proportions), poorer decisions can be expected.[19]

Academics who approach this issue from a law and economics perspective reach the same result as the corporate bar. As Easterbrook and Fischel (1983) observe:

> As the residual claimants, the shareholders are the group with the appropriate incentives . . . to make discretionary decisions. The firm should invest in new products, plants, etc., until the gains and costs are identical at the margin. Yet all of the actors, except the shareholders, lack the

appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion.

Accordingly, the Anglo-American model takes the view that the exclusive focus of corporate governance should be to maximize shareholder value.

There is a conflict between the argument that shareholders are the exclusive beneficiaries of fiduciary duties and the idea that a corporation is merely a nexus of contracts, with no set of claimants having any a priori rights in relation to any other. After all, if a corporation is simply a complex web of contracts, the various participants to the corporate venture should be able to contract among themselves to obligate the directors to serve broad societal interests, the interests of the firm's workers, or the interests of any other nonshareholder constituency. By contrast, fiduciary duties do not appear to be subject to negotiation. There is a single one-size-fits-all solution: the parties should write the corporate contract such that the shareholders always win. Accordingly, one cannot consistently claim that the corporation is defined by the contractual relationships that exist among shareholders, employees, managers, suppliers, customers, creditors, and others, while simultaneously arguing that these contractual provisions must always subordinate the claims of nonshareholder constituencies to the claims of the shareholders because shareholders are the exclusive beneficiaries of nonwaivable fiduciary duties.

There are many situations in which nonshareholder constituencies such as uninsured depositors in banks might value a particular contractual right or protection more than shareholders value it. One obvious example is when the social costs of an outcome exceed the private costs of an outcome. This negative-externality problem is particularly relevant for banking because an individual bank failure can affect the operation of the entire banking system. Similarly, in the banking context, depositors' savings (or strong governmental interests) are at stake. In effect, there is a public interest dimension to the banking firm that vitiates the exclusive claims that its shareholders typically bring to the attention of directors.

In practice, corporate contracts often subordinate the claims of shareholders to those of nonshareholder constituencies. Banks, bondholders, and other fixed claimants commonly negotiate contractual protections for themselves to curb the ability of shareholders to access the cash flows of the corporation. Corporations in search of capital routinely agree to restrict their ability to make investments, loans, or other extensions of credit as a condition of receiving funds from lenders. Consequently, despite the appearance of intractability, fiduciary duties are simply another default rule that operates in the shadow of express contractual agreements and that shareholders and nonshareholder constituencies can customize as they please.

Thus, the way to reconcile the tension between the idea that fiduciary duties are exclusive and nonwaivable and the idea that the corporation is a nexus of contracts is to recognize that shareholders can, in fact, waive fiduciary duties by ex-ante agreement. Parties can make deals ex ante to change the default terms described by fiduciary duties. Corporate law establishes procedural rules to assure that the ex-ante agreement meets standard contractual prerequisites, such as requiring relative parity of bargaining power and forbidding fraud in the inducement. Beyond that, parties are free to make deals that carve into the fiduciary rights of shareholders. Shareholders can modify the terms of fiduciary duties both by crafting particularized definitions of fiduciary duties and by expressly providing that officers and directors can engage in certain actions, even if such actions clearly would breach the fiduciary duties in the absence of such an agreement.

Because shareholders are residual claimants, the fiduciary duties owed to shareholders are themselves nothing other than a special form of residual claim. Critically, in this context, the residual does not mean residual cash flows. Instead, the concept of the residual claim captures the idea of residual legal rights. Just as the standard default terms of corporate law provide that shareholders are entitled to the firm's residual cash flows after the financial claims of fixed claimants have been satisfied, so too are shareholders entitled to the residual legal rights that remain after the nonshareholder constituencies' agreements with the corporation are satisfied.

2.4 Separation of Ownership and Control

The problem of corporate governance is rooted in the Berle-Means (1932) paradigm of the separation of shareholders' ownership and management's control in the modern corporation. Agency problems occur when the principal (shareholders) lacks the necessary power or information to monitor and control the agent (managers) and when the compensation of the principal and the agent is not aligned. Several factors work to reduce these principal-agency costs. The "market for managers" penalizes management teams that try to advance their own interest at shareholders' expense.[20] Shareholders also can mitigate manager conflicts by creating incentive-compatible compensation arrangements.[21] And, of course, competition in product markets and capital markets constrains managers. Most importantly, the market for corporate control aligns managers' incentives with those of shareholders by displacing inept or inefficient management through hostile takeovers.

One possible solution to the agency cost problem is to give shareholders direct control over management. This is the case when management and shareholders are the same party and control rights automatically rest in the hands of shareholders. However, some specific problems arise when shareholders seek to exercise control. When shareholders are widely dispersed, free-rider problems prevent shareholders from exerting meaningful constraints on management. Problems also arise when large shareholders participate in management. Large shareholders may face conflicts of interest that undermine their incentives to maximize firm value. For example, they may enjoy private benefits of control that distort their decision-making. Alternatively, large shareholders may themselves be part of organizations that face governance problems, such as (public) pension funds.

Although these are potentially powerful concerns about the effectiveness of shareholder control, recent research suggests that more fundamental trade-offs may guide the desired involvement of shareholders in corporate control. Burkhart, Gromb, and Panunzi (1997), for example, show that direct shareholder control may discourage new initiatives on the part of managers.

These observations are consistent with real-world corporate governance arrangements, which almost without exception limit direct shareholder involvement. In some cases—particularly in the United States—this is facilitated by relatively dispersed ownership. This limits direct shareholder involvement to at most periodic interference via proxy fights, hostile takeovers, or other mechanisms that seek to mobilize shareholders. In the Continental European context, concentrated ownership is the norm. However, such centralized ownership does not readily translate into greater shareholder control. In some countries (Germany and southern Europe) cross-holdings and pyramid structures shield firms from shareholders. Also, nonexecutive directors (or supervisory boards in a two-tier system) may shield management from direct shareholder involvement. In countries like the Netherlands—and, to a lesser extent, Germany—rather autonomous supervisory boards operate semi-independently from shareholders and effectively shield management from direct shareholder involvement (see Allen and Gale [2000] for a discussion of alternative governance structures).

Banks are organized in a variety of ways, from stand-alone corporate entities and single bank holding companies to multiple bank holding companies and the post–Gramm-Leach-Bliley Act (GLBA) diversified holding company. To the extent that some of the largest U.S. banks, like Citibank and Bank of America, are wholly owned subsidiaries of holding companies, these banks will not resemble the prototypical U.S. corporation in which ownership is divorced from control along the lines described by Berle and Means. For regulatory reasons, holding companies that include banks within their structures typically operate their nonbanking business lines, such as stock brokerage and insurance, through nonbank subsidiaries. Thus, holding companies that contain banks also can contain a portfolio of other firms.

This diversified structure permits such holding companies to reduce or eliminate the firm-specific risks associated with the banks they own. The GLBA significantly enhanced this diversification ability by permitting bank holding companies and certain other restricted firms to become a new entity: a financial holding company (FHC). FHCs may engage in any activity that is financial in nature, incidental to a financial activity or complementary to a financial activity. Thus, for the first time, securities trading, underwriting, insurance, and traditional banking activities can be conducted within a single holding company. Significantly, the GLBA is much more liberal about the scope of activities permitted at the holding company level than at the bank level. In addition, the statute explicitly incorporates a corporate governance perspective by requiring that a depository institution be "well managed" as a condition for engaging in expanded activities.

This dispersion of activity throughout the holding company structure also gives incentives to bank holding companies to put more risky behavior in their federally insured banks. To combat this problem, the Federal Reserve developed and applied a regulatory doctrine to require bank holding companies to provide financial strength to their bank subsidiaries.[22] The "source-of-strength" doctrine requires that bank holding companies maintain (and use) enough financial resources to aid their bank subsidiaries in case they experience financial difficulties. This doctrine reflects recognition of the fact that bank creditors need protection beyond what is provided by commercial law. The Supreme Court of the United States embraced the theory behind the source-of-strength doctrine in *Board of Governors v First Lincolnwood Corporation*.[23] A subsequent lower court decision called into question the statutory power of the Federal Reserve to issue the source-of-strength regulation.[24] However, regulators have continued to increase bank holding companies' financial obligations to their bank subsidiaries.

The holding company structure, with its concentration of ownership oversight, does have the potential to provide a greater ability to monitor the actions of the bank. Such board oversight takes on particular importance given the fact that increasing cross-border activity and greater intricacy of financial products have greatly increased the complexity of financial institutions. Recent regulatory reforms in the GLBA have also increased the need for board monitoring. The GLBA explicitly places greater reliance on corporate governance mechanisms to oversee the actions of the financial enterprise.

3. Special Problems of Banks

The discussion so far has focused on a general overview of corporate governance. We now turn to the specific problems of banks and attempt to address why the scope of the duties and obligations of corporate officers and directors should be expanded in the case of banks. Our argument is that the special corporate governance problems of banks weaken the case for making shareholders the exclusive beneficiaries of fiduciary duties. Our focus here is on establishing why banks are not like other firms and thus why they should be treated differently.

3.1 The Liquidity Production Role of Banks

Many different types of firms extend credit. Similarly, a variety of nonbank firms, most notably money market mutual funds and nonbank credit card companies, offer the equivalent of a check transaction account. What distinguishes banks from other firms is their capital structure, which is unique in two ways. First, banks tend to have very little equity relative to other firms. Although it is not uncommon for typical manufacturing firms to finance themselves with more equity than debt, banks typically receive 90 percent or more of their funding from debt.

Second, banks' liabilities are largely in the form of deposits, which are available to their creditors/depositors on demand, while their assets often take the form of loans that have longer maturities (although increasingly refined secondary markets have mitigated to some extent the mismatch in the term structure of banks' assets and liabilities). Thus, the principal attribute that makes banks as financial intermediaries "special" is their liquidity production function. By holding illiquid assets and issuing liquid liabilities, banks create liquidity for the economy.[25]

The liquidity production function may cause a collective-action problem among depositors because banks keep only a fraction of deposits on reserve at any one time. Depositors cannot obtain repayment of their deposits simultaneously because the bank will not have sufficient funds on hand to satisfy all depositors at once. This mismatch between deposits and liabilities becomes a problem in the unusual situation of a bank run. Bank runs are essentially a collective-action problem among depositors. If, for any reason, large, unanticipated withdrawals do begin at a bank, depositors as individuals may rationally conclude that they must do the same to avoid being left with nothing. Thus, in a classic prisoner's dilemma, depositors may collectively be better off if they refrain from withdrawing their money, but their inability to coordinate their response to the problem can lead to a seemingly irrational response—depositors rush to be among the first to withdraw their funds so that they can obtain their money before the bank's cash reserves are drained.

Critical to this analysis is the fact that failures can occur even in solvent banks. Thus, one argument used to justify special regulatory treatment of banks is that the collective-action problem among bank depositors can cause the failure of a solvent bank. Deposit insurance is often justified on the grounds that it solves this problem by eliminating the incentive for any single depositor to rush to demand repayment of his deposits.

3.2 The Deposit Insurance Fund

In the wake of the mass failure of depository institutions, Congress passed the Banking Act of 1933, establishing the Federal Deposit Insurance Corporation (FDIC) and giving the federal government the power to insure deposits in qualified banks. The creation of federal deposit insurance has been tremendously effective in preventing bank runs and keeping the failure of individual banks from affecting the larger economy. Deposit insurance "has succeeded in achieving what had been a major objective of banking reform for at least a century, namely the prevention of banking panics."[26]

Despite the positive effect of FDIC insurance on preventing bank runs, the implementation of deposit insurance poses a regulatory cost of its own—it gives the shareholders and managers of insured banks incentives to engage in excessive risk-taking. This moral hazard occurs for two reasons. First, bank shareholders are able to foist some of their losses onto innocent third parties. These third parties are the healthy banks whose contributions to the FDIC pay off depositors of failed banks, and ultimately the federal taxpayers whose funds replenish the federal insurance funds when they are depleted. Second, moral hazard is also present because "deposit insurance premiums have been unrelated to, or have not fully compensated the FDIC for increased risk posed by a particular bank."[27]

The problem of moral hazard is exacerbated in situations where a bank is at or near insolvency. In such a situation, the shareholders have a strong incentive to increase risk because they can allocate their losses to third parties while still receiving any gains that might result from the risky behavior. Companies outside the banking industry that are close to insolvency also have an incentive to take added risks. However, their ability to do so is limited by normal market forces and contractual obligations. Nonfinancial firms that are in financial distress usually have significant liquidity problems. Nearly insolvent banks, however, can continue to attract liquidity in the form of (government-insured) deposits. Federal insurance eliminates the market forces that starve nonfinancial firms of cash. The federal government has attempted to replace these market forces with regulatory requirements such as capital requirements. Higher capital requirements force shareholders to put more of their money at risk, and this reduces moral hazard. In the context of our previous discussion of contracts, capital requirements allow one set of claimants—the regulators (or deposit insurers)—to impose restrictions on the shareholders.

3.3 The Conflict between Fixed Claimants and Shareholders

A conflict between the interests of debtholders and the interests of shareholders exists in every firm. Among any particular set of asset allocation decisions, any investment strategy that increases risk will transfer wealth from the fixed claimants to the residual claimants. This problem is raised to a new dimension in the banking context because of the high debt-to-equity ratio and the existence of deposit insurance.

In the publicly held corporation, the problem of excessive risk-taking is mitigated by two factors. First, various devices serve to protect fixed claimants against excessive risk-taking. Corporate lenders typically insist on protection against actions by corporate managers that threaten their fixed claims. Second, risk-taking is reduced to some extent because managers are not perfect agents of risk-preferring shareholders. Managers are fixed claimants to that portion of their compensation designated as salary. In addition, managerial incentives for risk-taking are reduced, since managers have invested their nondiversifiable human capital in their jobs. This capital would depreciate significantly in value if their firms were to fail.

The second risk-reducing factor—the fact that managers tend to be more risk-averse than shareholders—is present for commercial banks as well as other corporations. What makes banks fundamentally different from other types of firms, however, is the lack of significant discipline of other fixed claimants. FDIC insurance removes any incentive that insured depositors have to control excessive risk-taking because their funds are protected regardless of the outcomes of the investment strategies that the banks select. In a world without deposit insurance, depositors would demand that banks refrain from engaging in risky investment strategies or else demand that they be compensated in the form of a higher interest rate for the extra risk. Thus, depositors of insured financial institutions cannot be expected to exert the same degree of restraint on excessive risk-taking as other fixed claimants, and this enhances the degree of influence exerted by shareholders, whose preference is to assume high levels of risk. The adverse incentive for risk-taking caused by federal insurance is one reason to have stricter accountability requirements for directors of banks.

3.4 Asset Structure and Loyalty Problems

The presence of a federal insurance fund also increases the risk of fraud and self-dealing in the banking industry by reducing incentives for monitoring. In the 1980s, it was estimated that fraud and self-dealing transactions were “apparent” in as many as one-third of today’s bank failures.[28] A similar statistic shows that between 1990 and 1991, insider lending contributed to 175 of 286 bank failures.[29] Such behavior, of course, is a possibility in any large firm, since it is inefficient for owners to monitor all employees at all times. These sorts of problems are particularly acute in financial institutions, however, because of the large portion of their assets held in highly liquid form.

The same regulatory structure that creates a problem of excessive risk-taking by banks also leads to a reduction in the normal levels of monitoring within the firm, resulting in a higher incidence of bank failures due to fraud. Not only does the protection afforded by the FDIC remove any incentive for insured depositors to control excessive risk-taking, it also removes their incentive to monitor in order to reduce the incidence of fraud and self-dealing.

Shareholders have an incentive to monitor to prevent fraud and self-dealing in banks, but such monitoring is notoriously ineffective in many cases because individual shareholders rarely have sufficient incentives to engage in monitoring because of collective-action problems. Outside the banking setting, fraud and self-dealing are monitored by fixed claimants and preferred shareholders through contractual devices and by lenders through regular oversight of their borrowers’ affairs.

One might argue that FDIC insurance simply replaces one set of creditors: depositors, with another set of creditors: state and federal regulators. These other creditors might appear more financially sophisticated than rank-and-file depositors and thus appear in a better position to conduct the monitoring necessary to prevent bank fraud. The fact that both federal and state regulators require periodic reports from banks and conduct on-site inspections of bank premises supports this contention.

In addition to regulators' power to monitor banks through reports and examinations, upon the discovery of a fraudulent banking practice—or indeed a practice that regulators deem to be "unsafe or unsound"—the appropriate federal banking agency may order the activity terminated. Courts have determined that the term "unsafe banking practice" may be liberally construed to give the relevant bank regulator discretion to correct perceived problems in their infancy. Under the Federal Deposit Insurance Corporation Improvement Act, regulatory agencies were required to issue guidelines or regulations creating standards for safety and soundness in the following areas: 1) internal controls, information systems, and internal audit systems, 2) loan documentation, 3) credit underwriting, 4) interest rate exposure, 5) asset growth, 6) compensation, fees, and benefits, and 7) asset quality, earnings, and stock valuation.[30]

Regulators have five main enforcement tools: cease and desist powers, removal powers, civil money penalty powers, withdrawal or suspension of federal deposit insurance powers, and prompt corrective-action powers. Cease and desist powers generally address both unsafe and unsound banking as well as violations of the law or regulations governing depository institutions. These powers allow regulators to issue injunctions as well as to take corrective actions against banks. Bank regulators also may remove officers and directors from their posts, or ban them from ever working for a depository institution in the United States, if they can show that the individual acted unlawfully, received a personal benefit, or acted in a manner detrimental to the bank or its depositors.

Federal banking agencies also have the power to impose civil monetary penalties against a banking institution and its affiliates. Prompt corrective-action powers are also triggered by capital requirements, and these allow regulators to reach every significant operational aspect of a bank. Finally, the FDIC has the authority to revoke a bank's depositor insurance if necessary. Thus, the problem with the current system—which substitutes government regulators for private-sector creditors as the primary monitors of bank activity—is not that the regulators lack the administrative authority to do an effective job.

Nevertheless, replacing private-sector creditors with public-sector regulators as the first line of defense against bank fraud and self-dealing presents two problems.[31] Private-sector creditors have stronger incentives than public-sector regulators to monitor closely for fraud and self-dealing. Because the creditors' own money is on the line, they will monitor until the losses avoided from such monitoring equal the marginal cost of such activity. In addition, if a competitive market for bank services exists, those bankers that can develop mechanisms for providing depositors and creditors with credible assurances that they will refrain from fraudulent activities will thrive at the expense of their competitors.

4. Bank Corporate Governance: What Standard to Apply?

Our analysis thus far has reviewed the various paradigms of corporate governance and analyzed the special features of banks as corporations. We now turn to our central issue: the nature of bank corporate governance. Previously, we observed that all directors owe fiduciary duties to the corporation and its shareholders, and that these duties include the duty of care and the duty of loyalty. We have also argued that the particular nature of banking makes it susceptible to greater moral hazard problems than a typical firm is. In this section, we maintain that the special nature of banking dictates that the duty of care owed by bank directors is more extensive than that of other directors. The courts have vacillated in their interpretations of this duty, resulting in confusion over the appropriate standard to apply.

The duty of care has a long and controversial history in banking. The first case to articulate the modern "tort-based duty of care for bank directors" was *Briggs v Spaulding.*[32] In *Briggs*, the president of the First National Bank of Buffalo caused the bank to become insolvent by making illegal and unsound loans to himself, members of his family, and third parties with little or no financial credibility. The bank's directors "gave no attention whatever to the management of the bank's business," but instead relied on the president to conduct and manage the affairs of the bank. The bank's receiver ultimately sued several of the bank's officers and directors, alleging that the bank had suffered losses as a result of "the misconduct of the officers and directors" and their failure "to perform faithfully and diligently the duties of their office." In determining the standard of care required of banking directors, the court held that, "directors must exercise ordinary care and prudence in the administration of the affairs of a bank," which requires "something more than officiating as figure-heads." Thus, by requiring that directors of depository institutions exercise "ordinary care" in conducting the affairs of a bank, *Briggs* established "a federal common law standard of simple negligence for directors of federally chartered and federally insured depository institutions."

In setting this standard of care, however, the *Briggs* Court recognized that there are costs to setting fiduciary standards too high: "One must be very careful . . . not to press so hard on honest directors as to make them liable for these constructive defaults, the only effect of which would be to deter all men of any property, and perhaps all men who have any character to lose, from becoming directors of companies at all."[33]

From *Briggs*, the history of banking directors' duty-of-care cases follows a cyclical pattern. During or immediately following a period of high bank failure, courts have traditionally raised the standard of care required of bank directors and curtailed the effects of the Business Judgment Rule. The courts, during such a period, have turned away from the traditional formulation of the Business Judgment Rule, which looks only at the decision-making process, and instead have looked at the substance of the decision and its end result. For example, in the wake of the Great Depression, the failure of thousands of banks, and the advent of federal deposit insurance, bank directors were held to a higher standard than nonbank directors.

Interestingly, the courts' justification for holding directors to a higher standard was grounded in the fact that bank shareholders needed protection from the increased risks of personal liability caused by statutory and contractual arrangements prevalent during the first half of the nineteenth century. These arrangements imposed greater liability on shareholders of banks than shareholders of other corporations, whose risk of loss did not extend beyond the amount of their original capital contribution.

New Hampshire and Pennsylvania imposed joint and several liability on bank shareholders early in the nineteenth century. The laws of other states imposed double liability on all corporate shareholders. These rules required shareholders to pay up to the amount of their original investment into the estate of the insolvent bank. During the 1840s and 1850s, some southern state legislatures made the granting of special banking charters subject to a requirement that the shareholders would be liable for their pro-rata share of the bank's debts in case of insolvency. Some banks established double shareholder liability by means of charter provisions. A number of states, including New York, Kansas, Iowa, Indiana, and Minnesota, adopted double liability rules in their constitutions.

Congress drew on these state provisions when, in the National Banking Act of 1863, it established a system of national banks and provided that "each shareholder shall be liable to the amount of the par value of the shares held by him, in addition to the amount invested in such shares."[34] Senator Sherman, who proposed the provision, explained that it tracked the laws of "most of the States of the Union"[35] and that the goal was to give bank creditors "something more than the stock to fall back upon." Looking back on the statute the following year, Sherman explained that in addition to providing security for creditors, the double liability provision "tends to prevent the stockholders and directors of a bank from engaging in hazardous operations."[36] A revision of 1864 added that the shareholders would be liable "equally and ratably, and not one for the other." This meant that no shareholder could be assessed for more than his or her pro-rata share, even if other shareholders were insolvent or beyond the jurisdiction of the court.

Following the implementation of the federal double liability system, states continued to adopt similar programs for their state-chartered banks; by 1931, almost all states had implemented double liability rules for bank shareholders. California's law made no mention of any limit of liability to par value, and Colorado imposed triple liability.

The wave of bank failures that occurred between 1929 and 1933 placed heavy strains on the double liability system and ultimately precipitated its downfall. Shareholders were assessed in large numbers at a time when many were already in serious financial difficulty. Meanwhile, the dispersal of bank shares among the public, which had progressed rapidly during the economic boom of 1923-29, meant that many of the shareholders being assessed had no insider connection to the failed bank, either by way of family relationships or employment status. Many had purchased their shares in prosperous times without serious consideration of their potential liability in the event of bank failure. Enforcing schemes of nonlimited liability also reduced the liquidity of secondary markets in bank stock by requiring shareholders to engage in costly cross-monitoring.

These factors resulted in political pressure during the 1930s to repeal double liability or blunt its force. Following—or perhaps inciting—the public dismay, the consensus of scholarly opinion as reflected in the law journals turned sharply against double liability after 1929. As one author noted in 1936, the double liability "effectively bankrupts many innocent stockholders who have taken no part in the active management and control of the bank."[37] By 1944, the tide had turned so far against double liability that the Supreme Court was roundly lambasted in much of the popular press for upholding an assessment of shareholders of a holding company for the liabilities of a failed subsidiary bank—a result that would almost certainly have received widespread acclaim twenty years earlier.[38]

Bolstering the objection to double liability was the widespread perception that double liability failed to fulfill its intended purpose.[39] Notwithstanding double liability, thousands of banks had failed and the nation had plunged into an unprecedented economic catastrophe. Double liability, despite its venerable heritage, seemed "inadequate as a means of protecting the depositing public."

The third and decisive factor contributing to the downfall of double liability was the establishment of federal deposit insurance in the Banking Act of 1933. At the time, most observers believed that government deposit insurance was a far more effective remedy for the problems of the banking system than the outmoded system of double liability—an evaluation borne out by the success of federal deposit insurance at stopping bank runs.

In 1933, Congress repealed double liability for newly issued national bank shares; and in 1935, it prospectively extinguished all double liability for national bank stock provided that a bank gave six months' notice of termination. Federal double liability was all but moribund after 1934. By 1953, all but 25 of the nearly 5,000 national banks had published the required notice and opted out of double liability. Congress eliminated the double liability of these few holdovers in 1953, thus bringing ninety years of double liability for national banks to a formal close.

State legislatures also dismantled their double liability systems after 1930. Iowa authorized state banks to issue nonassessable stock in 1933, and soon thereafter it repealed double liability altogether subject to a limited set of transition rules. Many other states did the same. By 1944, thirty-one states had abolished double liability. Today, double liability for bank shareholders is a dead letter everywhere.

Although this particular feature of increased bank corporate liability was dismantled, other vestiges of a higher standard for bank corporate liability remained. The 1940s case of *Litwin v Allen*[40] illustrates the propensity of post-Depression courts to require a higher standard of care for bank directors than nonbank directors. *Litwin v Allen* involved a shareholder's derivative action against the directors of Guaranty Trust Company ("Trust Company") and its wholly owned subsidiary, the Guaranty Company of New York ("Guaranty Company").

The issue in this case was whether there was a violation of the bank directors' duty of care in the bank's entry into a series of repurchase transactions with Alleghany Corporation. The court found that the duty of care is more strict for bank directors than for those of other companies because banks are charged with serving the public interest, not just the interests of the shareholders. Specifically, the court charged the directors with the care exercised by "reasonably prudent bankers." The court went on to determine that "this transaction . . . was so improvident, so risky, so unusual and unnecessary as to be contrary to fundamental conceptions of prudent banking practices." The court accordingly imposed personal liability on the bank's board of directors.

This tightening of judicial scrutiny of banking directors' duty of care has traditionally been followed by a corresponding judicial backlash resulting in a strict application of the Business Judgment Rule. For instance, following the *Litwin* case and World War II, during a time of economic prosperity, questionable lending practices such as "delinquent loan renewals, nonexistent underwriting standards, and absent internal controls, received protection by the courts under the Business Judgment Rule."[41]

The tide turned back in favor of higher standards of care for bank directors following the massive failure of banks and savings and loan associations in the mid-1980s. During this time, more than 700 savings and loans and 300 banks failed, costing American taxpayers hundreds of billions of dollars.[42] The FDIC and the Resolution Trust Corporation (RTC) filed hundreds of lawsuits against directors and officers of these failed banks and savings and loans, and approximately 1,300 people were indicted and most were convicted of a crime connected to the failure of a financial institution. Many of these cases involved allegations that the directors breached their duty of care by engaging in unsound lending practices. The courts again faced the issue of whether banking directors should be held to the higher standard of care articulated in the older banking cases. The FDIC and RTC argued in favor of this position, while the defendants agued that their actions should be evaluated under the Business Judgment Rule.

Concurrent with the federal government's attempts to increase pressure on bank directors, however, many states passed legislation in an attempt to insulate such directors from personal liability. Some states adopted legislation that imposed liability only for willful or wanton conduct or intentional conduct. This had the effect of limiting the opportunity for the federal government to recover some of its loss due to the widespread failure of financial institutions. In an effort to "strengthen the civil sanctions and criminal penalties for defrauding or otherwise damaging depository institutions and their depositors" and to "strengthen the enforcement powers of the federal regulators of depository institutions," Congress created a universal standard of care for directors of federally insured and chartered depositories as part of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

This statute provides in part that:

> A director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action by, on behalf of, or at the request or direction of the Corporation, which action is prosecuted wholly or partially for the benefit of the Corporation . . . for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortuous conduct, as such terms are defined and determined under applicable State law. Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law.

Despite Congressional intent to clarify the standard of care, courts were unable to agree on whether the statute established a national standard or whether it left room for federal common law and state law standards of liability. State courts had long established a variety of standards of care for state-created institutions, while federal courts had created a federal standard of care for directors of federally chartered banks.

Finally, in 1997, the Supreme Court settled the debate surrounding a federal standard of care in banking by overruling the early federal cases establishing a higher standard of care for banking directors. In *Atherton v F.D.I.C.*, the Court found that there is no longer federal common law providing for a standard of care for directors of federally insured financial institutions. Next, the Court held that "the statute's 'gross negligence' standard provides only a floor—a guarantee that officers and directors must meet at least a gross negligence standard. It does not stand in the way of a stricter standard that the laws of some States provide." In other words, the Court found that state law defines the duty of directors of both state- and federally chartered institutions. Directors of federally chartered institutions must be subject to at least a gross negligence standard. However, states are free to set higher standards of care for directors of banks.

5. Conclusion

What, then, are we to conclude about bank corporate governance? We think that a clear case can be made for bank directors being held to a broader, if not a higher, standard of care than other directors. The structure of bank balance sheets—particularly banks' highly leveraged condition and the mismatch in the term structure and liquidity of their assets and liabilities—supports the argument that bank directors should owe fiduciary duties to fixed claimants as well as to equity claimants. The importance of banks to the stability of the financial system also speaks to a broader public role of banks in the payments system and to interest claims on banks. The existence of the federally sponsored deposit insurance program administered by the FDIC provides further support for our position. Banking institutions face particularly acute moral hazard problems. Historically, double liability for banks' shareholders mitigated these problems. Government deposit insurance has reduced the political demand for expanded duties of bank directors, but the policy justification for imposing such duties remains.

It seems to us that the rationale for imposing broader duties on bank directors is clear. The more difficult question is what those duties should look like. The issue of directors' duties arises in two contexts. The first context, epitomized by *Litwin v Allen*, is that of a discrete decision brought to the board for approval. Here we argue that directors of federally insured depository institutions should have a legal obligation to consider the impact of their decisions on the safety and soundness of the bank. In particular, we believe that directors are obliged to inform themselves of whether a particular decision will: 1) impair the ability of the financial institution to pay its debts as such debts come due in the ordinary course of business, 2) materially increase the riskiness of the bank, as measured by the variance in returns on the bank's investments, or 3) materially reduce the bank's capital position, as measured both by a risk-based calculation and by the leverage test. As with other board decisions, directors should be entitled to rely on expert opinions and reports. But such reliance must be reasonable.

In certain contexts, even U.S. directors must take the interests of fixed claimants into account. For example, directors may not make distributions to shareholders if after payment of the distribution "the corporation would not be able to pay its debts as they become due in the usual course of business."[43] If such a distribution is made, a director may be held personally liable for the amount of the distribution.[44] Insolvent federally insured financial institutions, unlike other types of firms, seldom will be liquidity-impaired in the way we describe because they generally will be able to obtain cash by attracting new depositors. Thus, banks will often be able to pay their debts until they are closed by regulators. Therefore, the effects of board actions on a bank's leverage, risk, and balance-sheet solvency generally will be more important than the effects of board actions on liquidity. Similarly, in the bankruptcy context, directors must consider the interests of fixed claimants over those of shareholders. In banking, the need for protecting the interest of fixed claimants is far more profound.

The second context in which the issue of directors' duties and obligations arises is that of the obligation of directors to provide continuous oversight of the companies on whose boards they serve. As noted above, under *Caremark*, directors are simply required to exercise a good-faith judgment in deciding what sort of oversight is appropriate for their firm. When a board of directors is charged with losses arising out of activities that the board was unaware of, "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."[45]

As applied to the banking industry, we believe that this standard is too low. In particular, we believe that an inquiry should be made into why the directors were unaware of the activity in question. Liability should attach where failure to maintain and construct an adequate reporting system was the reason for the ignorance. Moreover, we challenge the notion that only "sustained and systematic failure to provide oversight" should give rise to liability in the banking industry. Instead, it is our view that in order to avoid liability, directors of banks have a continuing obligation to develop and maintain a detailed and elaborate system for monitoring and oversight. Furthermore, bank directors should not be able to eliminate their personal liabilities in duty-of-care cases. Accordingly, state statutes giving firms the power to enact provisions in their corporate charters that opt out of personal liability should not extend to banking directors.

The expanded set of fiduciary duties that we advocate in this paper would push the corporate governance of U.S. banks in the direction of the Franco-German corporate governance model, which has long reflected the view that the responsibilities of corporate directors extend beyond the confines of the shareholder population. There is some evidence that this alternative approach has allowed banks to avoid the pitfalls associated with applying the pure Anglo-American model to the special case of bank corporate governance (see, for example, Edwards and Fischer [1994] or Franks and Mayer [forthcoming]). More important, however, we believe that the Franco-German model is likely to be more successful in the United States than it has been on the European continent. We make this contention because, unlike Europe, the United States has a well-developed private enforcement system in which beneficiaries of fiduciary duties can litigate in order to vindicate their rights.

Implicit in our proposal is the assumption that, like shareholders, bank creditors (including the FDIC) should be able to sue bank directors for violations of the fiduciary duty of care and loyalty if they suffer losses due that are attributable to the violation of one of these fiduciary duties. In other words, although we advocate following the Franco-German model in broadening the scope of duties owed by corporate directors, we also advocate retaining the U.S. system under which directors incur genuine litigation risk if they violate their fiduciary duties. Increasing the standard of care for bank directors poses the risk of diminishing the quality of corporate governance as the pool of available directors shrinks to include only those persons who are judgment-proof. We believe that this is a realistic danger only when the legal standards for directors are unclear or when courts are unpredictable or corrupt. However, in our judgment, the standards we have articulated are sufficiently clear, and U.S. courts have sufficient competence and expertise to make our proposal work.

Finally, we note that the enhanced standards we advocate are concordant with the new financial regulatory environment envisioned by the Gramm-Leach-Bliley Act. As financial institutions become more complex and less centralized organizations, the risks they pose to the financial system also increase. Although regulators clearly have an important monitoring and oversight role, the concomitant role and responsibility of the board of directors cannot be ignored.

Endnotes

1. The rules of corporate governance specify the rights and obligations of the various claimants on the cash flows of business enterprises. Corporate governance issues arise because of the existence of agency problems that cannot be resolved through contractual solutions due to high transaction costs (see Hart [1995b]). These agency costs manifest themselves in the form of conflicts of interest between investors and other claimants on the firms' cash flows, on the one hand, and the managers and directors who have discretion over how those cash flows are used, on the other.

2. An excellent survey is Hermalin and Weisbach (2003).

3. See, for example, Franks and Mayer (forthcoming).

4. See Ziegler (2000).

5. See Easterbrook and Fischel (1989, pp. 1416, 1418). The nexus-of-contract theory has its intellectual origins in the work of Coase (1937); also see Kornhauser (1989, p. 1449), who argues that the term nexus of contracts has become a revolutionary banner that has "transformed not only our understanding of the law, but the law itself."

6. For example, investors in riskier firms should expect higher rates of return on their investments to compensate them for this additional risk. Workers with highly specialized skills or whom labor unions represent may be able to command higher levels of compensation than other workers. Similarly, suppliers or customers with better bargaining power, better negotiating skills, or better lawyers may be able to obtain better rates of return than similarly situated claimants in other firms.

7. See Macey and Miller (1993, pp. 401, 407).

8. See Varallo and Herring (1999), citing *Mills Acquisition Co. v Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989).

9. See Chancellor Allen, *In re Caremark International Inc. Derivative Litigation*, 1996 WL 549894 (Del. Ch. 1996), p. 967.

10. Van Gorkom, 488 A.2d, p. 875.

11. See McCoy (1996).

12. *Aronson v Lewis*, 473 A.2d 805, 812 (Del. 1984); see also *Shlensky v Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968). The court found that a corporation is not obligated to follow the direction of similar corporations because directors are elected for their own business capabilities and not for their ability to follow others.

13. See "The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule," *Business Law* 41 (1986, pp. 1237-42, 1247); also see Chancellor Allen, *In re Caremark International Inc. Derivative Litigation*, 1996 WL 549894 (Del. Ch. 1996), stating that "whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests."

14. *Sinclair Oil Corp. v Levien*, 280 A.2d 717, 720 (Del. 1971).

15. *Allaun v Consolidated Oil Co.* (Del. Ch. 147) A. 257, 261 (1929).

16. *Gimbel v Signal Companies, Inc.* (Del. Ch. 316) A.2d 599, 615, affirmed, *Gimbel v Signal Companies, Inc.*, Del. Supr., 316 A.2d 619 (1974).

17. For example, in *Francis v United Jersey Bank*, the court held that a director has an affirmative obligation to "keep informed about the activities of the corporation" and "maintain familiarity with the financial status of the corporation." 87 N.J. 15, 432 A.2d 814 (1981); see also *In re Caremark International Inc. Derivative Litigation*, 1996 WL 549894 (Del. Ch. 1996).

18. *Guth v Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

19. See ABA Committee on Corporate Laws, "Other Constituencies Statutes: Potential for Confusion," *Business Law* 45 (1990, pp. 2253, 2269).

20. The theory of a "market for managers" goes back at least to Alchian (1969, pp. 337, 342-51). The theory was formalized and extended in Fama (1980). We do not suggest, of course, that the "market for managers" is perfect in some idealized way, nor that it alone operates to monitor management. We note only that "an important premise of corporate finance theory is that markets discipline managers to maximize all stockholders' wealth. Competitive forces in two markets, the market for corporate control and the market for managerial labor services, are widely viewed as providing complementary enforcement of the stockholder wealth maximization rule." See Dann and DeAngelo (1983).

21. For example, the adoption of "golden parachute" agreements by shareholders as a means of aligning the interests of managers more closely with their own interests illustrates the ability of shareholders to react effectively to the agency cost problems described above. See William J. Karney, "Pols Poking Holes in Golden Parachutes," *Wall Street Journal*, April 16, 1984, p. 32.

22. See Jackson and Symons (1999, p. 307).

23. 439 U.S. 234 (1978).

24. *Mcorp Financial Inc. v Board of Governors*, 900 F.2d 852 (5th Cir. 1990), reversed in part on other grounds, 502 U.S. 32 (1991).

25. See Diamond and Dybig (1986).

26. See Friedman and Schwartz (1963, p. 440).

27. See Hanc (1999, p. 3).

28. Remarks by R. L. Clarke, The Exchequer Club, Washington, D.C., in Comptroller of the Currency *News Release* no. NR 88-5 (January 20, 1988, p. 6).

29. See Jackson and Symons (1999, p. 152), citing a study by the U.S. General Accounting Office. In 1990, the chairman of the FDIC claimed that approximately 60 percent of all failed savings and loan associations during the 1980s were the victims of "serious criminal activity."

30. 12 U.S.C. § 1831p-1.

31. See Macey and Garrett (1988, pp. 215, 225).

32. 141 U.S. 132 (1891).

33. 141 U.S. 132, 149 (1891), quoting *In re Forest of Dean Coal Mining Co.*, 10 L.R.-Ch. 450, 451 (Rolls Court).

34. National Banking Act of 1863, Ch. 58, 12 Stat. 665.

35. *Congressional Globe*, 37th Cong., 3d sess. 824 (1863).

36. *Congressional Globe*, 38th Cong., 1st sess. Part II 1069 (1864).

37. Statutory Liability, supra note 37, p. 620.

38. See "Note, Banks and Banking—Liability of Bank Stock Holding Company Shareholders," *Columbia Law Review* 44, no. 30 (1944, pp. 561, 565).

39. For congressional disenchantment, see House Committee on Banking and Currency, *Hearings on H.R. 141*, 71st Cong., 2d sess. 17 (1930), observing that double liability had afforded "inadequate" protection to depositors.

40. 5 N.Y.S.2d 667 (Sup. Ct. 1940).

41. See McCoy (1996, p. 43).

42. See Weinstein (1993).

43. Model Business Corporation Act § 6.40.

44. Model Business Corporation Act § 8.33.

45. *In re Caremark International Inc. Derivative Litigation*, 1996 WL 549894 (Del. Ch. 1996), pp. 967-71.

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