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ARTICLE

A POLITICAL ECONOMY OF THE
BUSINESS JUDGMENT RULE IN
BANKING: IMPLICATIONS FOR
CORPORATE LAW

Patricia A. McCoy[†]

What would the corporate world look like if directors were liable for honest, informed decisions that turned out wrong? The answer to that question, especially among corporate law scholars, has been the subject of dour debate. In addressing that question, scholars almost invariably speculate whenever they contemplate how a stricter liability rule might work. Some years ago, in fact, in the bondholder context, Professor William Bratton, Jr., specifically acknowledged the speculative tenor of the debate when he painted

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an imaginary corporate governance regime in which corporate law would regulate "management risk taking" by "constrain[ing] management's discretion to finance, invest, and distribute assets once [insufficient capital] was reached."¹

In one industry, however, the picture that Professor Bratton painted already has come to pass. In the banking industry, most visibly due to last decade's savings and loan crisis, potential negligence liability attends directors in practically every aspect of bank lending.² Indeed, the banking regime is more extreme than that which Professor Bratton envisioned because it constrains management discretion in solvency and near-insolvency alike.³ Thus, the judiciary's response to the savings and loan debacle provides a valuable laboratory for evaluating whether curtailing the business judgment rule in corporate law at large would result in benefit or harm.

This article is the first comprehensive attempt to analyze the business judgment rule cases in banking on their facts and to consider the larger import of those holdings for corporate law in general. At first glance, it is mystifying why this analysis has not been performed before, considering that the banking cases have been on the books for over a century. The reason for this gap is that corporate law scholars tended to assume that the banking cases were an oddity that was cured by federal deposit insurance, with no wider relevance to corporate law at large.⁴ But in making that assump-

1. William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 112.

2. See generally Patricia A. McCoy, *The Notional Business Judgment Rule in Banking*, 44 CATH. U. L. REV. 1031 (1995) (noting the increased significance of cases involving the business judgment rule in the banking industry).

3. In one sense, the bank director liability rulings are quite traditional. Depositors, like other creditors, lack standing, due to the absence of actual damages, to sue third parties before their banks become insolvent. See Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 81, 82 n.170 (1982) (discussing the advantages and disadvantages of affording creditors standing to sue). In other respects, however, the cases are thoroughly radical. The relief they afford sounds in tort, rather than being confined to the limited contractual rights that are all that most bondholders can expect. See *infra* note 217 and accompanying text. Further, the cases empower bank creditors to challenge board decisions that cumulatively result in insolvency, whenever made. Due to the long-term nature of many bank loans, losses from such loans may not materialize for years. See NATIONAL COMMISSION ON FINANCIAL INSTITUTION REFORM, RECOVERY AND ENFORCEMENT, ORIGINS AND CAUSES OF THE S&L DEBACLE: A BLUEPRINT FOR REFORM 49 (1993) [hereinafter BLUEPRINT FOR REFORM] (noting that commercial real estate development loans often take several years to mature). Hence, the bank cases do not simply regulate after insolvency, but impose a unitary standard of care that applies to solvency and near-insolvency alike. In so doing, the decisions implicitly recognize that creditors' interests can be damaged during solvency through investment decisions that render their claims less secure.

4. Professor Bishop, for example, assumed that the advent of federal deposit insurance ended any need for negligence relief. See Joseph W. Bishop, Jr., *Sitting Ducks and Decoy*

tion, scholars made little or no attempt to examine the actual political and economic underpinnings of the banking cases. Until scholars explore the political economy of those cases, we cannot assume that the banking authorities are irrelevant to corporate law.

Contrary to received wisdom, courts curtailed the business judgment rule in banking long before federal deposit insurance was adopted in 1933. Courts did so in reaction to profligate lending practices that wiped out depositors and triggered bank runs. Their rulings conferred an unprecedented negligence cause of action in favor of depositors, who formed the most visible class of debtholders in banks. In essence the courts that scaled back the business judgment rule in banking were attempting to mediate the same conflict between shareholders and debtholders that all corporations face, notably the aspect of that conflict known in the finance literature as "asset substitution."⁵

Asset substitution refers to the incentive that shareholders have to replace low-risk company investments with riskier ones bearing higher potential rates of return. This strategy is attractive to shareholders, subject to limits. If the investment succeeds, they will reap the higher gain in its entirety; if it fails, the most they stand to lose is the purchase price of their stock, due to limited liability. Conversely, asset substitution *threatens* debtholders such as bondholders and depositors, because they will be forced to absorb any leftover losses if shareholders' equity is wiped out.

For over a century, most of the cases that curtailed the business judgment rule in banking sought to redress asset substitution in the form of high-risk loan decisions. Thus, far from merely being a creature of federal deposit insurance, the banking cases sought to respond to the same problems that all debtholders face, both in banks and non-banking corporations alike. Why, then, did the banking cases take a kindlier view toward debtholders than general corporate law?

Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 YALE L.J. 1078, 1096 n.63, 1098-99 (1968) (stating that the class of cases finding a director liable for honest negligence "has been virtually extinct, partly because of Federal Deposit Insurance"). See also Richard B. Dyson, *The Director's Liability For Negligence*, 40 IND. L.J. 341, 343-44, 354 (1965) (asserting that most bank director liability holdings predated World War II); See, e.g., Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1360 n.22, 1377-78 (1989) (noting that courts applied a higher standard of care to directors of banks than to directors in other industries, even before the advent of federal deposit insurance); Kenneth E. Scott, *Fears and Phobias: Management Liability and Insurance in Thrift Insurance in Thrift Institutions*, 88 BANKING L.J. 124, 129 (1971).

5. See Bratton, *supra* note 1, at 127; Richard C. Green & Eli Talmor, *Asset Substitution and the Agency Costs of Debt Financing*, 10 J. BANKING & FIN. 391, 391 (1986).

The answer lies, at least in part, in the fact that depositors and their federal insurers suffer less from depersonalization than corporate bondholders. In the eyes of the law, corporate bondholders tend to be treated as impersonal creditors who deal through contract and who have market power to redress market injustices.⁶ In contrast, courts tend to equate bank debtholders with depositors. As such, bank debt arouses populist images of individual depositors who entrust their savings to banks and of individual taxpayers who put the government's full faith and credit behind insured deposits.⁷ While these images have not always translated into legal relief, increasingly they have done so and to a far greater degree than for corporate bondholders.⁸ That is true even though bondholders in industrial companies do not enjoy the protection of the bank regulatory system. Similarly, courts have responded to the political imperatives of the federal deposit insurance funds to an extent never experienced by corporate bondholders, who have no such insurance—much less an insurance fund sponsored by the federal government.

Notwithstanding these divergent political norms, the banking cases respond to the same asset substitution problems that all debtholders face. When debt-to-equity ratios are high (as has increasingly been the case in non-bank firms in modern times), the economic distinction between the interests of depositors and those of corporate bondholders is only one of degree, not of kind. That being the case, the banking cases *are* in fact relevant to corporate law.

As such, the banking cases furnish the first body of historical data for assessing how a modified business judgment rule might work. The question, then, is whether curtailing the business judgment rule in banking was a success or whether it made bank directors unduly cautious, as many would predict.

The answer turned out to be neither. Somewhat surprisingly, even despite the added overlay of the complex American system of statutory bank regulation, the historical record suggests that the banking cases *underdeter*, rather than *overdeter*, in the long run. In part that is because bankers and lawyers regard the banking cases

6. See Bratton, *supra* note 1, at 103 (detailing the contractual image of the corporate creditor); Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1174 (1990) (describing bondholders' traditional categorization as contractual creditors).

7. In this article, I use "populist" in a broader sense than its original 1890's Populist Party denotation. By "populist" I mean a way of thinking that identifies debtholders or depositors with individuals of modest means and champions their interests against the interests of larger corporate entities with generally superior bargaining power.

8. See Bratton, *supra* note 1, at 150, 166-67 nn. 329-330.

as outdated when bank failures are few and bank profitability is high. Additionally, in banking, periods of judicial activism generally precede periods of judicial backlash in which courts repudiate earlier restrictive cases due to judicial competency concerns and fears over stifling business innovation. Due to these cyclical downswings, the banking cases have not deterred irrational risks; instead, they have done little more than react to bank crises in the immediate past. And even at that, there are serious questions whether the latest crop of cases has been cost-effective. Thus, far from chilling banking innovation, the banking cases are notable mostly for their inefficacy in combatting bank director mismanagement over the long term. As the banking cases show, the business judgment rule is flawed, but a strengthened state-law negligence claim in favor of depositors, corporate bondholders, and other debtholders is not the cure.

In Part I, I discuss the economic incentives for asset substitution in banking and the effect of federal deposit insurance and traditional legal rules on those incentives. Part II traces the judiciary's historical attempts to address asset substitution in banking through increased legal redress. In Part III, I evaluate the success of those attempts. Part IV proposes a new federal claim for bank director liability. I discuss the broader ramifications for corporate law in Part V. I conclude in Part VI by considering the larger implications of the stricter bank director liability case law for corporate debt-equity conflicts at large.

I. THE ECONOMIC CONSEQUENCES OF THE BUSINESS JUDGMENT RULE

A. *The Classic Business Judgment Rule and its Economic Effect*

In banking, as in other industries, directors who breach their duty of care to the corporation face liability for simple or gross negligence.⁹ Today's formulations of the duty of care in banking trace directly back to the U.S. Supreme Court's 1891 decision in *Briggs v. Spaulding*,¹⁰ where the Court charged bank directors with the care "which ordinarily prudent and diligent men would exercise under similar circumstances," taking into account "the restrictions of the statute and the usages of business."¹¹ While

9. This article uses the terms "bank," "banking," and "banking industry" to designate all bank and bank-like financial institutions, whatever their type, including banks, savings and loan institutions, credit unions, trust companies, savings banks, and the like.

10. 141 U.S. 132 (1891).

11. *Id.* at 152; see also *id.* at 171 (Harlan, J., dissenting) (stating that depositors have the right to expect that bank directors will exercise ordinary due care). *Accord* *Michelsen v. Penney*, 135 F.2d 409, 417 (2d Cir. 1943); *RTC v. Hess*, 820 F. Supp. 1359, 1366-67

there are individual variations on the *Briggs* rule today from state to state, the variations are largely minor, and a majority of states still subscribe at least nominally to it.¹²

(D. Utah 1993); *FDIC v. Stanley*, 770 F. Supp. 1281, 1310 (N.D. Ind. 1991), *aff'd sub nom.* *FDIC v. Bierman*, 2 F.3d 1424 (7th Cir. 1993); *but see* *FDIC v. Cohen*, No. 95 Civ. 683 (LLS), 1996 U.S. Dist. LEXIS 2247, at *30 (S.D.N.Y. Feb. 28, 1996) (noting the Virginia statute that limits a director's liability to a "purely subjective inquiry into whether a director acted in accordance with his good faith business judgment").

12. *See generally* William L. Cary and Sam Harris, *Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 BUS. LAW 61, 64 (1972); Marcia M. McMurray et al., Note, *A Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605, 607-08 (1987) (tracing development of the duty of care owed by corporate directors in various states); McCoy, *supra* note 2, at 1035 n.13 (listing cases that follow the decision in *Briggs*).

Courts have recently divided on whether bank directors sued for disinterested business decisions can be liable for simple negligence. This debate has both statutory and common-law dimensions. The most important statutory issue involves the effect of 12 U.S.C. § 1821(k) (1994), which provides that officers and directors of insured depository institutions may be held personally liable for monetary damages in any civil action by the Federal Deposit Insurance Corporation ("FDIC") for gross negligence. *See also* 12 U.S.C. §§ 1441a(b)(1)(B), (b)(4)(A) (1995) (applying § 1821(k) to the Resolution Trust Corporation ("RTC")). Section 1821(k) goes on to state that "[n]othing in this paragraph shall impair or affect any right of the [FDIC or RTC] under other applicable law." In cases governed by state law, every circuit court that has considered the issue has held that § 1821(k) does not preempt state-law actions for simple negligence. *See, e.g.*, *FDIC v. Stahl*, No. 94-4684, 1996 U.S. App. LEXIS 19011, at *16 (11th Cir. Aug. 2, 1996); *RTC v. CityFed Financial Corp.*, 57 F.3d 1231, 1235, 1245-49 (3d Cir. 1995), *cert. granted sub nom.* *Atherton v. FDIC*, 116 S. Ct. 1587 (No. 92-4281) (1996); *RTC v. Chapman*, 29 F.3d 1120, 1122 (7th Cir. 1994) (dictum); *FDIC v. Canfield*, 967 F.2d 443, 444-45 (10th Cir. 1992) (en banc), *cert. dismissed*, 506 U.S. 993 (1992). In cases governed by federal common law, the circuits have split over the effect of § 1821(k). *Compare* *RTC v. Frates*, 52 F.3d 295, 296-97 (10th Cir. 1995) (holding that § 1821(k) supersedes federal common law); *FDIC v. Bates*, 42 F.3d 369, 370-73 (6th Cir. 1994) (same); *Chapman*, 29 F.3d at 1122-25 (same); *RTC v. Miramon*, 22 F.3d 1357, 1359-64 (5th Cir. 1994) (same); *RTC v. Gallagher*, 10 F.3d 416, 425 (7th Cir. 1993) (same) *with CityFed Financial Corp.*, 57 F.3d at 1235, 1245-49 (holding that § 1821(k) does not preclude federal common law suits for ordinary negligence). *See also* Douglas V. Austin & Sidney M. Weinstein, *Bank Officer and Director Liability Under FIRREA: The Need for a National Standard of Gross Negligence*, 111 BANKING L.J. 67 (1994) (analyzing the ambiguity in § 1821(k), and discussing both the majority and minority views interpreting application of the gross negligence standard); Harris Weinstein, *Advising Corporate Directors After the Savings and Loan Disaster*, 48 BUS. LAW. 1499, 1503 (1993) (arguing that a simple negligence standard will give directors too much "management responsibility" and "erode their independence"); Michael P. Battin, Note, *Bank Director Liability Under FIRREA*, 63 FORDHAM L. REV. 2347 (1995) (arguing that § 1821(k) should be amended to include a simple negligence standard); David B. Fischer, Comment, *Bank Director Liability Under FIRREA: A New Defense for Directors And Officers of Insolvent Depository Institutions—Or A Tighter Noose?*, 39 UCLA L. REV. 1703, 1709-10, 1775-76 (1992) (same); DeLisa R. Kilpatrick, Note, *FDIC v. Canfield: A Death Penalty for Banks and Their Directors for Breach of Fiduciary Duty*, 3 GEO. MASON INDEP. L. REV. 281 (1994) (arguing that a simple negligence standard will force risk-averse decisions instead of risk-neutral decisions); Christopher J. Nelson, Note, *Director Liability and the Insolvent, Federally Chartered Financial Institution: A Standard Emerges*, 73 WASH. U. L.Q. 1477 (1995) (arguing that some circuits have frustrated congressional intent by "insulating directors of federally chartered institutions from liability"); Jon Shepherd, Note, *The Liability of Officers and Directors Under the Financial Reform, Recovery and Enforcement Act of 1989*,

If the unvarnished duty of care were dispositive, directors could be liable for honest but mistaken judgment calls that fact-finders found imprudent in the harsh glare of hindsight. Concerned that entrepreneurial spirit might be dampened as a result, courts grafted the business judgment rule onto the duty of care. Under the classic definition of the business judgment rule, directors are not liable for honest business decisions that turn out wrong, assuming those decisions are disinterested, informed and in compliance with all laws, corporate charter provisions, and by-laws.¹³ To qualify

90 MICH. L. REV. 1119 (1992) (concluding that § 1821(k) preempts state law only to the extent that the state law standard of care is lower than gross negligence).

Based on the conflict in the circuits, the Supreme Court granted certiorari on April 15, 1996, on the issue of whether the wording of § 1821(k) precludes simple negligence suits against bank directors by the FDIC under federal common law. *See* Atherton v. FDIC, 116 S. Ct. 1415 (1996) (granting review). The issue is complicated by the discord in the lower courts over whether federal common law should displace state law in bank director negligence suits in the absence of § 1821(k), and if so, should federal common law apply to federally-chartered institutions alone or to all federally-insured banks and thrifts. *Compare Stahl*, 1996 U.S. App. LEXIS 19011, at *16 (holding that state law applies to federally-chartered institutions) with *CityFed Financial Corp.*, 57 F.3d at 1236 n.5 (holding that federal common law applies to federally-chartered institutions); *Frates*, 52 F.3d at 296-97 (same); *Bates*, 42 F.3d at 370-72 (same); *Chapman*, 29 F.3d at 1122-25 (same) and *Miramón*, 22 F.3d at 1359 & n.2 (holding that federal common law applies to all federally-insured institutions, whether state- or federally-chartered); *Gallagher*, 10 F.3d at 419 (holding that federal common law governs federally-chartered institutions).

Wholly apart from the effect of § 1821(k), certain jurisdictions have declined to assess bank directors with common law liability for anything short of gross negligence, with some courts holding that the business judgment rule bars suits for simple negligence. *See, e.g.*, *FDIC v. Harrington*, 844 F. Supp. 300, 305 (N.D. Tex. 1994); *RTC v. Acton*, 844 F. Supp. 307, 313-16 (N.D. Tex. 1994), *aff'd*, 49 F.3d 1086 (5th Cir. 1995); *RTC v. Hovnanian*, Civ. No. 94-450 (HLS), 1994 U.S. Dist. LEXIS 19359, at *16-*24 (D.N.J. Oct. 11, 1994); *RTC v. Blasdel*, 930 F.Supp. 417, 423-36 (D. Ariz. 1994); *RTC v. Gibson*, 829 F. Supp. 1110, 1117 (W.D. Mo. 1993); *FDIC v. Mintz*, 816 F. Supp. 1541, 1546 (S.D. Fla. 1993); *Godbold v. Branch Bank*, 11 Ala. 191, 200 (1847); *Percy v. Millaudon*, 8 Mart. (n.s.) 68, 74-75, 78 (La. 1829); *Spring's Appeal*, 71 Pa. 11, 24 (1872). *But see, e.g.*, *RTC v. Gregor*, 872 F. Supp. 1140, 1150-51 (E.D.N.Y. 1994) (holding that business judgment rule does not preclude bank director liability for simple negligence; "no New York authority [applies] the Business Judgment Rule to bank directors"); *RTC v. Gross*, No. CIV. 93-5056, 1994 U.S. Dist. LEXIS 14732, at *2 (E.D. Pa. Oct. 13, 1994) (declining to dismiss RTC simple negligence claim under Pennsylvania law). Similarly, some courts have held that § 1821(k)'s gross negligence standard does not incorporate the business judgment rule. *See RTC v. O'Bear, Overholser, Smith & Huffer*, 886 F. Supp. 658, 668-69 n.8 (N.D. Ind. 1995); *RTC v. Gallagher*, 800 F. Supp. 595, 602-03 (N.D. Ill. 1992).

The Lending Enhancement Through Necessary Due Process Act, H.R. 316, 104th Cong., 1st Sess. (1995) would have eliminated common-law simple negligence claims and codified the business judgment rule in suits against financial institution directors. The bill was voted down by the House Banking Committee on June 28, 1995. *See House Committee Deletes D&O Relief, But D&Os See Tide Turning Their Way*, BANK BAILOUT LITIG. NEWS, Aug. 2, 1995, at 1; *House Panel Votes to Give D&Os Relief, but Victory Is Tenuous*, BANK BAILOUT LITIG. NEWS, July 5, 1995, at 5; *June Action Likely to be Pivotal on Bank Bailout Issues in Congress*, BANK BAILOUT LITIG. NEWS, June 21, 1995, at 3; *McCullum Measure Would Remedy Host of D&O Liability Concerns*, BANK BAILOUT LITIG. NEWS, Mar. 1, 1995, at 5.

13. *See Hun v. Cary*, 82 N.Y. 65, 70 (1880) (finding that bank trustees can only be

for protection under the business judgment rule, board decisions also must meet a minimum rationality standard by having at least some profit potential on their face.¹⁴

Thus, the business judgment rule, in its classic sense, permits (but does not require) managers to engage in profit-maximizing conduct, at least in the short term. As such, the rule has two important consequences, one which deepens conflicts between shareholders and debtholders and one which mediates them.

First, the business judgment rule is indifferent to asset substitution by shareholders at the expense of debtholders as long as the new, riskier asset is "rational" in the sense of having some realistic potential for gain. Under the rule, shareholders have incentives to substitute riskier assets for safer ones, at least until financing costs outweigh anticipated gains. Thus, the rule condones wealth transfers from debtholders to shareholders by allowing boards to pursue profit-maximizing strategies with heightened levels of risk. This outcome was traditionally justified as necessary for business innovation and corporate wealth maximization. Any resulting harm to debtholders was dismissed as inconsequential because debtholders, as fixed claimants, have rights that shareholders, as residual claimants, do not, including full return of principal, a set rate of return, and priority in the event of bankruptcy.¹⁵

In contrast with this first consequence, which drives a wedge between shareholders and debtholders, the second consequence serves the interests of both groups. The business judgment rule does so by subjecting economically irrational decisions (i.e., decisions with no real prospect for gain) to liability for violation of the duty of care. Obviously, economically irrational decisions endanger corporate solvency and as such they normally are not in the interests of shareholders, debtholders, or managers. But when directors and/or managers find it in their personal self-interest to pursue decisions that are financially irrational from the shareholders' point of view, the duty of care gives shareholders a negligence cause of

liable for damages if they violate a bank's charter or act fraudulently; "if they act in good faith within the limits of powers conferred, using proper prudence and diligence, they are not responsible for mere mistakes or errors of judgment"). See also *FDIC v. Wheat*, 970 F.2d 124, 131 n.13 (5th Cir. 1992); *Joy v. North*, 692 F.2d 880, 885 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983); *Wheeler v. Aiken County Loan & Sav. Bank*, 75 F. 781, 783-85, 787-89 (C.C.D.S.C. 1896); *Wynn v. Tallapoosa County Bank*, 53 So. 228, 239 (Ala. 1910) (holding directors liable only for failure to exercise reasonable care and not mere errors in judgment); *Litwin v. Allen*, 25 N.Y.S.2d 667, 727 (N.Y. Sup. Ct. Special Term 1940); *Spering's Appeal*, 71 Pa. 11, 24 (1872).

14. See *Hun*, 82 N.Y. at 78-79; *Litwin*, 25 N.Y.S.2d at 697-99 (holding bank director liable where there was no rational basis for decision); *McCoy*, *supra* note 2, at 1037-40 (discussing cases where courts have found that bank directors' decisions fall below minimum standards of rationality).

15. See *Mitchell*, *supra* note 6, at 1219.

action.¹⁶ Although debtholders traditionally have lacked standing to sue for similar types of harm, shareholder suits vindicate both debtholder and shareholder interests, as Professor Lawrence Mitchell has pointed out.¹⁷

The asset substitution debate has centered, in significant part, on whether debtholders should receive extracontractual tort remedies or be left to market constraints and contractual relief.¹⁸ Normally, of course, increased financing costs and the desire to avoid insolvency will provide important market constraints on irrational risks. The business judgment rule regime tolerates asset substitution on the assumption that such market constraints exist. But in certain industries, and under certain market conditions in industries across the board, such constraints can be severely dampened. In such circumstances, the business judgment rule can accelerate asset substitution to the point of economically irrational decisions. In order to understand these potentially extreme incentives toward

16. As Professors Dooley and Palmiter have noted, this is why the duty of care serves as a surrogate for the duty of loyalty. See Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 471-72 (1992) (all disinterested board decisions except those that are grossly negligent are protected by the business judgment rule); Palmiter, *supra* note 4, at 1376-85 (noting that when decisions are not tainted enough to trigger loyalty review, care review becomes meaningful). *But see infra* notes 190, 203.

17. See Mitchell, *supra* note 6, at 1190 (discussing the similarity of debtholders to shareholders); see also Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1837 n.48 (1992) (noting that management can do a disservice to both shareholders and bondholders alike); George C. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1078-79, 1111 (1995) (noting the interdependency between shareholders and depositors, and proposing a new scheme of interactive governance).

18. Compare Brudney, *supra* note 17, at 1838-40 (stating that contract doctrine can give adequate relief to debtholders); David M.W. Harvey, *Bondholders' Rights and the Case for a Fiduciary Duty*, 65 ST. JOHN'S L. REV. 1023, 1025-26 (1991) (arguing against "the imposition of a fiduciary duty for bondholders"); Stewart M. Robertson, Comment, *Debenture Holders and the Indenture Trustee: Controlling Managerial Discretion in the Solvent Enterprise*, 11 HARV. J.L. & PUB. POL'Y 461, 462 (1988) (rejecting a fiduciary duty on corporate management and arguing for a stricter legal framework based upon a contractual relationship between a corporation and its debtholders); Dale B. Tauke, *Should Bonds Have More Fun? A Reexamination of the Debate Over Corporate Bondholder Rights*, 1989 COLUM. BUS. L. REV. 1, 8 (finding that the limited scope of the problem makes extensive judicial intervention in the debtholder-corporate relationship unnecessary), with Albert H. Barkey, *The Financial Articulation of a Fiduciary Duty to Bondholders with Fiduciary Duties to Stockholders of the Corporation*, 20 CREIGHTON L. REV. 47, 83-84 (1986) (concluding that a general managerial fiduciary duty should be owed to all security holders); Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 206 (1988) (arguing that courts should impose a fiduciary duty on corporate managers); Mitchell, *supra* note 6, at 1168-71. See also John C. Coffee, Jr., *Shareholders versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 81-86 (1986) (looking at fiduciary duties through implicit contracting). In the general corporate arena, courts regulate asset substitution at the margin in the form of rules against fraudulent conveyance and the minimum rationality exception to the business judgment rule. See generally Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985); *infra* notes 128-30 and accompanying text.

asset substitution, it is useful to consider an economic model of the business judgment rule.

B. The Economic Problem Defined: Wealth Expropriation and Asset Substitution

The age-old conflict between corporate debtholders and shareholders arises from the incentives that both groups have to maximize their wealth at the other group's expense, a phenomenon known as "expropriation."¹⁹ Although expropriation is a two-way street, the law has traditionally favored shareholder expropriation at the expense of corporate debtholders in order to allow bold and innovative business decisions that can maximize corporate wealth. Courts countenance shareholder wealth expropriation through a variety of doctrines, including limited liability, standing to sue, and the business judgment rule.²⁰

Expropriation can take different forms. On the liability side of the ledger, shareholder expropriation can occur when a corporation increases its borrowing because the debtholders' claims on finite company assets increase in proportion and amount.²¹ As a result of expanded borrowing, the holdings of senior unsecured debtholders take on added risk and drop in value because there are new and additional claims on the company's assets in the event of insolvency.²² In leveraged buyouts, debt financing results in a wealth transfer to shareholders because debt secured by the assets of the target company is used to finance the repurchase of publicly held shares.

19. See, e.g., Baird & Jackson, *supra* note 18, at 850-51 (providing examples of how expropriation may occur in corporate setting); Bratton, *supra* note 1, at 136-37 (explaining "wealth transfers" and the contracting practices that permit them); Green & Talmor, *supra* note 5, at 391 (noting that managerial decisions affecting the risk of the firm are the primary means of wealth reallocation between debtholders and stockholders); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 345 (1976); Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 182 (discussing shareholders' incentives to shift resources from safe to risky investments); McDaniel, *supra* note 18, at 225 (same); Mitchell, *supra* note 6, at 1213-15 (same). See generally Brudney, *supra* note 17 (examining how shareholder behavior affects the interests of debtholders); John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207 (1991) (demonstrating how threat of bankruptcy can force debtors to accept unfavorable recapitalization in the shareholders' favor).

20. See generally Macey, *supra* note 19, at 181 (discussing doctrines that protect shareholders).

21. This article uses the terms "bondholder" and "debtholder" interchangeably in the general corporate context to refer to holders of senior, unsecured corporate debt. In the banking context, the term "debtholder" includes depositors.

22. See Bratton, *supra* note 1, at 137.

Expropriation can also occur on the asset side of the ledger. Shareholders can expropriate wealth from debtholders by replacing conservative investments with investments bearing a higher risk of loss, a phenomenon known as "asset substitution."²³ Shareholders have an incentive to do so because if the substitution pays off, they will reap higher returns, while if losses occur, their liability will be capped at their initial investments under limited liability law. Because any remaining losses will be absorbed by the debtholders, debtholders, as fixed claimants on company assets, have more conservative risk preferences than company shareholders, who will stand in line behind the debtholders if the company goes bankrupt. As the following model shows, the greater the ratio of debt to equity, the greater the shareholders' incentives to engage in asset substitution.

C. *Added Incentives Toward Risk*

Assume that in planning their investment strategy, the directors of a firm must choose between Decision A and Decision B in Table 1, both of which hold out an expected \$2 million gross profit. If the board seeks to maximize shareholder wealth, which investment should the firm's board choose?

Decision A is the riskier investment, with a 75% chance of a \$2 million profit and a 25% chance of complete loss. Because of its higher risk, Decision A offers a higher nominal rate of return of 15%, which necessitates a lower total investment of \$13,333,333. Decision B is safer than Decision A, with an 80% chance of a \$2 million profit and a 20% chance of total loss. As such, Decision B offers a lower 10% nominal rate of return, which necessitates a steeper \$20 million investment to generate a \$2 million gross profit. Both decisions are financed by 10% equity and 90% debt. To reflect the higher risk of loss, the interest rate on the debt financing for Decision A (8.25%) is 2% higher than the rate for Decision B (6.25%).

Once the cost of servicing the debt is subtracted from the expected gross profit, the expected net profits from Decisions A and B are \$1,010,000 and \$875,000 respectively. But before they can be realistically compared, Decisions A and B must be further discounted for their likelihood of loss.²⁴ After this is done, Deci-

23. See *supra* note 5 and accompanying text.

24. This computation, known as risk-adjusted value, is calculated as: (probability of success x expected net profit) minus (probability of failure x equity invested). See GEORGE J. BENSTON ET AL., PERSPECTIVES ON SAFE & SOUND BANKING—PAST, PRESENT, AND FUTURE 18-19 (Richard Schmalensee, ed., 1986). For variations on this model, see *Joy v. North*, 692 F.2d 880, 886 & n.6 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983) (applying the model to high risk/high return ventures); Melvin A. Eisenberg, *The*

sion A is the investment that is in the best interests of the company's shareholders, because it has a risk-adjusted value of \$424,167, as opposed to \$300,000 for Decision B.

DECISION A - Higher Risk			DECISION B - Lower Risk			DECISION A1-- With Artificially Low Cost of Funds		
Expected Gross Profit	15%	\$ 2,000,000	Expected Gross Profit	10%	\$ 2,000,000	Expected Gross Profit	15%	\$ 2,000,000
Total Funds		13,333,333	Total Funds		20,000,000	Total Funds		13,333,333
Equity (10%)		1,333,333	Equity (10%)		2,000,000	Equity (10%)		1,333,333
Debt @ 8.25%		12,000,000	Debt @ 6.25%		18,000,000	Debt @ 6.25%		12,000,000
Cost of Funds @ 8.25%		990,000	Cost of Funds @ 6.25%		1,125,000	Cost of Funds @ 6.25%		750,000
Expected Net Profit		1,010,000	Expected Net Profit		875,000	Expected Net Profit		1,250,000
Expected Net Rate of Return on Equity		75.8%	Expected Net Rate of Return on Equity		43.8%	Expected Net Rate of Return on Equity		93.8%
Success Probability 0.75		757,500	Success Probability 0.8		700,000	Success Probability 0.75		937,500
Failure Probability 0.25		(333,333)	Failure Probability 0.2		(400,000)	Failure Probability 0.25		(333,333)
Risk-Adjusted Value		424,167	Risk-Adjusted Value		300,000	Risk-Adjusted Value		604,167
Risk-Adjusted Rate of Return on Equity		31.8%	Risk-Adjusted Rate of Return on Equity		15%	Risk-Adjusted Rate of Return on Equity		45.3%

The business judgment rule permits (but does not require) this result by shielding boards that aggressively seek to maximize profits with a concomitantly higher risk of loss. Thus, in its classic form, the business judgment rule is impervious to the statistical likelihood of any potential loss as long as the risk-adjusted value is positive. So long as that condition is met, the rule promotes the norm of potential profit maximization, untempered by any concern for risk. Under such conditions, the classic form of the rule permits boards, acting in the shareholders' best interests, to compromise debtholders' financial security by choosing risky investments over conservative ones.

Duty of Care of Corporate Directors and Officers, 34 CORP. PRAC. COMMENTATOR 323, 344 (1992-1993) [hereinafter *Duty of Care*] (illustrating the conflict between riskier investments with higher potential returns and less risky investments); Edward J. Kane, *Appearance and Reality in Deposit Insurance*, 10 J. BANKING & FIN. 175, 178-80 (1986) [hereinafter *Appearance and Reality*] (noting the asymmetric mechanism between shareholders and debtholders for sharing unanticipated gains and losses); Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1489-93 (1993) (providing examples of risk-adjusted value model and illustrating shareholders' incentives to make riskier decisions); Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1163-64 (1988) (discussing shareholders' advantage in higher risk investments); R. Mark Williamson, *Regulatory Theory and Deposit Insurance Reform*, 42 CLEV. ST. L. REV. 105, 109 & n.17 (1994) (examining the risk assumption function). The flaw with certain of those models lies in failing to account for differentials in the cost of funds.

D. Market Constraints and Market Failure

To some extent, of course, the market acts as a brake on risky investments that are funded by debt. In a world with perfect information, Decision A will carry a higher cost of funds than Decision B because the debtholders furnishing the funds—be they bondholders, depositors, or other creditors—will normally demand a higher rate of return to defray the increased risk that Decision A bears. If the risk level is too high for an individual debtholder's personal tolerance for risk, he or she can deny financing to the firm altogether. This increased financing cost and the possibility of impaired access to financing will reduce and possibly negate the difference between the risk-adjusted values of investments such as Decisions A and B.

In theory, if a firm wants to use debt financing for higher-risk investments, the firm can respond to the problem of higher cost of funds in one of several ways. The board can finance the investment entirely with equity. Alternatively, it can offer debtholders a higher interest rate sufficient to compensate them for their added share of risk.²⁵ Or, if either of these options is unattractive, the board can simply select a more conservative investment.²⁶

Under certain circumstances, however, debt financing costs may be underpriced, distorting the risk analysis. There are at least two significant reasons why this may be the case. First, debtholders may find information-gathering too costly to price the firm's current value accurately and demand an appropriate rate of return. This is a perennial problem for bank depositors, particularly small depositors.²⁷

Second, even if current value could accurately be assessed, normally it is impossible for debtholders to price the future hazard of asset substitution (i.e., the hazard that the firm's risk profile might increase) through disclosures about past performance.²⁸ This

25. Interest paid on corporate bonds and on bank deposits is fully deductible. See I.R.C. § 163 (1994).

26. See BENSTON ET AL., *supra* note 24, at 86.

27. See Robert C. Merton, *An Analytic Derivation of the Cost of Deposit Insurance and Loan Guarantees*, 1 J. BANKING & FIN. 3, 3 (1977); Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 DUKE L.J. 469, 514 (1992) (noting that insured depositors have little incentive to invest in monitoring bank solvency); Williamson, *supra* note 24, at 115 (noting that depositors will have difficulty ascertaining a bank's actual degree of risk). Depositors' access to information is further impeded by federal laws that limit or prohibit the release of financial information that is directly germane to risk, particularly examination results. See Kenneth E. Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, 44 BUS. LAW. 907, 916 (1989) [hereinafter *Deposit Insurance*] (noting the limited nature of disclosure in the banking industry as opposed to the securities market).

28. See Brudney, *supra* note 17, at 1826-27, 1849-52 (explaining that shareholders' strategic behavior can distort current values and deprive debtholders of meaningful choice);

second problem is not unique to depositors: it is one that all debtholders face, depositors and bondholders alike. Further compounding matters is the problem that asset substitution is difficult to guard against because depositors and other debtholders almost never have a voice in (and thus a veto over) such investments before the fact.²⁹

Thus, whenever debt financing is used, information asymmetries create incentives for shareholders and their boards to court added risks.³⁰ In banking, however, unlike other industries, due to the nature of demand deposits, depositors can exact stiff discipline for such risks in the form of bank runs. The dread economic consequences of this form of market discipline—bank runs, bank panics, and an ensuing shrinkage in the money supply—generate strong political pressures to forestall such discipline.³¹ It was precisely in response to such pressure that the United States inaugurated federal deposit insurance in 1933 to defuse the threat of bank runs made possible by demand deposits.³²

Deposit insurance has had the salutary effect of bolstering depositors' confidence in the banking system, whether their institutions are risk-prone or risk-averse. The success of deposit insurance in this respect has been such that no depositor has lost a cent in federally insured deposits since 1933, and panics were largely averted during last decade's bank and thrift crisis.³³ That said, de-

Coffee & Klein, *supra* note 19, at 1218-20 (noting that information about debt securities is often inadequate).

29. To be sure, some asset decisions by industrial corporations may be more likely to come to investors' attention than comparable decisions by banks. Financial institution assets are often highly liquid and can be substituted quietly without triggering required disclosures. In contrast, in industrial settings, major asset sales may take the form of fundamental corporate decisions such as mergers or divestitures that trigger public disclosure requirements. Likewise, where assets are illiquid and large in scale, analysts are more likely to detect attempts to substitute assets, due to the time needed for sale and the perceived effect that asset sales might have on the going concern value of the firm. See Robert C. Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 14-15 (1976); Swire, *supra* note 27, at 512-13 (banks have more ability to "shift their corporate strategy without notice to shareholders or bondholders" than industrial companies). Nonetheless, lesser asset decisions by industrial corporations will not necessarily come to the attention of investors or analysts in advance. Over time, the accumulated toll of such decisions can be quite significant.

30. See Gautam Goswami et al., *Debt Financing and Myopia: Cause or Consequence?*, at 2, 17 (August 1994) (unpublished manuscript).

31. See ROGER J. VAUGHAN & EDWARD W. HILL, *BANKING ON THE BRINK: THE TROUBLED FUTURE OF AMERICAN FINANCE* 85 (1992).

32. Today, when a federally-insured financial institution goes into conservatorship or receivership, the appropriate federal deposit insurance fund must compensate depositor losses up to \$100,000 per customer, per institution. 12 U.S.C. § 1821(a)(1)(B) (1993).

33. See, e.g., F. Stevens Redburn, *Never Lost a Penny: An Assessment of Federal Deposit Insurance*, 7 J. POL'Y ANALYSIS & MGMT. 687, 687 (1988). The few panics that did occur in the 1980's happened in financial institution sectors that were not federally insured. State-chartered savings and loan institutions in Maryland, Ohio, and Rhode Island,

posit insurance has the highly undesirable effect of dampening market restraints on undue bank risk. With deposit guarantees, depositors have no incentive to research bank risk profiles. Similarly, insured depositors have no reason to demand compensation for risk in the form of higher rates of return. Previously, the government's preference for bank resolution methods that extended protection to large, uninsured depositors also undermined the market discipline that wholesale depositors otherwise would have provided.³⁴

Of course, deposit insurance premiums could offset debt underpricing problems if the premiums were properly priced. But despite the advent of risk-based premiums that vary by institution according to risk, it is difficult to price premiums to compensate the deposit insurance funds accurately. Deposit insurers have not perfected risk-rating mechanisms to measure banks' current values.

for example, suffered systematic runs on deposits when private deposit insurance systems collapsed in those states in the early 1980's. See LAWRENCE J. WHITE, *THE S&L DEBACLE* 46 n.5, 135, 138 (1991) [hereinafter *S&L DEBACLE*] (discussion of private deposit insurance systems failure); M. Mazen Anbari, Comment, *Banking on a Bailout: Directors' and Officers' Liability Insurance Policy Exclusions in the Context of the Savings and Loan Crisis*, 141 U. PA. L. REV. 547, 580-81 (1992); Anna J. Schwartz, *Financial Stability and the Federal Safety Net*, in *RESTRUCTURING BANKING & FINANCIAL SERVICES IN AMERICA* 34, 51 (William S. Haraf & Rose M. Kushmeider eds., 1988). Similarly, in 1984 the federal government nationalized the failed Continental Illinois Bank out of fears that Continental's large base of uninsured corporate depositors would withdraw deposits wholesale and trigger a major systemic panic in the process. See JAMES L. PIERCE, *THE FUTURE OF BANKING* 104-05 (1991).

34. See William S. Haraf & Rose M. Kushmeider, *Redefining Financial Markets*, in *RESTRUCTURING BANKING & FINANCIAL SERVICES IN AMERICA*, *supra* note 33, at 1, 24-25 (moral hazard "has been compounded in recent years as bank and thrift failures have been resolved in ways that protect even large depositors. . ."); *Appearance and Reality*, *supra* note 24, at 175-76; Redburn, *supra* note 33, at 690 (stating that the protection of uninsured depositors "induc[ed] greater risk-taking. . ."); W.F. Sharpe, *Bank Capital Adequacy, Deposit Insurance, and Security Values*, in *RISK AND CAPITAL ADEQUACY IN COMMERCIAL BANKS* 187, 201 (Sherman J. Maisel ed., 1981) (arguing that deposit insurance premiums should equal or exceed the anticipated claims on the deposit insurance fund).

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") curtailed the FDIC's ability to protect uninsured depositors by mandating that the FDIC use the resolution method that results in the least cost to the deposit insurance funds. 12 U.S.C. § 1823(c)(4)(A)(ii) (1994). In particular, the FDIC may not protect uninsured deposits so as to increase losses to any deposit insurance fund. See *id.* § 1823(c)(4)(E)(i). Under FDICIA, the FDIC can still enter into purchase and assumption agreements whose effect is to protect uninsured deposits. The agency may only do so, however, if the insurance funds sustain no additional losses. See *id.* § 1823(c)(4)(E)(iii). Similarly, FDICIA made it significantly harder for the FDIC to bail out large institutions under the "too big to fail" doctrine. Today, the FDIC may resort to open bank assistance only if two-thirds of the FDIC's Board of Directors and two-thirds of the Board of Governors of the Federal Reserve System vote to recommend such action and the Secretary of the Treasury, in consultation with the President, determines that closure would have "serious adverse effects on economic conditions or financial stability" and that the proposed action "would avoid or mitigate such adverse effects." *Id.* § 1823(c)(4)(G)(i). These provisions have not yet been put to a practical test.

Similarly, the future risk of asset substitution almost never can be accurately priced and in the case of new bank products may not be priced at all. Both of these deficiencies boost bank incentives to increase their risk levels once premium rates have been assigned. Additionally, the risk-rating system is the focus of constant bank lobbying campaigns to keep premium differentials low.³⁵

How, then, does debt underpricing affect risk levels? When the cost of funds is artificially depressed, as is generally true in banking, the gap between the risk-adjusted values of Decisions A and B will grow. This is evident from Decision A₁ in Table 1, which shows what will happen if the firm can finance the riskier Decision A at the same low cost of funds as Decision B due to information deficits on the part of depositors and their insurers. When the cost of funds for Decision A equals that of Decision B, Decision A₁ results in a risk-adjusted value of \$604,167, widening the gulf between Decisions A and B from \$124,167 to \$204,167. As a result of this artificially low cost of funds, the risky Decision A is even more attractive to the firm than it was before. Alternatively, for the same reduced differential in risk-adjusted values, the firm can pursue even riskier investments than Decisions A and A₁.³⁶

Thus, by subsidizing risk-taking, debt underpricing increases firm incentives to take risk, to the detriment of depositors and corporate debtholders alike. Indeed, as one set of economists has noted in the banking industry context, "the only way a bank can take advantage of this . . . subsidy is by adopting a riskier-than-normal stance."³⁷ This, in turn, puts pressure on more conservative

35. See EDWARD J. KANE, *THE GATHERING CRISIS IN FEDERAL DEPOSIT INSURANCE* 13-14, 19, 82 (1985) [hereinafter *GATHERING CRISIS*]; Richard C. Aspinwall, *On the "Specialness" of Banking*, 7 *ISSUES IN BANK REG.* 16 (1983), reprinted in JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW AND REGULATION* 73, 78 (1992) [hereinafter *BANKING LAW AND REGULATION*]; *Appearance and Reality*, *supra* note 24, at 182, 185, 186-87; *Deposit Insurance*, *supra* note 27, at 915; Sharpe, *supra* note 34, at 188, 201.

The mispricing problem was even more acute before the passage of FDICIA, when deposit insurance premiums were priced at a flat rate per \$100,000 of deposits with no adjustment for risk. In FDICIA, Congress abolished flat premiums and ordered the federal deposit insurance funds to calibrate deposit insurance premiums according to risk. 12 U.S.C. § 1817(b)(1) (1996 Supp.).

36. See BENSTON ET AL., *supra* note 24, at 86 (noting that banks will tend to take greater risks when covered by deposit insurance because they "can get away with a riskier portfolio without increasing [their] cost of funds. . ."); *GATHERING CRISIS*, *supra* note 35, at 14-15 (same); Sherman J. Maisel, *The Theory and Measurement of Risk and Capital Adequacy*, in *RISK AND CAPITAL ADEQUACY IN COMMERCIAL BANKS*, *supra* note 34, at 19, 112 (describing how deposit insurance works to underprice debt); Williamson, *supra* note 24, at 119 ("[a]n assumption that the regulators are guaranteeing the safety of a bank's debt [at flat premium rates] lowers its cost even at extreme levels of leverage").

37. BENSTON ET AL., *supra* note 24, at 86; see also Peter Ritchken et al., *On flexibility-*

banks to match yields offered by their riskier counterparts in order to retain depositors. These pricing problems tilt the entire banking industry toward added risk.³⁸ Nonetheless, the classic economic model of the business judgment rule is indifferent to this heightened propensity toward risk.

The economic model of the business judgment rule is doubly deficient due to its failure to consider the effect of underpriced debt on decisions with negative risk-adjusted values. In lay terms, such decisions have no realistic profit potential and are statistically likely to result in losses. For example, take Decision C in Table 2, which is Decision B with two variations. Decision C is riskier than Decision B, with a 75% chance of success and a 25% chance of total loss. And its cost of funds is 2% higher (8.25%) to compensate for the added risk of loss. The risk-adjusted value of Decision C is negative, a projected \$113,750 loss.

Obviously, because the cost of funds is accurately priced, rational shareholders and board members will reject Decision C because it has a negligible chance of profit and a very real chance of loss. Market discipline in the form of shareholder self-interest ordinarily should insure that this type of economically irrational decision is nixed.

DECISION C - Economically Irrational Investment			DECISION D - Moral Hazard Effect of Artificially Low Cost of Funds		
Expected Gross Profit	10%	\$ 2,000,000	Expected Gross Profit	10%	\$ 2,000,000
Total Funds		20,000,000	Total Funds		20,000,000
Equity (10%)		2,000,000	Equity (10%)		2,000,000
Debt @ 8.25%		18,000,000	Debt @ 5.00%		18,000,000
Cost of Funds @ 8.25%		1,485,000	Cost of Funds @ 5.00%		900,000
Expected Net Profit		515,000	Expected Net Profit		1,100,000
Expected Net Rate of Return on Equity		25.8%	Expected Net Rate of Return on Equity		55.0%
Success Probability 0.75		386,250	Success Probability 0.75		825,000
Failure Probability 0.25		(500,000)	Failure Probability 0.25		(500,000)
Risk-Adjusted Value		(113,750)	Risk-Adjusted Value		325,000
Risk-Adjusted Rate of Return on Equity		-5.7%	Risk-Adjusted Rate of Return on Equity		16.3%

But two different factors can skew this calculus toward economically irrational decisions, such as Decision C, that are freight-

ty, capital structure and investment decisions for the insured bank, 17 J. BANKING & FIN. 1133, 1134 (1993) (providing a model of how shareholders select a capital structure and investment policy in the face of underpriced debt); Sharpe, *supra* note 34, at 200 (discussing bank risk behavior).

38. See STAFF STUDY OF THE SUBCOMM. ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE OF THE HOUSE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 101ST CONG., 2D SESS., BRIEFING PAPER ON DEPOSIT INSURANCE: HOW IT ORIGINATED AND HOW IT WORKS 78 (1990) [hereinafter STAFF STUDY].

ed with abnormally high risk.³⁹ First, when the cost of funds is substantially underpriced due to information deficits on debtholders' part, risk-adjusted values may appear positive in the eyes of shareholders and the board. Thus, as Decision D shows, if the company can execute the irrational Decision C for a 5% cost of funds rather than an 8.25% cost, the risk-adjusted value will jump to a positive \$325,000.

Second, if leveraging sufficiently increases, a negative risk-adjusted value may appear positive to shareholders and the board because the equity at risk is less.⁴⁰ In Table 3, Decision E replicates Decision C but increases the ratio of debt to total funds to 98 percent. When equity drops to only two percent of total financing, the risk-adjusted value changes from a negative number to a positive \$187,250, making Decision E rational to shareholders and the board. That is true even though Decision E obviously presents a negative risk-adjusted value to *someone*, because that someone consists of debtholders (or, in the case of banks, uninsured depositors and the deposit insurance funds). Shareholders, nevertheless, will view the expected return as positive; they can reap any gain while shifting most of any losses to debtholders or deposit insurers. This results directly from the principle of limited liability, which caps shareholder losses at the amount of their investments, leaving any further losses to be absorbed by debtholders and other creditors.⁴¹

39. See Ritchken et al., *supra* note 37, at 1134 n.2 (noting that projects with negative net value may appear the most desirable when incentives become perverse). See also BENSTON ET AL., *supra* note 24, at 19-20 (explaining that fear of bankruptcy or job loss would encourage a bank manager to pursue higher risk strategies offering greater returns); GATHERING CRISIS, *supra* note 35, at 106-07 (describing circumstances where a high risk venture is attractive to managers); Macey, *supra* note 19, at 182 n.32 (explaining that managers may pursue projects with negative net present values if shareholders' equity increased as a result); Maisel, *supra* note 36, at 59 (noting that the less adequate initial capital is, the more an increase in risk will raise the bank's net worth).

40. See generally Green & Talmor, *supra* note 5, at 398 ("[M]ore debt aggravates shareholders' incentives to take risk"); cf. Brudney, *supra* note 17, at 1858 ("In many cases, debtors seek voluntary adjustment when bankruptcy is not imminent, but neither is the economic recovery of the enterprise—the enterprise is in distress and its prospects under its prevailing capital structure are not encouraging."); Triantis & Daniels, *supra* note 17, at 1111 ("While stakeholder interests in solvent firms normally coalesce around the goal of controlling managerial slack, this convergence weakens as the financial condition of the firm deteriorates.").

41. See Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 103-04 (1985); Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 126, 140-41 (1980) (describing limited liability and moral hazard); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1586 (1991) ("Limited liability does not simply offset positive externalities, but rather encourages excessively risky activity.").

TABLE 3		
DECISION E - Near Insolvency		
Expected Gross Profit	10%	\$ 2,000,000
Total Funds		20,000,000
Equity (2%)		400,000
Debt @ 8.25%		19,600,000
Cost of Funds @ 8.25%		1,617,000
Expected Net Profit		383,000
Expected Net Rate of Return on Equity		95.7%
Success Probability 0.75		287,250
Failure Probability 0.25		(100,000)
Risk-Adjusted Value		187,250
Risk-Adjusted Rate of Return on Equity		46.8%

The banking sector, of course, is the archetype of a highly leveraged industry and is highly prone to the problems illustrated by Decision E. In banking, shareholders' equity has historically formed a far smaller percentage of total liabilities than in industrial companies, with average book equity since 1960 hovering between seven to eight percent.⁴² As a result, deposits, not equity, furnish the predominant source of funds for bank loans and other investments. This high leveraging means that depositors (joined, since

42. While deposits are less than half of liabilities at certain major money-center banks, average equity-debt ratios across the banking industry have remained much lower. See Anthony Saunders & Berry Wilson, *Bank Capital Structure: An Analysis of the Charter Value Hypothesis* 20-22, Figure 1 (N.Y.U. Salomon Center Working Paper S-94-14 1994) (unpublished manuscript); see also FEDERAL DEPOSIT INSURANCE CORPORATION, *HISTORICAL STATISTICS ON BANKING 1934-1991*, at 102-05 (1993); HELEN A. GARTEN, *WHY BANK REGULATION FAILED* 25-31, 45 (1991); BANKING LAW AND REGULATION, *supra* note 35, at 56-58; PIERCE, *supra* note 33, at 76, 82 (placing stockholder equity at only six percent of all bank funds); McDaniel, *supra* note 18, at 214 (explaining that the equity-debt ratio has steadily declined since the early 1900's); Merton, *supra* note 27, at 9-11 (discussing high debt-equity ratios of banks). Today, under the Basle Accord, U.S. banks must have capital of at least eight percent of total risk-adjusted assets. See Hal S. Scott, *The Competitive Implications of the Basle Capital Accord*, 39 ST. LOUIS U. L.J. 885, 885-86 (1995).

In contrast, in 1962, the ratio of debt to book equity in the non-financial services sector averaged 58.2%. Subsequently, however, this gap began to close as debt-to-equity ratios climbed in non-financial corporations generally in the United States. By 1984, the average debt-to-equity ratio in non-financial companies had risen to 81.4%. See Coffee, *supra* note 18, at 41-42 & Exhibit A (citing Federal Reserve Bank statistics). After 1984, the Standard & Poor's Industrial Index continued to show a long-run rising trend. Average debt-to-equity ratios for companies listed in the Standard & Poor's Industrial Index rose from 42% in 1985 to 66% in 1994. See STANDARD & POOR'S ANALYSTS' HANDBOOK 220 (1995 Annual Edition); STANDARD & POOR'S ANALYSTS' HANDBOOK 192 (1989 Annual Edition); HOWARD M. BERLIN, *THE HANDBOOK OF FINANCIAL MARKET INDEXES, AVERAGES, AND INDICATORS* 59 (1990) (noting that the Standard & Poor's Industrial Index excludes financial companies, public utilities, and transportation companies).

1933, by the federal deposit insurance funds) stand to absorb the majority of any losses from bank asset activities. Thus, debt underpricing and leveraging perversely increase shareholders' and directors' propensity to seek risk, at potential increased losses to debtholders. When firms suffer losses that result in reduced capital, boards will have incentives to pursue increasingly risky strategies because the equity at risk is closer to zero and the firm will reap higher profits and possibly escape insolvency if the risk pays off.⁴³ Furthermore, even in profitable times, banks and other firms have incentives to increase risks if they can finance those ventures with artificially cheap funds.⁴⁴

To be sure, these effects can be partially offset by other market forces. In banking, one such force consists of bank charters, which have added value due to government rationing. Healthy banks have countervailing incentives to avoid ruinous risks in order to preserve the oligopolistic advantages of their charters and the future business prospects that their charters represent.⁴⁵ When deregulation lowers entry barriers into the banking industry, however, bank charters drop in value, reducing their effectiveness as market constraints.⁴⁶ Charter values similarly drop when banks approach insolvency, reducing the prospects for future business to zero.⁴⁷

A second market constraint, as Dr. Anna J. Schwartz has pointed out, consists of economic indicators that help reduce long-term interest rate risk, primarily price stability and stable interest rates. Banks make money by borrowing more cheaply than they lend, which pressures them to pursue higher-risk investments if

43. See BENSTON ET AL., *supra* note 24, at 19-20; GATHERING CRISIS, *supra* note 35, at 65, 103, 106-07; William K. Black et al., *The Savings and Loan Debacle of the 1980s: White-Collar Crime or Risky Business?*, 17 L. & POL'Y 23, 33-36 (1995) (describing the after-effects of some firms having taken extreme risks in the 1980's in pursuit of large rewards); Stephen A. Buser et al., *Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital*, 36 J. FIN. 51, 59 (1981) (same); Alan J. Marcus, *Deregulation and Bank Financial Policy*, 8 J. BANKING & FIN. 557, 561 (1984) (stating that a "go for broke" strategy of exploiting FDIC insurance increases equity value for banks who have suffered loan losses).

44. As Professor Reinier Kraakman has noted: "[S]hareholders can displace the expected costs of legally risky or proscribed conduct either by operating the firm with net assets well below the level of its potential tort liabilities or by increasing the legal risk assumed by the firm." Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 869 (1984).

45. See ANLONG LI ET AL., *REGULATORY TAXES, INVESTMENT, AND FINANCING DECISIONS FOR INSURED BANKS 2-3* (Federal Reserve Bank of Cleveland Working Paper No. 9303, 1993) (describing the value, in terms of options and opportunities, of a charter to a bank).

46. See Marcus, *supra* note 43, at 558 (stating that deregulation can reduce the oligopolistic value of bank charters).

47. See LI ET AL., *supra* note 45, at 3; Marcus, *supra* note 43, at 557-58, 561 (observing that banks turn to high-volatility strategies as they approach insolvency and their charter values decrease).

interest on deposits rises. In the first two decades after World War II, banks did not have to court risky assets to pay for deposits because interest rates on deposits were statutorily capped and interest rates in general stayed low. When interest rates shot up in the 1970's, however, market pressures caused Congress to abolish interest caps, which in turn triggered a need for higher earnings, causing bank risks to climb.⁴⁸

A further possible market constraint consists of managerial fears of job loss if the firm goes under. Such fears vary, however, according to individual managers' degrees of risk aversion.⁴⁹ At least in banking, as the 1980's showed, some managers were willing to pursue high risks if the "potential rewards in the form of growth and earnings" were sufficiently high.⁵⁰ That proved particularly true when revenues from conservative investments were too low to offset costs. In such straits, with possible insolvency and job loss at hand, managers had every incentive to "go for broke" and make reckless investments in a quest for higher gains.⁵¹

In sum, the degree of asset substitution that the business judgment rule permits fluctuates widely according to the efficacy of the market constraints at work. Nonetheless, in its classic form, the business judgment rule does not discriminate among widely disparate industry and economic conditions. To the contrary, the rule is thoroughly indifferent to increased levels of asset substitution, except, in theory, for economically irrational decisions. To put it differently, under the pure form of the business judgment rule, debtholders' interests do not count. That is so even though the rule not only tolerates but *accelerates* shareholder incentives toward wealth expropriation.

48. See Schwartz, *supra* note 33, at 40-41. See also *infra* notes 146-47 and accompanying text.

49. See GATHERING CRISIS, *supra* note 35, at 113; see also Brudney, *supra* note 17, at 1837 n.48 (discussing managerial risk aversion).

50. Robert E. Barnett et al., *Deposit Insurance: The Present System and Some Alternatives*, 94 BANKING L.J. 304, 321 (1977); see also BENSTON ET AL., *supra* note 24, at 85-86 (suggesting that bankers have a greater propensity to pursue highly risky ventures because their cost of funds is subsidized).

51. BENSTON ET AL., *supra* note 24, at 19-20; see also GATHERING CRISIS, *supra* note 35, at 113; STAFF STUDY, *supra* note 38, at 76-77. One set of commentators noted the psychological dimensions of this problem:

Furthermore, might not bankers in such a situation convince themselves and their boards of directors that the possible negative outcome [of a risky decision] is very unlikely to occur? In addition, the banker has a moral and probably a legal responsibility to take actions that benefit the owners. Refusal to take a risky investment that has a positive present value could be interpreted as an evasion of this responsibility.

BENSTON ET AL., *supra*, at 20.

Given the extreme tilt toward asset substitution in the banking industry and the periodic paucity of market constraints, one might expect to see the business judgment rule curtailed in favor of legal relief for depositors.⁵² In fact, that has been the case. Episodically, American courts have sought to redress the problems that information asymmetries and leveraging create in banking by scaling back the business judgment rule in favor of depositor relief. Moreover, as the history of this case law shows, the banking cases cannot simply be dismissed as a quirk of federal deposit insurance, because some of the most important cases predate federal deposit insurance by decades. To the contrary, and in their own crude way, the banking cases seek to address the same asset substitution problems that all debtholders face.

II. THE HISTORICAL RECORD

At its inception in the nineteenth century, American bank director liability law resulted in the same outcomes that one would expect under the classic economic model of the business judgment rule. Beginning in the late nineteenth century, however, the banking cases struck out on a divergent path. As shareholder wealth expropriation from depositors took its toll, courts began to respond by curtailing the business judgment rule in banking in various ways. In doing so, the class of interests that courts protected gradually widened to include depositors' interests (joined, after 1933, by those of the deposit insurance funds).

A. *The Nineteenth Century: Potential Profit Maximization*

American bank director law was not always protective of depositors. When the first reported bank director liability cases appeared in the nineteenth century,⁵³ courts protected board autonomy and potential profit maximization, irrespective of risk. The outcomes in those cases were quite like the outcomes that one finds in general corporate law today. What makes the early banking cases intriguing is that the old cases today are largely relics.

52. Judge Richard Posner has argued that similar circumstances might justify regulation of some kind:

Oddly, perhaps, the argument for direct regulation comes back into play when the injury is not very small but very large. An injurer may not have the resources to pay a very large damages judgment; and if not, his incentive to comply with the law will be reduced—in effect he is able to shift from himself to the victim the difference between the victim's actual cost and the maximum collectable judgment.

RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 344 (3d ed. 1986).

53. Some of the earliest cases in that regard were *Percy v. Millaudon*, 8 Mart. (n.s.) 68 (La. 1829), and *Spering's Appeal*, 71 Pa. 11 (1872).

Over time, the judiciary responded to the asset substitution incentives that the early cases spawned by curbing the business judgment rule in banking.

Why did courts curtail the rule in banking to a greater degree than in other industries? Is modern banking law solely motivated by a narrow impulse to protect the federal deposit insurance funds, as some scholars have assumed, or do these cases constitute a broader judicial response to the same asset substitution that all debtholders face? And if the latter is the answer, why give preferential treatment to depositors over bondholders? To answer those questions, it is necessary to examine the origins of American bank director liability law.

The early nineteenth-century bank director cases reflected a theory of the firm and of directorial powers in which the principal interests served were those of shareholders and directors, to the exclusion of the interests of depositors. Nineteenth-century bank director liability law proceeded from the premise that shareholders invest capital in a bank with the implicit expectation of maximized profits. This premise gave rise to three allied propositions. First, it was assumed that shareholders either constituted the board or delegated authority to the board to make profit-maximizing decisions. Second, courts assumed that shareholders expected directors to take the necessary risks to achieve such profits. Finally, because shareholders stood to gain from any profits, courts concluded that shareholders bore the corresponding risk of loss.⁵⁴

This conception of shareholders' interests militated in favor of broad board discretion, largely free from judicial supervision. When shareholder and director interests clashed, nineteenth-century courts almost always subordinated shareholder claims to board autonomy. The upshot was that courts from that era rewarded, rather than penalized, risk. Nineteenth-century courts, for example, refused to hold directors of state-chartered institutions liable for overconcentrations of credit to single borrowers.⁵⁵ Early decisions

54. See *Spring's Appeal*, 71 Pa. at 21-24 (holding directors not liable for any losses outside of those arising from fraud or violations of charter); HERBERT HOVENKAMP, *ENTERPRISE AND AMERICAN LAW 1836-1937*, at 59-61 (1991) (describing these premises in terms of the development of contractual rights and obligations between investors and directors of firms). For modern statements of these rationales, see *Joy v. North*, 692 F.2d 880, 885-86 (2d Cir. 1981), *cert. denied*, 460 U.S. 1051 (1983) (setting forth rationales for the business judgment rule); Dooley, *supra* note 16, at 466-71 (discussing theory of shareholder delegation to board of directors); *Duty of Care*, *supra* note 24, at 344-45 (explaining how the business judgment rule can advance profit maximization); Palmiter, *supra* note 4, at 1371-72 (describing the rights, expectations, and responsibilities assumed by managers and investors when they contract with each other).

55. Compare *Wheeler v. Aiken County Loan & Sav. Bank*, 75 F. 781, 783 (C.C.D.S.C. 1896) (absolving bank directors in a shareholder suit even while criticizing their decision to loan one-third of the bank's capital to a prominent local merchant as

also showed lenience toward numerous practices treated harshly today, including worthless junior liens,⁵⁶ loose appraisal practices,⁵⁷ disregard of internal loan procedures,⁵⁸ and additional loans to delinquent borrowers.⁵⁹ Taken together, the nineteenth-century cases displayed an appetite for bank risk that is virtually shocking by modern mores.

The ethos of potential profit maximization at any risk level was also evident in the numerous nineteenth century cases that denied injured depositors the standing necessary to sue bank directors for negligent mismanagement.⁶⁰ The depositor standing cases proceeded from the premise that the sole contractual relationship depositors had was with their banks and not with the banks' boards of directors. The necessary consequence, in the eyes of many courts, was that depositors lacked privity of con-

"unwise and hazardous") with 12 U.S.C. § 1464(u) (Supp. 1994) (limiting loans to one borrower); 12 C.F.R. § 215.2(i), n.2 (1995) (allowing lower state limits on loans to one borrower to preempt federal limit if state limit is lower); *id.*, pt. 215, subpt. A, app. (limiting total loans and extensions of credit); *id.*, § 563.93 (defining lending limitations on savings associations); 59 Fed. Reg. 58146 (1994) (describing regulations for loans to one borrower); 58 Fed. Reg. 64460 (1993) (containing original regulations for loans to one borrower); *Bailey v. O'Neal*, 122 S.W. 503, 505 (Ark. 1909) (affirming directed verdict for plaintiff bank depositors after bank loaned nearly half of its assets to a local lumber company).

56. *Compare* *Citizens Building, Loan & Sav. Ass'n v. Coriell*, 34 N.J. Eq. 383, 384-88, 390-93 (Ch. 1881) (holding bank directors not negligent for insufficient junior mortgages) with *FDIC v. Stanley*, 770 F. Supp. 1281, 1292-93, 1296-98, 1313-14 (N.D. Ind. 1991), *aff'd sub nom.* *FDIC v. Bierman*, 2 F.3d 1424 (7th Cir. 1993) (holding the making of junior liens negligent).

57. *Compare* *Williams v. McKay*, 18 A. 824, 832 (N.J. Ch. 1889) (refusing to impose liability for appraisal methods) with *Alliance Federal Savings & Loan Ass'n v. FHLBB*, 782 F.2d 490, 493 (5th Cir.), *modified, per curiam*, 790 F.2d 34 (5th Cir. 1986) (affirming an agency order putting a thrift institution into receivership due in part to poorly documented appraisals of collateral); *RTC v. Rahn*, 854 F. Supp. 480, 490 (W.D. Mich. 1994) (condemning inflated appraisals as negligent).

58. *Compare* *Wheeler v. Aiken County Loan & Sav. Bank*, 75 F. 781, 787, 789 (C.C.D.S.C. 1896) (finding no negligence for disregarding ban on loans to shareholders who had not paid their subscriptions) with *FDIC v. Wheat*, 970 F.2d 124, 129 & n.11 (5th Cir. 1992) (holding bank director who approved a loan in violation of internal loan procedures negligent).

59. *Compare* *Wheeler*, 75 F. at 784 (exonerating bank officers who advanced additional funds to delinquent borrower) with *Medford Trust Co. v. McKnight*, 197 N.E. 649, 660 (Mass. 1935) (holding advances to delinquent borrowers negligent).

60. *See, e.g.*, *Union Nat'l Bank v. Hill*, 49 S.W. 1012 (Mo. 1899); *Hart v. Evanson*, 105 N.W. 942 (N.D. 1895); *Swentzel v. Penn Bank*, 23 A. 405, 414-15 (Pa. 1892); *Deadrick v. Bank of Commerce*, 45 S.W. 786 (Tenn. 1898); *Zinn v. Mendel*, 9 W. Va. 580 (1876).

tract with, and thus standing to sue, bank directors.⁶¹ The depositor standing doctrine neatly aligned with the view that the duty of care only served the interests of shareholders.

The bar against depositor negligence suits was highly significant because it assured that potential profit maximization would not be eclipsed by the risk avoidance that many depositors undoubtedly would have preferred. Thus, early bank failure cases accepted shareholder wealth expropriation from depositors, in the form of asset substitution and otherwise, as the price of potential profit maximization.⁶²

Similarly, the rare exceptions to leniency corroborated the overarching goal of potential profit maximization. Those exceptions make clear that courts normally deemed shareholder interests and board autonomy as pre-eminent. They equated those interests with potential profit maximization in the absence of contractual restrictions, and intervened only when necessary to protect those interests. The upshot was that early bank director liability cases gave asset substitution free rein to the detriment of depositors.

61. See *Union Nat'l Bank*, 49 S.W. at 1016 (holding that no privity of contract existed between creditors and directors); *Hart*, 105 N.W. at 943 (same); *Deadrick*, 45 S.W. at 788; see also *Briggs v. Spaulding*, 141 U.S. 132, 147 (1891) (holding that the relationship between the corporation and creditors "is that of contract and not of trust").

62. The harshness of this result was tempered in part by "double liability" provisions in state and federal statutes, state constitutions, and bank charters making bank shareholders liable to creditors for an assessment up to the amount of the par value of their stock in the event of insolvency. See, e.g., National Banking Act of 1863, ch. 58, 12 Stat. 665; Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31, 31 & n.1, 35-37 (1992) (describing the rise and fall of the double liability concept in the early 1900's). Beginning in the Great Depression, double liability provisions were repealed to make it easier for banks to raise equity financing. See 12 U.S.C. § 64a (1993); Act of September 8, 1959, Pub. L. 86-230, § 7, 73 Stat. 457; Banking Act of 1935, ch. 614, § 304, 49 Stat. 684, 708 (repealed 1959); Banking Act of 1933, ch. 89, § 22, 48 Stat. 162, 189 (repealed 1959); Macey & Miller, *supra*, at 38-39 (discussing the factors contributing to the decision to repeal double liability laws); John R. Vincens, *On the Demise of Double Liability for Bank Shareholders*, 12 BUS. LAW. 275, 276-78 (1957) (describing the movement away from double liability provisions).

Double liability provisions may partly explain the judiciary's hands-off attitude during this early period. However, those provisions do not explain that lenience in full. For one thing, many states delayed adopting double liability and some states never adopted it at all. See Macey & Miller, *supra*, at 36-37. Furthermore, in those states that did adopt double liability, such provisions did not purport to afford full compensation to depositors for their losses and did not, in fact, shift anywhere near the full cost of asset substitution from depositors and other creditors onto shareholders. See *id.* at 57 (between 1865 and 1934, shareholder recoveries compensated 28.3% of national bank creditors' losses). Even when double liability clauses are taken into account, then, the directorial case law of this period still displayed a decided appetite for risk.

1. Corporate Charters and By-Laws

The principal situation in which nineteenth-century courts countermanded bank board decisions on the merits involved violations of corporate charters and by-laws.⁶³ Conversely, bank directors normally could expect to be exonerated where charters or by-laws permitted the disputed decision, either expressly or by inference.⁶⁴

As these holdings show, where fundamental corporate documents did not explicitly define shareholders' interests, nineteenth-century courts equated those interests with potential profit maximization and gave directors virtually limitless discretion to take risks commensurate with high profits. Where, however, shareholders explicitly modified those interests by imposing restrictions on profit-seeking conduct through corporate charters and by-laws, courts enforced those restrictions. Indeed, during this early period, when the duty of care largely consisted of observance of corporate charters and by-laws, there was no business judgment rule because there was no need for it. Any disinterested decision that was not barred by charter, by-law, or statute satisfied the duty of care.

2. Statutory Restrictions

In theory, statutory prohibitions formed a second legal constraint on bank director conduct in the nineteenth century. Before 1875, most state-chartered banks were organized under special chartering statutes that mandated substantive charter restrictions. However, this constraint was relatively weak, at least for purposes of asset substitution concerns, because few state codes mandated

63. See *Williams v. McKay*, 18 A. 824, 825, 829-30 (N.J. Ch. 1889) (imposing bank director liability for a second mortgage that violated bank charter restrictions on loan collateral); *Citizens Building, Loan & Sav. Ass'n v. Coriell*, 34 N.J. Eq. 383, 397 (Ch. 1881) (holding bank directors liable for approving a loan in violation of a by-law restricting loans secured by stock). See also *infra* notes 65, 94-95 and accompanying text (discussing statutorily-mandated bank charter provisions).

64. See *Wallace v. Lincoln Sav. Bank*, 15 S.W. 448, 454 (Tenn. 1891) (interest-free check overdrafts were not negligent "in the absence of a by-law or order of a superior officer"); *Coriell*, 34 N.J. Eq. at 397 (absolving bank directors for loans in arrears because the loans were not "in contravention of any express provision of the constitution [notwithstanding the board's] error of judgment"); *Spring's Appeal*, 71 Pa. 11, 20, 24 (1872) (dismissing suit against bank directors for inadequately secured loans where counsel had advised them that the loans were permitted by the charter); *Percy v. Millaudon*, 8 Mart. (n.s.) 68, 75-76 (La. 1829) (stating that directors should not be held responsible for events occurring outside the realm of prudent care, for such care is not mandated by their banks' charters). This line of cases persisted until the Great Depression. See *Castetter v. Barnard*, 183 N.E. 681, 686 (Ind. App. 1932) (absolving bank cashier for failure to collect loan because he did not "violate[] any by-law, direction, or resolution of the board of directors"); *Ford v. Taylor*, 4 S.W.2d 938, 938-42 (Ark. 1928) (holding directors solely liable for loans made in violation of board resolution).

charter provisions on asset-side activities (such as lending) or otherwise regulated those activities before 1900. Instead, state banking codes principally dealt with entry barriers, minimum capital, reporting requirements, government bank examinations, and state precursors to deposit insurance.⁶⁵ Statutory constraints thus had little

65. See generally GEORGE H. EVANS, JR., BUSINESS INCORPORATIONS IN THE UNITED STATES 1800-1943, at 10, 24-26 (1948) (describing charters, including bank charters, granted during the 1800's); GERALD C. FISCHER, AMERICAN BANKING STRUCTURE 179, 184 (1968) [hereinafter AMERICAN BANKING STRUCTURE] (describing bank regulations and charters with respect to American banks during the 19th century); LAWRENCE FRIEDMAN, A HISTORY OF AMERICAN LAW 180 (2d ed. 1985) (same); JAMES W. GILBART, THE HISTORY OF BANKING IN AMERICA 58-59, 101-02 (Augustus M. Kelley 1967) (1837) (describing bank charters in New York during the 18th and 19th centuries); JAMES GRANT, MONEY OF THE MIND—BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN 136-37 (1992) (describing New York reformers' preference for deposit insurance over loan underwriting standards); BRAY HAMMOND, BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR 695-96, 715-17 (1957) (describing state-mandated minimum capital requirements for banks in the 1800's); NOBLE F. HOGGSON, EPOCHS IN AMERICAN BANKING 94, 97 (1929) (describing Massachusetts' bank report requirements and New York's minimum capital requirements); JAMES W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970, at 39 (1970) (listing mandatory provisions enacted by state legislatures for inclusion in state bank charters); BENJAMIN J. KLEBANER, AMERICAN COMMERCIAL BANKING—A HISTORY 43-46, 99-101 (1990) (describing New England charters, regulating reserve requirements and governmental supervision and inspectors); I FRITZ REDLICH, THE MOLDING OF AMERICAN BANKING—MEN AND IDEAS 92, 94-95, 199, 201-04 (Johnson Reprint Corp. 1968) (1951) (describing bank examinations and free banking acts); II FRITZ REDLICH, THE MOLDING OF AMERICAN BANKING—MEN AND IDEAS 2, 32-40 (recounting the history and effects of the Louisiana Banking Act of 1842); PAUL B. TRESCOTT, FINANCING AMERICAN ENTERPRISE—THE STORY OF COMMERCIAL BANKING 29-30, 91-92 (1963) (addressing bank examinations and the lack of lending requirements in the early 1800's); EUGENE NELSON WHITE, THE REGULATION AND REFORM OF THE AMERICAN BANKING SYSTEM, 1900-1929, at 23-25, 34-35 (1983) [hereinafter REGULATION AND REFORM] (detailing the effects of charter provisions enacted regarding banks); Allen D. Boyer, *Activist Shareholders, Corporate Directors, and Institutional Investment: Some Lessons from the Robber Barons*, 50 WASH. & LEE L. REV. 977, 1016-17 (1993) (stating that the statutes had "protected directors from liability for minor infringements on special charters"); Richard S. Grossman, *Deposit Insurance, Regulation, and Moral Hazard in the Thrift Industry: Evidence from the 1930's*, 82 AM. ECON. REV. 800, 804 (1992) (describing the slow introduction of asset regulation to the thrift industry). Only a few states had statutes governing loans to single borrowers or placing any restrictions on real estate loans. See Trescott, *supra*, at 29-30; Kenneth E. Scott, *The Patchwork Quilt: State and Federal Roles in Bank Regulation*, 32 STAN. L. REV. 687, 707-08 (1980) (noting that state loan-to-one-borrower rules date back to the early nineteenth century). Gerald C. Fischer noted in this regard:

[A]s the number of state banks began to increase in the 1870s and 1880s, their operations were inhibited by out-of-date laws in some states and in others they were subjected to virtually no regulation whatsoever. If the state authorities had a "chartering philosophy" in this period it is almost impossible to describe except to note that in present-day terms it would appear to have been extremely liberal.

AMERICAN BANKING STRUCTURE, *supra*, at 180.

Double liability provisions constituted an important exception to the general pattern of lenience. The effectiveness of those provisions for purposes of compensation and deter-

effect on asset decisions at state-chartered banks.

The situation was notably different for national banks, which operated under statutory strictures as to loans to one borrower, real estate lending and securities underwriting.⁶⁶ National Banking Act violations accounted for most of the early reported cases involving bank violations of statutory asset limitations.⁶⁷ As a consequence, with state-law constraints during this period noticeably weak or absent, state-chartered banks gained a valuable competitive edge vis-à-vis their national bank counterparts which labored under the restrictions of the National Banking Act.⁶⁸

3. Prohibitions Against Fraud and Self-Dealing

The third nineteenth-century constraint on bank director conduct consisted of bans on bank director fraud⁶⁹ and, eventually,

rence, however, remains a matter of debate, given their equivocal recovery experience. See *supra* note 62.

66. Federal limits on loans to one borrower date back to 1863, when Congress barred national banks in the Currency Act from lending more than 10% of their unimpaired capital and surplus to a single borrower. Act of February 25, 1863, 12 Stat. 665 (codified as amended at 12 U.S.C. § 84 (1989)).

Similarly, the National Banking Act placed significant limitations on real estate loans. Before 1900, loans secured by real estate were forbidden to national banks in New York, Chicago, and St. Louis and permitted elsewhere only up to 25% of bank capital. Where real estate loans were permitted, they were subject to statutory loan-to-value requirements as low as 50%. See 12 U.S.C. § 371(a) (Supp. 1994) (authorizing Comptroller to regulate real estate loans by national banks); *id.*, Historical and Statutory Notes (West 1989) (discussing amendments to statutorily-mandated loan to value ratios); REGULATION AND REFORM, *supra* note 65, at 23. Due to these restrictions, state banks had "a virtually open field to make loans on security of real estate." *Id.* See also Trescott, *supra* note 65, at 91-92 (describing the surge in business for state banks due to the limitations imposed on national banks).

The National Banking Act likewise was construed to bar securities underwriting. In 1897 the Supreme Court ruled that the National Banking Act barred national banks from owning stock and, thus, barred banks from firm-commitment securities underwriting (although national banks could conduct underwriting activities through their securities affiliates). *California Bank v. Kennedy*, 167 U.S. 362, 366-67 (1897) (construing the National Banking Act, ch. 106, 13 Stat. 101 (1864) (codified at 12 U.S.C. § 24 (1989)). See also II MICHAEL P. MALLOY, BANKING LAW AND REGULATION at 7.13-7.15 (1994) (discussing securities dealings by wholly-owned subsidiaries of national banks).

67. See, e.g., *Yates v. Jones Nat'l Bank*, 206 U.S. 158 (1907) (lending limits); *Thompson v. Sioux Falls Nat'l Bank*, 150 U.S. 231 (1893) (same); *Movius v. Lee*, 30 F. 298 (C.C.N.Y. 1887), *aff'd*, 141 U.S. 132 (1891) (same). Two rare instances of state-law statutory claims were *Gause v. Commonwealth Trust Co.*, 89 N.E. 476, 478-79, 483 (1909) (invalidating bank contract because directors had violated statutory procedural requirements for board approval) and *Gilson v. Cambridge Sav. Bank*, 62 N.E. 728, 728-29 (1902) (same).

68. See II Redlich, *supra* note 65, at 124 (discussing the advantage that state banks achieved over national banks as a result of the Act's restrictions on real estate loans and minimum capital requirements); *McCoy*, *supra* note 2, at 1041-42, 1048-50, 1053.

69. See *Wheeler v. Aiken County Loan & Sav. Bank*, 75 F. 781, 785 (C.C.D.S.C. 1896) (stating that "in every case where such directors have been held to account, they have been [somehow] guilty of some fraud"); *Spering's Appeal*, 71 Pa. 11, 20, 24 (1872)

conflicts of interest.⁷⁰ These constraints were adopted to prevent directors from defeating shareholder expectations that their capital would be put to profitable ends.

Up through the 1930's, however, some courts diluted these constraints by refusing to hold directors liable where self-interested decisions had profitable outcomes or even profitable prospects.⁷¹ Thus, even with the heightened risks of self-dealing, some older American banking decisions resolved self-dealing claims in favor of potential profit maximization.

Those self-dealing cases epitomize the extreme laissez-faire attitude toward asset substitution by shareholders and their boards that permeated the early stages of American bank director liability law. During most of the nineteenth century, potential profit maximization, not loss avoidance, was the prevailing norm. The vast majority of courts during that period refused to interfere with lending decisions, even when such decisions were reckless and likely to result in losses. Some courts went so far as to permit conflicts of interest where a possible profit was to be had.

As the nineteenth century drew to a close, however, the judiciary's blind eye to heedlessly risky bank practices helped trigger a destabilizing series of bank failures and bank panics. Although laissez-faire sentiment largely continued to prevail, there were early signs by the mid-1880's, as recurrent bank panics took

(holding bank directors responsible for losses arising from fraud for their own benefit). See also II Redlich, *supra* note 65, at 12 (referring to a Pennsylvania law that held bank directors liable for "fraudulent insolvency").

70. See *Wheeler*, 75 F. at 785, 787; *Wallace v. Lincoln Sav. Bank*, 15 S.W. 448, 450 (Tenn. 1891); *Spring's Appeal*, 71 Pa. at 20, 24. Self-dealing always has been a heightened concern in bank director liability law due to the common practice of recruiting bank directors from major borrowers and prominent businessmen. Cf. I Redlich, *supra* note 65, at 56, 252-53 nn.100-116 (noting that "[t]he ideal bank director [in the early nineteenth century] seems to have been rather rare; and, as might be expected, those who were anxious to become bank directors were impelled by the desire for capital, or profit or prestige, or all of these") (footnotes omitted).

71. See, e.g., *Gallin v. National City Bank*, 152 Misc. 679, 273 N.Y.S. 87, 99-101 (N.Y. Sup. Ct. Special Term 1934) (holding that business judgment rule protected loans to bank officers and employees to purchase securities from the bank's securities affiliate, even if the loans were "unwise and hazardous," where the purpose of the loans was to maintain continued efficiency of the bank's personnel); *Caster v. Barnard*, 183 N.E. 681, 683, 686 (Ind. App. 1932) (cashier not liable for making a bank loan to his father that was designed to conceal his embezzlement because the loans appeared collectible when made); *Scott's Executors v. Young*, 21 S.W.2d 994, 999 (Ky. 1929) (affirming dismissal of claim against bank directors for approving unsecured loans to bank cashier who later turned out to be an embezzler); *Smith v. First Nat'l Bank*, 217 Ky. 471, 290 S.W. 346, 346-47 (1926) (reversing judgment against bank director who had recommended an uncollectible loan to a manufacturer for whom he served as a director based on a business judgment rule defense); *Pocomoke City Nat'l Bank v. Crockett*, 125 A. 712, 713-16 (Md. 1924) (affirming judgment for bank directors sued for lending nearly half of a bank's assets to the bank's vice president); *Wheeler*, 75 F. at 781-83 (exonerating bank directors for loaning over one-third of the bank's capital to a fellow director).

their toll, that the judiciary's tolerance for shareholder wealth expropriation from depositors was beginning to wane.

B. *The Laissez-Faire Approach in Decline*

By 1891, the United States had experienced no fewer than twelve bank panics, with another panic in the wings.⁷² Triggered by rumors that bank failures were imminent, depositors rushed in an exodus to convert their deposits into currency, causing the money supply (and consequently bank credit) to contract. As successive waves of panic pounded the country, some courts began to second-guess the extreme risks taken by banks and to adopt stricter legal protections for depositors.

1. The Savings Bank Cases

The first bank director liability decisions to disavow potential profit maximization in favor of depositor protection were cases involving savings banks. Savings banks first appeared in America in the early 1800's and started as philanthropic institutions designed to encourage industry and thrift among the working class.⁷³ To that end, savings banks were nominally prohibited from profit-seeking and speculation. Instead, their only permissible role was to "take the deposits, usually small, which are offered, aggregate them, and keep and invest them safely, paying such interest to the depositors as is thus made, after deducting expenses, and paying the principal upon demand."⁷⁴ To minimize investment risks,

72. See NICHOLAS A. LASH, *BANKING LAWS AND REGULATIONS: AN ECONOMIC PERSPECTIVE* 8 (1987) (describing the bank panic of 1893); AMERICAN BANKING STRUCTURE, *supra* note 63, at 186 (same); Charles W. Calomiris, *Regulation, Industrial Structure, and Instability in U.S. Banking: A Historical Perspective*, in *STRUCTURAL CHANGE IN BANKING* 19, 22, 26-29 (Michael Klausner et al. eds., 1993); Schwartz, *supra* note 33, at 38-39, Table 2-1 (listing the years that the United States experienced bank panics).

73. See *People v. Franklin Nat'l Bank*, 305 N.Y. 453, 461 (1953), *rev'd on other grounds*, 347 U.S. 373 (1954); *People v. Ulster County Sav. Inst.*, 20 N.Y.S. 148, 151 (Sup. Ct. Spec. Term Ulster Co. 1892) (describing savings banks as noncommercial enterprises intended to serve members of the community); *In re Wilkins*, 131 Misc. 188, 193 (1928) (differentiating between commercial and savings banks). See generally I Redlich, *supra* note 65, at 209-30.

74. *Hun v. Cary*, 82 N.Y. 65, 78 (1880). See also *People v. Binghamton Trust Co.*, 139 N.Y. 185, 192 (1893) (stating that the purpose of savings banks is to make safe investments and secure a moderate return); *Ulster County Sav. Inst.*, 20 N.Y.S. at 150 (noting that savings banks are not profit-oriented, while commercial banks are); *People v. Franklin Nat'l Bank*, 200 Misc. 557, 566-67 (N.Y. Sup. Ct. 1951), *rev'd on other grounds*, 118 N.Y.S. 2d 210 (1953) (describing the purpose of savings banks); Suzanne Cutler, *History, Character and Recent Difficulties of Mutual Savings Banks*, in *FEDERAL RESERVE BANK OF NEW YORK ET AL., PUBLIC POLICY TOWARD MUTUAL SAVINGS BANKS IN NEW YORK STATE: PROPOSALS FOR CHANGE* 33, 35 (1974); see generally ALAN L. OLMSTEAD, *NEW YORK CITY MUTUAL SAVINGS BANKS, 1819-1861*, at 6-19 (1986).

savings banks were only permitted to invest in vehicles that were permitted by law.⁷⁵

In some states, most notably New York, these origins dictated a philanthropic form of governance for savings banks. Unlike commercial banks, New York savings banks did not have shareholders or boards of directors. Instead, their governance was entrusted to trustees who owed fiduciary duties to the depositors.⁷⁶ The trustees' overriding purpose was "the protection of depositors against the loss of hard-earned savings."⁷⁷ "[T]heir principal method[s] of accomplishing that purpose [were] caution and conservatism in investments."⁷⁸ Moreover, New York required a mutual form of ownership which meant that no independent equity was available to absorb any losses. "No capital, as in the case of a bank of deposit and discount, stands between the depositors and loss. The loss must fall directly upon the deposits, or upon the earnings of those deposits, to which the depositors are entitled."⁷⁹

Thus, savings banks were the one species of nineteenth-century banks in which depositors' interests were not only legally cognizable, but paramount. The rhetoric of those cases makes clear that the operative legal principle was loss avoidance, not potential profit maximization, in claims against trustees or directors of such banks. In *Marshall v. Farmers' & Mechanics' Savings Bank*,⁸⁰ for example, the court explicitly stated: "The directors of a bank are not trustees for the stockholders alone, *but they owe an even earlier duty to the depositors.*"⁸¹ That duty, courts stressed, inhered in the fact that depositors entrusted their funds to the bank for safekeeping:

These defendants voluntarily took the position of trustees of the bank. They invited depositors to confide to them their savings, and to intrust the safe-keeping and management of them to their skill and prudence.⁸²

75. See *Binghamton Trust Co.*, 139 N.Y. at 192; *Franklin Nat'l Bank*, 200 Misc. at 567 (discussing state-imposed restrictions on investments by savings banks); *In re Wilkins*, 131 Misc. at 193 (same); cf. MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 56 & n.8 (1994) (Massachusetts prohibited its savings banks from out-of-state lending).

76. See *Ulster County Sav. Inst.*, 20 N.Y.S. at 150; Cutler, *supra* note 74, at 35.

77. Cutler, *supra* note 74, at 35.

78. *Franklin Nat'l Bank*, 305 N.Y. at 461.

79. *Williams v. McKay*, 18 A. 824, 837 (N.J. Ch. 1889).

80. 8 S.E. 586 (Va. 1889).

81. *Id.*, at 590 (emphasis added); see also *id.* at 591 ("The question arises in this case as between the directors and depositors, and not between the directors and the stockholders. . . ."); *Gilson v. Cambridge Savings Bank*, 62 N.E. 728, 728 (Mass. 1902) ("[S]avings banks [are] intended to protect the interests of depositors. . . .").

82. *Hun v. Cary*, 82 N.Y. 65, 74 (1880).

Courts showed a distinctly populist solicitude toward savings bank depositors, because they generally were individuals of modest means:

Each of these [director] defendants was so associated with wage-workers that his connection with the bank tended to induce the confidence of those people in that institution. Mr. Sweeney superintended five or six hundred freight handlers; Dr. O'Callaghan had a large practice among the very people who became depositors in this bank; and Kelly, Murphy, and Meehan were employers of numerous workingmen. They each undertook to care for the deposits of these poor people⁸³

That solicitude had several objectives, all of which centered on depositors. Some cases voiced the sentiment that working men and women needed to be instilled with the virtues of frugality and hard work.⁸⁴ Other passages emphasized the catastrophic personal nature of losses to working-class victims.⁸⁵ One case stressed the importance of public trust in banks, and thus implicitly in bank system liquidity.⁸⁶

The solicitude toward depositors in the early savings bank cases was evident not only from their rhetoric but also from their outcomes. *Hun v. Cary*,⁸⁷ for example, which excoriated bank trustees for building an expensive new building, involved a savings bank.⁸⁸ The same is true of *Jemison v. Citizens' Savings Bank*,⁸⁹ which banned savings banks from dealing in securities. *Marshall v. Farmers' & Mechanics' Savings Bank*⁹⁰ penalized extensions of non-performing loans, and *Gilson v. Cambridge Savings Bank*⁹¹ held that loans ridden with procedural irregularities were *ultra vires*.

83. *Williams*, 18 A. at 836 (emphasis added).

84. See *Jemison v. Citizens' Savings Bank*, 25 N.E. 264, 265 (N.Y. 1890) ("Savings banks are designed to encourage economy and frugality among persons of small means. . . ."); see also *Williams*, 18 A. at 837 (stating that a savings bank's failure to invest properly discourages the frugality of depositors).

85. See *Williams*, 18 A. at 837 ("The failure of a bank of this character entails suffering"); *Jemison*, 25 N.E. at 265 (savings banks "are organized with restrictions and provisions intended to secure depositors against loss").

86. See *Williams*, 18 A. at 837 (the failure of a savings bank "produces distrust").

87. 82 N.Y. 65 (1880).

88. *Id.* For discussions of *Hun*'s significance as one of the earliest minimum rationality cases, see Dooley, *supra* note 16, at 480 n.60; Dyson, *supra* note 4, at 370; McCoy, *supra* note 2, at 1037, 1039-40, 1058 & n.115.

89. 25 N.E. 264 (N.Y. 1890).

90. 8 S.E. 586, 591-92 (Va. 1889).

91. 62 N.E. 728 (Mass. 1902).

Similarly, some of the savings bank cases were brought by plaintiffs who were uniquely aligned with depositors' interests. In *Marshall v. Farmers' & Mechanics' Savings Bank*, for example, the plaintiffs were the failed bank's creditors.⁹² In *Hun v. Cary*, the plaintiff was the bank's receiver.⁹³ To be sure, both suits were filed after insolvency, when creditors' interests traditionally have received priority. Nevertheless, these cases were significant because they set restrictive standards that applied to savings bank directors across the board, regardless of whether their institutions were in good financial health or approaching insolvency. These cases were the earliest examples where depositor's representatives were permitted to regulate bank affairs prospectively, as it were, from the grave.

The savings bank cases are important in two significant respects. By conferring creditor standing, and by favoring loss avoidance at the expense of board discretion, they were the first decisions to clothe depositor concerns over asset substitution with legally protected status through tort law. Moreover, they embraced this result nearly a half century before federal deposit insurance was instituted in 1933. Thus, far from being limited to protection of the federal fisc, the earliest restrictive banking cases sought to redress direct harm to individual depositors through asset substitution.

Why such solicitude for depositors, when corporate bondholders received none? As a legal matter, this doctrinal departure was possible because the avoidance of losses was legally paramount in savings banks. More importantly, the departure was hastened by the fact that the injured debtholders were working-class men and women who had parted with their savings solely on guarantees of a full return. Thus, the early savings bank cases had a distinctly populist cast not found in bondholder law at large.

The savings bank cases gave debtholder-depositors a human face, revealing a sensitivity to the human harm caused by asset substitution that is atypical of general corporate law as a whole. In the century to come, this solicitude for depositors would not only characterize the narrow sector of savings banks, but would also come to characterize the banking sector as a whole.

92. 8 S.E. at 586.

93. 82 N.Y. at 70. See also *Williams v. McKay*, 18 A. 824 (N.J. Ch. 1889), where a bank receiver successfully sued a savings bank's former directors for charter violations.

2. The Diminished Policing Power of Charters

During the latter half of the nineteenth century, changes in state bank chartering practices also may have fueled the impetus for tighter bank director liability standards. It is questionable whether corporate charters and by-laws were effective constraints on undue risk-taking at all, particularly because they rarely constrained asset activities directly. However, to the extent that charters and by-laws did constrain asset risk indirectly, they had their greatest force before 1875, when special chartering statutes required the inclusion of clauses on subjects such as minimum paid-in capital, reserves, and reporting and examination requirements.⁹⁴ But by the latter half of the 1800's, charters and by-laws began to wane as a policing force. During that period, banks convinced state legislatures to scrap special chartering laws for general incorporation statutes that permitted banks to engage in all activities not otherwise barred by law. That transition was substantially completed by 1900 and spelled the death knell for corporate instruments as effective legal constraints on bank board conduct.⁹⁵

Thus, with the rise of general incorporation statutes and the relative rarity of reported cases imposing liability for violations of bank charters and by-laws, some courts began to conclude that corporate governance instruments were not a convenient or effective rein on behavior.⁹⁶ Beginning in the 1890's, courts stepped into the breach, substituting common-law tort standards for bank charters and by-laws as the most important basis of bank director liability.

94. See Hurst, *supra* note 65, at 39; see also Evans, *supra* note 65, at 10, 24-26; Klebaner, *supra* note 65, at 43; Boyer, *supra* note 65, at 1016-17 (stating that peculiar corporations were the subject of detailed regulation). Few of those statutes restricted bank asset activities, however. See *supra* notes 65-68 and accompanying text.

95. See AMERICAN BANKING STRUCTURE, *supra* note 65, at 180 (describing the evolution of state bank chartering); Hovenkamp, *supra* note 54, at 59-60 (describing the decline of the special charter as a legal restraint on corporate officers' conduct); Hurst, *supra* note 65, at 69-73, 135, 138; I Redlich, *supra* note 65, at 187-204; Trescott, *supra* note 65, at 30-31. Cf. *Liggett Co. v. Lee*, 288 U.S. 517, 557 (1932) (Brandeis, J., dissenting) ("The removal by the leading industrial States of the limitations upon the size and powers of business corporations appears to have been due, not to their conviction that maintenance of the restrictions was undesirable in itself, but to the conviction that it was futile to insist upon them.").

96. See Friedman, *supra* note 65, at 180. See also Hurst, *supra* note 65, at 39-40, 46; Gregory A. Mark, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441, 1455 (1987).

One recent case has gone so far as to assert that "the business judgment rule will protect a director even if the acts are ultra vires." *FDIC v. Benson*, 867 F. Supp. 512, 522 (S.D. Tex. 1994). As a proposition of law, however, that is plainly wrong: observance of corporate charters and by-laws always has been a prerequisite of the business judgment rule, however peripheral that prerequisite is as a practical matter today.

C. From Charter to a Common-Law Duty of Care

The late nineteenth century marked a significant shift in the doctrinal bases of bank director liability that paved the way for greater judicial intervention in bank board affairs. The 1880's savings bank cases had opened the breach by charging trustees and directors with a tort duty of care, over and above their duties under statutes, charters, and by-laws. Not long after, in 1891, the U.S. Supreme Court extended the tort-based approach to directors of national banks in the watershed case of *Briggs v. Spaulding*,⁹⁷ decided by a 5-to-4 majority.

In *Briggs*, the receiver of the First National Bank of Buffalo sued the bank's former directors for negligence. According to the receiver, the directors were guilty of not stopping the officers from violating lending limits and making illegal loans.⁹⁸ Because the bank was a national bank, the *Briggs* majority turned to the National Banking Act for guidance on the standard of care. It determined that § 5239, which made national bank directors personally liable for knowing violations of the Act,⁹⁹ did not directly apply because the complaint did not allege that the directors acted knowingly or fraudulently.¹⁰⁰ Nonetheless, reasoning by analogy, the Court concurred that the National Banking Act furnished a common-law standard of care.¹⁰¹

The majority and dissent divided over the directors' culpability on the facts, with the dissent arguing that the directors had breached the duty to supervise and the majority holding that they had not.¹⁰² But as to the formulation of the duty of care, the dissent and the majority essentially agreed: "In any view the degree of care to which [bank directors are] bound is that which ordinarily prudent and diligent men would exercise under similar circumstances"¹⁰³

Strictly speaking, the common-law duty in *Briggs* derived from an analogy to the National Banking Act and was tailored to national banks. Soon, however, *Briggs* began to be adopted outside of the national bank context. By the turn of the century, state and federal courts were applying the duty of care announced in *Briggs* to state and national bank directors alike.¹⁰⁴

97. 141 U.S. 132 (1891).

98. *Id.* at 142-43.

99. The current version is 12 U.S.C. § 93(a) (1989).

100. 141 U.S. at 145.

101. *Id.* at 146.

102. Compare *id.* at 166, with *id.* at 173 (Harlan, J., dissenting).

103. *Id.* at 152; see also *id.* at 169-70 (Harlan, J., dissenting).

104. See, e.g., *Wheeler v. Aiken County Loan & Sav. Bank*, 75 F. 781, 785 (C.C.D.S.C. 1896) (applying *Briggs*); *Holmes v. McDonald*, 226 Ill. 169, 175-76 (1907)

Briggs, then, marked a watershed in bank director liability standards, in which the narrow emphasis on charter and by-law provisions gave way to a new and potentially expansive standard of tort care.¹⁰⁵ To be sure, some earlier bank cases had language to the effect that directors owed a duty of skill and diligence to their banks or to shareholders.¹⁰⁶ But the outcomes in those cases ultimately hinged on the absence of chargeable charter and by-law violations.¹⁰⁷ In contrast, charter and by-law violations were of marginal importance to the reasoning of *Briggs*. Thus, *Briggs* was the first truly modern articulation of a tort-based duty of care for bank directors.

Precisely because of the tort rule's expansive nature, *Briggs* set the stage for the business judgment rule in its modern sense. There had previously been no need for liability-limiting devices such as the business judgment rule, because liability for honest bank director decisions was largely restricted to violations of statutes, charters and by-laws. The duty of care announced in *Briggs*, however, was far broader than most charter restrictions and potentially more intrusive of board autonomy. To insure that the new tort duty of care would not unduly impede profit-seeking by directors of banks, post-*Briggs* courts fashioned the business judgment rule to curb the expanded liability that the duty of care posed.¹⁰⁸ Thus, the newly-

(citing *Briggs*); *Earle v. Humphrey*, 121 Mich. 518, 525 (1899) (applying the *Briggs* test); *Swentzel v. Penn Bank*, 147 Pa. 140, 151 (1892) (same). See also *Bowerman v. Hamner*, 250 U.S. 504, 510-11 (1919) (affirming the common law rule of negligence used in cases involving national banks); *Yates v. Jones National Bank*, 206 U.S. 158, 180 (1907) (expressing no opinion whether courts can apply the *Briggs* test to hold bank directors liable for negligence).

105. As such, *Briggs* was emblematic of the larger shift in late nineteenth-century American law from contract-based remedies to tort recovery for negligence. See MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW 1870-1960*, at 13, 115-16 (1992).

106. See, e.g., *Spering's Appeal*, 71 Pa. 11, 21 (1872) (stating that there is a strong presumption that directors use their best skill and judgment in managing depositors' accounts); *Percy v. Millaudon*, 8 Mart. (n.s.) 68, 75 (La. 1829) judging fault according to "the exercise of that diligence and care which was necessary to a successful discharge of [a director's] duty . . .").

107. See *Spering's Appeal*, 71 Pa. at 24-25 (absolving bank trustees who inadvertently violated the charter based on advice of counsel, and finding that "[i]t is well settled that trustees will be protected from responsibility under such circumstances"); *Percy*, 8 Mart. (n.s.), at 75-76 ("It is not contemplated by any of the charters . . . that [the directors] should devote their whole time and attention to the institution to which they are appointed."). See also *Ford v. Taylor*, 4 S.W.2d 938, 938-42 (Ark. 1928) (quoting a common-law standard of care but absolving directors for all loans except those made in violation of board resolution). Cf. *Friedman*, *supra* note 65, at 300 (stating that the nineteenth century concept of negligence referred mostly "to failures to perform a specific duty—often a contractual one").

108. See, e.g., *Hovenkamp*, *supra* note 54, at 62-63 (describing the debate over the advisability of the business judgment rule prior to *Briggs*); see also *Wheeler v. Aiken County Loan & Sav. Bank*, 75 F. 781, 785 (C.C.D.S.C. 1896) ("No case has been cited where directors have been held responsible to stockholders for mistakes of judgment, or

minted business judgment rule helped preserve the *status quo* and particularly the principle of potential profit maximization at any risk.

At the same time, Justice Harlan's influential dissent in *Briggs* contained the seeds of the business judgment rule's decline in the banking industry. Under the old approach, only shareholders of the bank had the necessary contractual privity to sue bank directors. But by eschewing contract-based liability and holding that bank directors could be sued for breach of a duty of care, *Briggs* revived the question of to whom that duty was owed.

The majority opinion sought to straddle the issue without deciding it, stressing that the receiver had tried the case on the theory that the directors owed a duty "not to stockholder[s] nor to creditors, as such, but to the bank."¹⁰⁹ In contrast, Justice Harlan repeatedly emphasized that bank director liability rules had to take cognizance of depositor as well as shareholder interests.¹¹⁰ As such, Justice Harlan's dissent was one of the first opinions outside of the savings bank context (and certainly the most prominent) to advance the assertion that the common law should serve depositor interests in regulating asset substitution.¹¹¹ In this regard, Justice

want of skill . . ."); *Wynn v. Tallapoosa County Bank*, 53 So. 228, 239 (Ala. 1910) (holding that a cashier is not liable "for losses [which are] the result of mere errors in judgment . . .").

109. *Briggs*, 141 U.S. at 149-50.

110. This is apparent from at least two passages in the dissent:

[A] considerable part of the amount lost to the bank, and therefore to its stockholders *and depositors*, could have been saved, if [the directors] had exercised such care in the supervision and management of the bank's business, as men of ordinary diligence exercise in respect to their own business. . . .

A banking corporation, publicly avowing that its business was to be wholly administered by executive officers, and that the directors would have nothing in fact to do with its management, would not long retain the confidence of stockholders *and depositors*; a fact which, of itself, shows that the abdication by directors of their duties and functions not only tends to defeat the object for the creation of such an institution, but puts in peril the interests of stockholders *and depositors*.

Id. at 166, 174 (Harlan, J., dissenting) (emphasis added).

111. The influence of Justice Harlan's opinion was such that later cases expanding bank director liability often did so in reliance on his dissent. *See, e.g.*, *Robinson v. Hall*, 63 F. 222, 227 (4th Cir. 1894); *Dudley v. Hawkins*, 239 F. 386, 389 (S.D. Ga. 1917); *Bank of Commerce v. Goolsby*, 129 Ark. 416, 196 S.W. 803, 810 (1917); *Anderson v. Bundy*, 171 S.E. 501, 507 (Va. 1933).

Other cases decided during the same period contained dicta to the effect that depositors could sue bank directors for negligence. Many of those cases, in fact, involved fraudulent misrepresentation. *See, e.g.*, *Solomon v. Bates*, 24 S.E. 478, 480 (N.C. 1896); *Cassidy v. Uhlmann*, 63 N.E. 554, 556 (N.Y. 1902); *Swentzel v. Penn Bank*, 23 A. 405, 414-15 (Pa. 1892); *Dyson*, *supra* note 4, at 354-55 (discussing cases involving fraudulent misrepresentation). Others involved the continued acceptance of new deposits after insolvency in circumstances that were tantamount to fraudulent inducement to contract. *See,*

Harlan implicitly recognized that absent any liability-limiting device such as the business judgment rule, the new tort approach was easily broad enough to accommodate depositors' interests.

The depositor interests that the dissent sought to advance were those in avoiding asset substitution and its concomitant losses. But Justice Harlan did not consider how these depositor interests should be reconciled with shareholders' interests in potential profit maximization. That inevitable clash took center stage after the turn of the century.

D. Loss Avoidance Eclipsed Potential Profit Maximization

After the turn of the century, a handful of other decisions began to appear in which loss avoidance trumped potential profit maximization in the banking context. Between 1901 and 1918, state courts in Arkansas, New Jersey, and New York issued decisions curtailing the business judgment rule in banking in certain key respects. The most notable decisions in this regard were cases that took their cue from the National Banking Act and that sought to regulate securities underwriting and loans to single borrowers by state banks as a matter of common law.¹¹² Other decisions from those states held bank directors negligent for loans to start-up businesses,¹¹³ loans to cover worthless overdrafts,¹¹⁴ and loans on dubious collateral.¹¹⁵ Nearly all of these decisions specifically acknowledged protecting depositor interests.¹¹⁶

Along with the savings bank cases, these cases are significant not only for their holdings, but also for the light they shed on the

e.g., *Delano v. Case*, 12 N.E. 676 (Ill. 1887) (holding directors of insolvent bank negligent for portraying bank as solvent); *Seale v. Baker*, 7 S.W. 742, 745 (Tex. 1888) (same). Still others were depositor suits in a handful of states that permitted depositor suits by statute. *See, e.g.*, *Hi-Pro Fish Prods., Inc. v. McClure*, 224 F. Supp. 485, 489-90 (E.D. Ark. 1963) (discussing earlier cases); *Forbes v. Mohr*, 76 P. 827, 829 (Kan. 1904) (suit brought by depositors against directors under statute); *Bank of Mutual Redemption v. Hill*, 56 Me. 385, 388-89 (1868). Nonetheless, the dicta in those cases, taken collectively, set the stage for increased cognizance of depositor interests by the bench.

112. For instance, *Bailey v. O'Neal*, 122 S.W. 503, 505 (Ark. 1909), condemned overconcentrations of loans to one borrower. *Davidge v. Guardian Trust Co.*, 96 N.E. 751, 754 (N.Y. 1911), and *Gause v. Commonwealth Trust Co.*, 89 N.E. 476, 483 (N.Y. 1909), both forbade New York depository institutions from engaging in firm-guarantee securities underwriting.

113. *Magale v. Fomby*, 201 S.W. 278, 280 (Ark. 1918). After finding the directors negligent, the *Magale* court nevertheless denied recovery to the plaintiffs because their claim was time-barred. *Id.*

114. *Campbell v. Watson*, 50 A. 120, 142 (N.J. Ch. 1901).

115. *Bailey v. O'Neal*, 122 S.W. 503, 505 (Ark. 1909).

116. *See Magale*, 201 S.W. at 278 (negligence suit for "the benefit of creditors and shareholders"); *Bailey*, 122 S.W. at 504 (permitting depositors to recover under statute for board negligence); *Campbell*, 50 A. at 124 (bank receiver awarded verdict for negligence). *See also Bank of Commerce v. Goolsby*, 196 S.W. 803, 807-08 (Ark. 1917) (holding bank directors liable to shareholders and depositors for negligent mismanagement).

economic forces underlying this divergent strain of case law. As the pre-1933 cases show, courts attempted to regulate asset substitution at banks for years before federal deposit insurance was enacted. The stated rationale for doing so was invariably concern for the welfare of depositors, as had been true in the savings bank cases.¹¹⁷ Thus, contrary to the prevailing wisdom, those cases provide additional proof that a populist concern for harm to individual depositors, rather than any specific solicitude for the federal insurance funds, was the original impetus for the divergent banking cases.

At the same time, it would be misleading to contend that the early banking cases were widely influential, at least in the short term. Outside Arkansas, Massachusetts, New Jersey, New York, and Virginia, the same *laissez-faire* attitude that permeated the early bank director liability cases continued to hold sway, due to liberal reliance on the business judgment rule.¹¹⁸ It is particularly telling in this regard that individual holdings restricting specific types of bank practices almost never migrated across state lines.¹¹⁹

117. Ostensibly, other concerns, such as monitoring problems, or the avoidance of bank runs and panics, also could have been a factor in these cases. Notably, however, none of the pre-1933 cases ever explicitly raised those considerations. Instead, courts emphasized the need to protect depositors' expectations that banks would safeguard their money and vouchsafe its return. See *Bank of Commerce*, 196 S.W. at 810 ("When one deposits money in a savings bank . . . thus divesting himself of the immediate control of his property, he expects, and has the right to expect, that the trustees or directors, who are chosen to take his place in the management and control of his property, will exercise ordinary care and prudence in the trust committed to them.") (quoting *Briggs v. Spaulding*, 141 U.S. 132, 174 (Harlan, J., dissenting)); *Gause v. Commonwealth Trust Co.*, 89 N.E. 476, 482 (N.Y. 1909) ("A banking corporation . . . invites individuals to submit to it the possession and care of their money and property"). The *Gause* court went on to stress that the element of depositor trust distinguished banks from ordinary trading corporations. *Id.* For these reasons, these cases held that a bank director's duty of care ran not only to shareholders, but also to depositors and other creditors. See *Magale*, 201 S.W. at 279 ("[D]irectors of a bank . . . are liable to stockholders, as well as depositors, for its losses from their negligence."); *Bailey*, 122 S.W. at 504 (bank directors are "[l]iable to whom? Manifestly to the creditors of the corporation . . ."); *Campbell*, 50 A. at 124 (bank directors "are not only trustees for the corporation, but also, though perhaps in a modified sense, for the creditors of the corporation, who become such by depositing their money with the bank in the ordinary course of such business").

118. See, e.g., *Gamble v. Brown*, 29 F.2d 366, 380 (4th Cir. 1928), *cert. denied*, 279 U.S. 839 (1929) (refusing to hold directors personally liable for loss on irregularly-discounted note); *McRoberts v. Spaulding*, 32 F.2d 315, 316-17 (S.D. Iowa 1929) (refusing to hold bank directors liable for speculative farm loans); *Wheeler v. Aiken County Loan & Sav. Bank*, 75 F. 781, 784-85 (C.C.D.S.C. 1896) (using standards of community to determine liability under business judgment rule); *Wynn v. Tallapoosa County Bank*, 53 So. 228, 239-41 (Ala. 1910) (bank cashier not liable for judgment errors); *Scott's Ex'rs v. Young*, 21 S.W.2d 994, 998-99 (Ky. 1929) (directors who approved worthless loan to bank employee exonerated because they relied on the employee's character and thrift); *Pocomoke City Nat'l Bank v. Crockett*, 125 A. 712, 716 (Md. 1924) (directors not found liable for "mere default or mistakes of judgment") (citations omitted).

119. Those holdings regulated bank practices ranging from securities underwriting, pre-

This fractured state of affairs lasted until the introduction of federal deposit insurance in 1933,¹²⁰ when for the first time a majority of bank director negligence cases subordinated potential profit maximization in favor of loss avoidance. Thus, while some courts had responded to the asset substitution problems of individual depositors early on, it was only when bank losses came to be shifted onto a party with political muscle—the federal government—that the business judgment rule in banking began to unravel in any serious way.

The Depression-era cases that stressed loss avoidance over profit maximization addressed that concern in three separate contexts: practices that were high-risk but potentially profitable; practices that appeared unprofitable on their face; and failed deposit insurance schemes. The majority of those cases involved the first problem (i.e., unduly risky practices that had some profit potential). A signal decision in this regard was *Michelsen v. Penney*,¹²¹ decided in 1943, in which the Second Circuit condemned bank directors for salvaging a junior mortgage on an office building. According to the court, a glut of office space made the prospects of renting the building hopeless. Rejecting the old saw that bank boards could lend to troubled borrowers to help them grow out of their troubles, *Michelsen* concluded that the risk of loss was too great to justify salvaging the mortgage.¹²²

The 1930's cases imposed liability for a variety of other unsafe practices as well. Several cases, for example, required bank directors to adopt loan underwriting standards as a matter of common law, regardless of charters or by-laws. The 1935 case of *Medford Trust Co. v. McKnight*,¹²³ for example, was one of the first common-law cases to hold that bank directors could not lend additional funds to delinquent borrowers. *Castetter v. Barnard*¹²⁴ and

mature releases of security and commercial real estate loans to overconcentrations of credit and loans to startup ventures. See McCoy, *supra* note 2, at 1041-42, 1045-54, 1066.

120. See Banking Act of 1933, codified at 12 U.S.C. §§ 1811-1831 (1989).

121. 135 F.2d 409 (2d Cir. 1943).

122. *Id.* at 422-23. The New Jersey Chancery Court had reached the same conclusion in 1889 in *Williams v. McKay*, 18 A. 824, 830 (N.J. Ch. 1889). Unlike *Michelsen*, however, *Williams* was based on a charter violation and not on breach of a common-law duty of care. *Michelsen* was the forerunner of today's federal banking regulations and guidelines requiring directors to monitor real estate conditions and adjust their lending policies accordingly. See 12 C.F.R. §§ 34.62(c), 208.52(c), 365.2(c), 563.101(c) (1995).

123. 197 N.E. 649, 660-61 (Mass. 1935); accord *Michelsen v. Penney*, 135 F.2d 409, 425-26 (2d Cir. 1943) (holding bank directors liable for bond financing of foreclosed company where bonds could not be resold). But see *Atherton v. Anderson*, 99 F.2d 883, 894 (6th Cir. 1938) (bank decision to lend additional funds to a defaulting borrower not negligent).

124. 183 N.E. 681, 686 (Ind. App. 1932).

Broderick v. Marcus,¹²⁵ decided around the same time, prohibited certain types of unsecured loans. *Castetter* also banned loans to insolvent debtors and overconcentrations of loans to single borrowers.¹²⁶ In addition, *Medford* and other Depression-era decisions were the first reported cases to second-guess bank appraisals and require their expanded use.¹²⁷ All of these cases entailed judicial assessments of risk and the ensuing judgment that risk levels were too high to merit protection under the business judgment rule.

The celebrated 1940 case of *Litwin v. Allen*¹²⁸ addressed the principle of loss avoidance in the second context, involving investments that were seemingly unprofitable on their face. There, a New York court censured a trust company's directors for buying 5.5% subordinated debentures on the condition that the issuer could buy back the securities at cost within the first six months. The purchase was negligent, in the judgment of the court, because the trust company assumed the risk of loss during the six-month option period with no prospect for gain.¹²⁹ *Litwin's* analysis is undeniably questionable in this regard, as the debentures did in fact pay interest.¹³⁰ As a theoretical matter, however, it would seem that the court correctly recognized that assets will waste unless they are invested in vehicles with at least some potential for earnings or appreciation. In that sense, then, *Litwin* was fully consistent with the new stress on loss avoidance that appeared in the 1930's.

The last group of Depression-era cases that imposed liability advanced the goal of loss avoidance by using the business judgment rule offensively to protect failed deposit insurance schemes. Thus in *O'Connor v. Bankers Trust Co.*,¹³¹ a New York court held that bank directors who had voted to join a private deposit insurance consortium had not engaged in *ultra vires* conduct. The fact that the consortium had gone insolvent, causing the bank in question to fail, was irrelevant: bank boards had broad authority to address concerns over depositor losses.¹³²

125. 272 N.Y.S. 455, 461 (Sup. Ct. 1934).

126. 183 N.E. at 686. Specifically, the court imposed liability for a loan to insolvent businessmen that equalled almost one-third of the bank's capital. *Id.*

127. See *Michelsen*, 135 F.2d at 421-23 (holding directors negligent for acquiring title to property without obtaining a disinterested and honest appraisal); *Medford*, 197 N.E. at 658-59, 664 (noting the importance of appraisals in determining financial ability); *Litwin v. Allen*, 25 N.Y.S.2d 667, 709-728 (Sup. Ct. 1940) (finding no negligence where directors relied upon thorough and conservative appraisal).

128. 25 N.Y.S. 667 (Sup. Ct. 1940).

129. *Id.* at 696-99.

130. See *McCoy*, *supra* note 2, at 1039 and authorities cited therein.

131. 289 N.Y.S. 252, 270-72 (Sup. Ct. 1936), *aff'd*, 1 N.Y.S.2d 641 (1937), *aff'd*, 16 N.E.2d 302 (N.Y. 1938).

132. *Id.* at 272.

Depression-era cases that absolved bank directors on business judgment rule grounds were relatively rare. Generally, when courts granted bank directors lenient treatment, they did so for reasons that still merit business judgment rule protection today.¹³³ While a smattering of other cases countenanced practices that now would not be tolerated, almost all of those cases curtailed the business judgment rule in other significant respects.¹³⁴ Thus, the Great Depression witnessed a decided tilt toward loss avoidance in bank director negligence cases.

In hindsight, this transformation was hardly surprising, given the changed political and financial calculus ushered in by economic hardship and federal deposit insurance. The economic effect of the business judgment rule was to allow “bolder”—and potentially riskier—business decisions with a higher potential rate of return than a regime without such deference to board decisions. But, with the onslaught of the Depression, thousands of bank failures, federal deposit insurance, and a powerful new federal interest in risk avoidance, the profit-maximization rationale was too indifferent to risk to persist in an undiluted form.

By no means was this development inevitable. The class of losses that Congress shifted to federal deposit insurers in 1933 was the same class of losses that had been absorbed by individual depositors prior to 1933.¹³⁵ Moreover, both were incapable of demanding higher compensation to defray the risk of loss—depositors due to information deficits and the federal government due to flat premium rates. Yet courts proved decidedly more inclined to im-

133. For example, *Milburn v. Martin*, 76 S.W.2d 952, 954-55 (Ark. 1934), and *Gallin v. National City Bank*, 273 N.Y.S. 87, 96-102 (Sup. Ct. 1934), declined to hold bank directors responsible for declines in collateral value because the loans in question had been adequately secured when made. *Payne v. Ostrus*, 50 F.2d 1039, 1044 (8th Cir. 1931), absolved directors from negligence for selling foreclosed property at a loss. Similarly, *Gallin*, 273 N.Y.S. at 104-07, and *Atherton v. Anderson*, 86 F.2d 518, 525 (6th Cir. 1936), *rev'd on other grounds*, 302 U.S. 643 (1937), embraced the proposition that holding foreclosed properties in lieu of sale does not amount to negligence. All three principles remain good law. See *McCoy*, *supra* note 2, at 1055-58, 1069 (discussing cases).

134. Compare *Castetter v. Barnard*, 183 N.E. 681, 686 (Ind. App. 1932) (permitting renewal of loans without security) and *Litwin v. Allen*, 25 N.Y.S.2d 667, 677, 720-21 (Sup. Ct. 1940) (allowing inadequately secured loans, pre-funded interest clauses, and advances to defaulting borrowers) with *supra* notes 124-130 and accompanying text. The only case from that period whose overall outcome was more favorable to bank directors than comparable cases would be today was *Atherton v. Anderson*, 99 F.2d 883, 894 (6th Cir. 1938), which sanctioned new loans to borrowers already in default.

135. This is implicit in the fact that almost all of the Depression-era cases awarding recovery against bank directors did so in the name of depositors. See *Michelsen v. Penney*, 135 F.2d 409, 412 (2d Cir. 1943) (depositor suit against board chairman for negligence); *Castetter*, 183 N.E. at 688 (suit by receiver); *Medford Trust Co. v. McKnight*, 197 N.E. 649, 654-55 (Mass. 1935) (suit by state commissioner of banks for the benefit of depositors); *Broderick v. Marcus*, 272 N.Y.S. 455, 457 (Sup. Ct. 1934) (suit by receiver).

pose liability when the federal fisc was at stake than when the victims were individual depositors. It was only when the risk of loss was shifted from politically unorganized individual depositors to the politically powerful federal government that the majority of courts subordinated shareholder interests and elevated loss avoidance to a legally protected plane.

E. A Deceptive Lull

Despite the significant contraction of the business judgment rule in banking in the 1930's and 1940's, that contraction did not progress in a linear fashion. To the contrary, the same downswing cycle that marked the earlier restrictive cases set in after World War II.

After 1945, numerous doubtful lending practices—including delinquent loan renewals, non-existent underwriting standards, and absent internal controls—continued to receive protection under the business judgment rule.¹³⁶ In addition, very few restrictive state law cases migrated across state lines during that period. As early as 1889, for example, Massachusetts and New Jersey courts recognized the dangers of real estate construction loans by savings banks and sought to control those risks by banning or restricting such loans.¹³⁷ Nonetheless, no other state adopted those holdings before the 1980's, and those cases did little to deter disastrous real estate loans in other states. Likewise, notwithstanding two 1889 cases penalizing directors for renewing loans in arrears,¹³⁸ virtually no other decision replicated those holdings before the 1980's. As had happened in the decades leading up to the Great Depression, those cases had minimal deterrent effect because other jurisdictions simply ignored them.¹³⁹ State courts had incentives to favor their home-state institutions in this regard, because most losses from overly risky bank activities would be borne by the federal deposit insurance funds and not by the states.

136. See McCoy, *supra* note 2, at 1066, 1073-77.

137. See *Medford Trust Co. v. McKnight*, 197 N.E. 649, 659-60 (Mass. 1935) (holding directors negligent for excessive construction loans); *Williams v. McKay*, 18 A. 824, 830 (N.J. Ch. 1889) (imposing liability for risky construction loans); see also *Michelsen v. Penney*, 135 F.2d 409, 425-26 (2d Cir. 1943) (penalizing bank bailout of insolvent land development company).

138. See *Williams*, 18 A. at 838; *Marshall v. Farmers' & Mechanics' Savings Bank*, 8 S.E. 586, 587-88, 591-92 (Va. 1889).

139. See Gerald T. Dunne, *The Liability of Bank Directors Under the New Federal Common Law or Swift v. Tyson Resurgent*, 8 FORUM 286, 293 (1972) (noting that only a minority of courts have not substantially abandoned a hard-lined fiduciary standard for bank directors); McCoy, *supra* note 2, at 1047-49, 1066 (discussing isolated effect of early restrictive holdings).

Notwithstanding this rift in the case law, neither Congress nor the courts seriously questioned bank director liability rules until the late 1980's. Instead, as the banking industry entered a long period of stability after 1945 and bank failures became a relative rarity,¹⁴⁰ the effectiveness of those rules was not called into serious question. In the next thirty years bank director duty of care cases slowed to a trickle,¹⁴¹ and it seemed self-evident that the liability rules worked.¹⁴²

Only later did it become apparent that this seemingly permanent stability was the product of a unique set of factors (mainly low inflation and low interest rates) that prevailed during the 1950's and 1960's. During that period, banks and thrifts did not have to fret about losing deposits to non-bank competitors, because few (if any) investments offered comparable liquidity, and low interest rates held down yields. At the same time, banks could make money on low-risk loan portfolios because blue-chip companies flocked to them for their short-term borrowing needs. The cautious mores of post-World War II bank managers, who had grown up during the Depression and had come of age in an era that fostered risk aversion, further reinforced bank tendencies toward conservatism.

Thus, the economic conditions of the 1950's and 1960's created unique market constraints on bank risk. In tandem with those conditions, the regulatory climate placed additional dampers on risks. The advent of deposit insurance made it easier than ever for banks to lure deposits.¹⁴³ Similarly, Regulation Q boosted bank earnings by capping the interest paid on bank accounts and keeping the cost of funds low.¹⁴⁴

But in the 1970's, this vaunted stability began to fray as inflation heated up and non-bank competitors eyed the profitable pre-

140. See GARTEN, *supra* note 42, at 48, 56.

141. See Bishop, *supra* note 4, at 1096 n.63, 1098-99 (asserting that bank director liability cases had become "virtually extinct" due to New Deal reforms such as federal deposit insurance and also the increased experience of bank directors). Among the few notable duty of care cases during this period were *McDonnell v. American Leduc Petroleum, Ltd.*, 491 F.2d 380 (2d Cir. 1974), *First Nat'l Bank v. Keller*, 318 F. Supp. 339 (N.D. Ill. 1970), and *Neese v. Brown*, 405 S.W.2d 577, 581-83 (Tenn. 1964).

142. See, e.g., Norwood P. Beveridge, Jr., *The Corporate Director's Duty of Care: Riddles Wisely Expounded*, 41 DEFENSE L.J. 519, 545-46 (1992) (maintaining that "the duty of care is an effective check against management negligence" in the banking area because "there exists a very substantial body of case law upholding suits against bank directors for violation of the duty of care").

143. See ROE, *supra* note 75, at 96.

144. Under the Banking Act of 1933, as amended, and Regulation Q, banks and thrifts could not pay interest on demand deposits and could only pay interest on time and savings accounts up to rates specified by the Federal Reserve Board and the Federal Home Loan Bank Board. See 12 U.S.C. §§ 371b, 1425b(a), 1828(g)(1), 1832 (1988), *repealed* by Pub. L. 96-221, title V, § 29, Mar. 31, 1980, 94 Stat. 168; 12 C.F.R. pt. 217 (1979).

serves of banks and thrifts. On the asset side, as interest rates soared and bank loans became prohibitively costly, corporate borrowers fled commercial banks for the burgeoning markets in commercial paper and bonds. In a classic example of asset substitution, some money-center banks replaced that business with high-risk loans to developing nations and energy concerns. On the liability side, Regulation Q's interest caps suddenly became a handicap, as individual and corporate depositors moved their deposits out of banks into short-term bonds and newly-innovated money market funds.¹⁴⁵

Congress' efforts to lift Regulation Q's interest caps triggered new, adverse consequences of their own. In an attempt to halt deposit outflows, Congress phased out interest rate caps on bank and thrift deposits in the Depository Institutions Deregulation and Monetary Control Act of 1980.¹⁴⁶ But it soon became apparent that Congress should have revised lending policies first, to permit banks and thrifts to diversify their assets before they started to pay market rates for deposits. The interest cap phase-out soon triggered a wave of financial institution insolvencies as low-yield portfolios generated too little income to pay the new, higher rates on deposits.¹⁴⁷

In a desperate attempt to rescue banks and thrifts from their interest risk woes, Congress and the Reagan Administration then deregulated the asset side of the ledger in the Garn-St. Germain

145. For further descriptions of the changed economic climate in the banking industry during this period, see JAMES R. BARTH, *THE GREAT SAVINGS AND LOAN DEBACLE* 17-19 (1991); BENSTON ET AL., *supra* note 24, at 26-28; GARTEN, *supra* note 42, at 10-13; GATHERING CRISIS, *supra* note 35, at 15 (describing risky loans to energy industry and developing countries); PIERCE, *supra* note 33, at 6-7, 67-71; BLUEPRINT FOR REFORM, *supra* note 3, at 29-31 (discussing interest rate effects on banks); L. WILLIAM SEIDMAN, *FULL FAITH AND CREDIT* 17 (1993) (discussing problem of inflation with respect to thrifts and banks); VAUGHAN & HILL, *supra* note 31, at 3, 37; Michael Klausner & Lawrence J. White, *Bank Regulatory Reform and Bank Structure in STRUCTURAL CHANGE IN BANKING*, *supra* note 72, at 1, 7; Redburn, *supra* note 33, at 691-92; Schwartz, *supra* note 33, at 48-49.

146. Pub. L. No. 96-221, §§ 201-210, 94 Stat. 142-45 (1980) (codified at 12 U.S.C. §§ 3501-3509 (1988)); see also Nicolle Fundette, *How A Good Idea Went Wrong: Deregulation and the Savings and Loan Crisis*, 47 ADMIN. L. REV. 643, 648-49 (1995) (describing the phaseout process).

147. Banks were crippled in this regard because it was difficult to raise the interest charged on corporate loans when their corporate borrowers were fleeing. Thrifts faced an identical interest squeeze because their long-term, fixed-rate mortgage portfolios did not generate enough income to pay higher interest rates on deposits. See generally R. DAN BRUMBAUGH, JR., *THE COLLAPSE OF FEDERAL INSURED DEPOSITORY INSTITUTIONS—THE SAVINGS AND LOANS AS PRECURSOR* 11, 25, 31 (1993); GARTEN, *supra* note 42, at 13; SEIDMAN, *supra* note 145, at 21-22 (discussing thrifts and their relationship to interest rates); VAUGHAN & HILL, *supra* note 31, at 4; Fundette, *supra* note 146, at 649; Lawrence H. White, *Why Is the U.S. Banking Industry in Trouble? Business Cycles, Loan Losses, and Deposit Insurance*, in *THE CRISIS IN AMERICAN BANKING* 1, 18-19 (Lawrence H. White ed., 1990).

Depository Institutions Act of 1982.¹⁴⁸ On the bet that high-yield loans would enable weakened financial institutions to grow out of their troubles, Congress allowed thrifts to expand beyond their traditional asset base of residential mortgages and to make commercial real estate development loans. Garn-St. Germain also allowed financial institutions to make loans at 100% of collateral value and without personal recourse.¹⁴⁹ Garn-St. Germain's effect was to encourage developers and other entrepreneurs to capture depository institutions and operate them as their own personal financing arms.¹⁵⁰ Unlike their predecessors, moreover, this new generation of financial institution managers had neither the memory nor the conservative ethos of the Great Depression.

In the meantime, state regulators in California, Texas, and Florida deregulated asset powers for state-chartered thrifts even beyond the expanded powers of their federal counterparts.¹⁵¹ Texas permitted thrift institutions chartered in that state to invest up to 100% of their assets in real estate equity holdings, in contrast with the limits on direct investments in service corporations by federally-chartered thrifts, which were capped at three percent of assets.¹⁵² For its part, the Federal Home Loan Bank Board ("FHLBB") turned a blind eye to state deregulation, based on the wrong-headed belief that state law took precedence over federal.¹⁵³

Still other deregulatory changes boosted the already high propensity toward financial institution risk. One such change was Congress' decision in 1980 to increase deposit insurance from \$40,000 to \$100,000 per account and to permit an unlimited number of accounts per investor, each insured up to \$100,000.¹⁵⁴ An-

148. Pub. L. 97-320, Title IV, Part A, § 403(a), 96 Stat. 1510.

149. *See id.*; *see also* BLUEPRINT FOR REFORM, *supra* note 3, at 34, 48-49 (listing the most significant provisions of the act); Fundette, *supra* note 146, at 650 (listing several new areas into which S&Ls were permitted to invest- beyond residential real estate).

150. Fundette, *supra* note 146, at 650.

151. *See, e.g.*, BANKING LAW AND REGULATION, *supra* note 35, at 174; BLUEPRINT FOR REFORM, *supra* note 3, at 40.

152. GENERAL ACCOUNTING OFFICE, THRIFT FAILURES: COSTLY FAILURES RESULTED FROM REGULATORY VIOLATIONS AND UNSAFE PRACTICES 25 (1989); *see also* NORMAN STRUNK & FRED CASE, WHERE DEREGULATION WENT WRONG 68-73 (1988) (describing experience with lax state regulations on direct investments).

153. *See* General Accounting Office, *supra* note 152, at 75; *Savings and Loan Policies in the Late 1970's and 1980's, Hearings before the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. 75, 88-89 (1990) (statement of Edwin Gray); *id.* at 89-91 (statement of Paul Volcker); *Final Oversight Hearings on the Savings and Loan Industry in the 100th Congress, Hearing before the Sen. Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 2d Sess. 127, 129 (1988) (statement of Richard T. Pratt); *Lincoln Savings & Loan Ass'n v. FHLBB*, 670 F. Supp. 449 (D.D.C. 1987), *aff'd*, 856 F.2d 1558 (D.C. Cir. 1988).

154. *See* 12 U.S.C. § 1821(a)(1) (1993). *See also* BLUEPRINT FOR REFORM, *supra* note

other was FHLBB's decision in 1981 to reduce thrift capital requirements to three percent of liabilities and to relax regulatory accounting principles, so as to make even this reduced requirement meaningless.¹⁵⁵ In the meantime, the failure to regulate brokered deposits allowed huge amounts of volatile, high-cost deposits to flood into institutions, where they chased too few good loans.¹⁵⁶

Taken together, these developments added up to a recipe for disaster. Even before asset deregulation, the flight of corporate borrowers and the erosion of deposit bases had given banks and thrifts incentives to acquire high-risk, high-yield assets. By the time deregulation began in earnest in 1981, many financial institutions had seriously depleted their capital, making them desperate to gamble on the highest possible returns in an attempt to regain solvency. In their battered state, banks and thrifts had little (if any) financial cushion to protect them in case a market downturn caused their borrowers to default.¹⁵⁷ It was precisely then, with traditional market constraints gone, that regulatory constraints on risk were most important. Instead, deregulation unlatched the barnyard door.

In the mid- to late-1980's, when the market for commercial real estate collapsed, banks and thrifts were glutted with real estate loans that went into default.¹⁵⁸ In a futile effort to stem thrift losses, FHLBB and the Federal Savings & Loan Insurance Corporation ("FSLIC") adopted a conscious policy of regulatory forbearance, excusing thrifts from meeting the already low three percent capital benchmark and permitting insolvent institutions to stay open. But forbearance had the pernicious effect of enabling trou-

3, at 6 (explaining how the increase led to heightened instability).

155. See *Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (H.R. 1278): Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess. 220 (1989) (statement of M. Danny Wall); *Problems of the Federal Savings and Loan Insurance Corporation, Hearings before the Sen. Comm. on Banking, Housing, and Urban Affairs*, 101st Cong., 1st Sess. 314 (1989) (statement of the ABA); *Final Oversight Hearings on the Savings and Loan Industry in the 100th Congress, Hearings Before the Sen. Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 2d Sess. 158, 158 (1988) (statement of Edwin Gray); *Deposit Insurance Reform and Related Supervisory Issues: Hearings before the Sen. Comm. on Banking, Housing, and Urban Affairs*, 99th Cong., 1st Sess. 491 (1985) (statement of James R. Barth); BLUEPRINT FOR REFORM, *supra* note 3, at 35-39.

156. See 12 U.S.C.S. § 1464, *History* (app.), at 763-64, 774-76 (Lawyers Coop. 1992) (discussing the regulation of brokered deposits); BRUMBAUGH, *supra* note 147, at 36-38; BLUEPRINT FOR REFORM, *supra* note 3, at 47; Redburn, *supra* note 33, at 694.

157. See GARTEN, *supra* note 42, at 11-15, 58-59, 68-71, 83 (describing the weakened financial state of the bank and thrift industries in the early 1980's); BLUEPRINT FOR REFORM, *supra* note 3, at 43-45 (noting that many S&Ls entered deregulation in the 1980's in a state of insolvency).

158. See BARTH, *supra* note 145, at 24-30, 40; BRUMBAUGH, *supra* note 147, at 25; VAUGHAN & HILL, *supra* note 31, at 35-38; S&L DEBACLE, *supra* note 33, at 7-8, 12, 18-22; Klausner & White, *supra* note 145, at 7.

bled thrifts to continue to make bad loans even after insolvency, when no more of their own capital was at risk.¹⁵⁹ An avalanche of bank and thrift failures ensued, triggering an unprecedented wave of director liability suits.

Thus, what the economic model predicted from the marriage of high leveraging, information asymmetries, and the business judgment rule eventually came to pass. The trigger was the disappearance in the 1970's and 1980's of market constraints (most notably low interest rates and competitive buffers) that the law had long taken for granted, combined with ill-timed deregulation. Significantly, the fact that courts had curtailed the business judgment rule in banking in prior decades did not prevent the massive financial institution losses of the 1980's. The enormity of those losses and the impotency of the old, restrictive cases propelled the courts to throw the business judgment rule in banking to the wind.

F. From Common Law to Code

The bank and thrift crisis of the 1980's precipitated cutbacks to the business judgment rule in banking on a scale hitherto unimagined. In the 1980's and early 1990's, courts second-guessed financial institution decisions with respect to a new range of loan activities that had previously gone unquestioned. As a result, bank and thrift directors now face common-law negligence liability for loans that are inadequately secured,¹⁶⁰ for overreliance on risky types of collateral,¹⁶¹ for pre-funded interest clauses,¹⁶² for fail-

159. See, e.g., BLUEPRINT FOR REFORM, *supra* note 3, at 32-33, 46; CONGRESSIONAL BUDGET OFFICE, RESOLVING THE THRIFT CRISIS 14-16 (1993); *Savings and Loan Policies in the Late 1970s and 1980s: Hearings before the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. 44, 48-49 (1990) (statement of Richard T. Pratt); *Federal Regulation of Direct Investment by Savings and Loans and Banks, and Condition of the Federal Deposit Insurance Funds: Hearings before a Subcomm. of the House Comm. on Government Operations*, 99th Cong., 1st Sess. 289 (1985) (statement of George Benston); H.R. REP. NO. 953, 98th Cong., 2d Sess. 12 (1984). The U.S. General Accounting Office recently estimated total losses from the savings and loan crisis to equal nearly one half trillion dollars. See GAO, FINANCIAL AUDIT—RESOLUTION TRUST CORPORATION'S 1995 AND 1994 FINANCIAL STATEMENTS 9-21 (GAO/AIMD-96-123 July 1996); Richard W. Stevenson, *G.A.O. Puts Cost of S. & L. Bailout at Half a Trillion Dollars*, N.Y. TIMES, July 12, 1996, § 1, at 34.

160. See *RTC v. O'Connell*, No. 94 C 4186, 1996 U.S. Dist. LEXIS 3999, at *9 (N.D. Ill. Apr. 1, 1996) (refusing to dismiss a claim of gross negligence stemming from loans lacking adequate security); *RTC v. Rahn*, 854 F. Supp. 480, 491 (W.D. Mich. 1994) (denying summary judgment where there was a disputed issue of fact whether appraisals supported size of loan); *FDIC v. Robertson*, No. Civ. A. 87-2623-S, 1989 U.S. Dist. LEXIS 9292, at *13-*14, *16, *20 (D. Kan. July 24, 1989) (holding a bank director negligent for making renewals of inadequately secured loans). Although the RTC in *Rahn* was able to get to trial on this issue, the director defendants eventually won a jury verdict on all counts. See *Michigan Jury Shuts Out RTC in \$7 Million D&O Case*, BANK BAILOUT LITIG. NEWS, Sept. 13, 1995, at 10.

161. See *FDIC v. Stanley*, 770 F. Supp. 1281, 1290-91, 1313 (N.D. Ind. 1991), *aff'd*

ures to perfect security,¹⁶³ and for rollovers of delinquent loans.¹⁶⁴ In addition, for the first time ever, irrespective of statutes or by-laws, courts held financial institution directors liable for defective internal controls.¹⁶⁵ The most important recent holdings in this regard penalize directors for eschewing or ignoring loan underwriting standards,¹⁶⁶ for not analyzing borrower credit pro-

sub nom. FDIC v. Bierman, 2 F.3d 1424 (7th Cir. 1993) (holding directors liable where loan was secured by a bulldozer that would depreciate too quickly); *Robertson*, 1989 U.S. Dist. LEXIS 9292, slip op. at *5-*6, *8-*9, *16, *19-*20 (holding bank directors liable where items accepted as security for loans included stock in closely-held corporations and partnership interests, the values of which were never investigated); *Omnibank v. United Southern Bank*, 607 So.2d 76, 87 (Miss. 1992) (finding liability where collateral for a loan included property owned by the mother of the borrower in Kentucky and an inheritance, neither of which were verified).

162. See *FDIC v. Schreiner*, 892 F. Supp. 869, 876 (W.D. Tex. 1995) (holding that extending "additional funds to pay the interest on past due credit" was potentially negligent); *FSLIC v. Williams*, 599 F. Supp. 1184, 1191 (D. Md. 1984) and subsequent opinion at 622 F. Supp. 132, 133 (D. Md. 1985), *rev'd in part on other grounds sub nom.* *FSLIC v. Reeves*, 816 F.2d 130 (4th Cir. 1987) (denying partial summary judgment where defendants were charged with "deducting interest and fees from [undisbursed] loan funds rather than requiring the borrowers to pay those charges").

163. See *Schreiner*, 892 F. Supp. at 876 (denying summary judgment for defendant directors where evidence showed directors failed to perfect bank's security interests); *Stanley*, 770 F. Supp. at 1313 (finding liability where two loaders were pledged as security for a loan, and lender did not file a security agreement on them until two weeks after the loan was purchased); *Robertson*, 1989 U.S. Dist. LEXIS 9292, slip op. at *7-*8, *17-*18 (holding bank officer liable for failing to perfect security interests).

164. See *FDIC v. Mijalis*, 15 F.3d 1314, 1324-25 (5th Cir. 1994); *Robertson*, 1989 U.S. Dist. LEXIS 9292 (slip op.), at *14-*19 (finding liability for renewing a loan where no reduction in principal had been made). See also *Schreiner*, 892 F. Supp. at 875-76 (holding loan rollovers potentially negligent).

165. In this regard, bank director liability law had lagged behind general corporate law, which had already defined monitoring duties to include the adoption of adequate internal controls.

166. See *FDIC v. Bierman*, 2 F.3d 1424, 1436-37 (7th Cir. 1993) (holding directors liable for new loan policy that "cut the Board of Directors out of loan approval matters"); *FDIC v. Wheat*, 970 F.2d 124, 129 & n.11 (5th Cir. 1992) (holding bank director liable for disregarding loan procedures that he had previously drafted); *O'Connell*, 1996 U.S. Dist. LEXIS 3999, at *8 (holding directors liable for gross negligence due to their disregard of prudent banking standards in their loan procedures); *RTC v. Franz*, 909 F. Supp. 1128, 1130, 1142 (N.D. Ill. 1995) (denying motion to dismiss count of gross negligence concerning losses sustained in funding construction loans, when none of the defendants had established written policies for such loans); *RTC v. Gladstone*, 895 F. Supp. 356, 361, 369 (D. Mass. 1995) (denying defendants' motion for summary judgment for ignoring internal lending policies); *RTC v. O'Bear, Overholser, Smith & Huffer*, 886 F. Supp. 658, 668-70 & n.8 (N.D. Ind. 1995) (denying summary judgment for directors on claim of grossly negligent conduct where evidence showed that the directors "recklessly ignored" internal loan procedures); *RTC v. Fortunato*, No. 94 C 2090, 1994 WL 478616, at *3 (N.D. Ill. Sept. 1, 1994) (holding that gross negligence claims for failing to follow thrift procedures properly withstood motion to dismiss); *FDIC v. Gonzalez-Gorron dona*, 833 F. Supp. 1545, 1561 (S.D. Fla. 1993) (denying motion to dismiss where it was alleged that directors failed "to establish proper monitoring procedures"); *FDIC v. Brown*, 812 F. Supp. 722, 726 (S.D. Tex. 1992) (refusing to allow director's motion for summary judgment on allegation of gross negligence in performance of duties); *Robertson*, 1989 U.S. Dist. LEXIS 9292, slip op. at *3, *13-20 (holding bank director liable for loans that

files,¹⁶⁷ and for lax administration of loans and other investments.¹⁶⁸ Thus, in banking, the common-law duty of care has significantly reduced board discretion to approve bank loans.

As drastic as these latest holdings are, they have been overtaken by events in the executive branch and on Capitol Hill. In the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), Congress directed federal bank regulators to adopt uniform, code-based rules regulating many of the same loan practices that once were entrusted exclusively to the courts and that once qualified for the business judgment rule.¹⁶⁹ FDICIA's

violated bank lending policy in multiple respects). *But see* *RTC v. Blasdel*, 917 F. Supp. 417, 426 (D. Ariz. 1994) ("[E]nacting deficient policies, however, falls well short of acting grossly negligent.").

167. *See* *RTC v. Eason*, 17 F.3d 1126, 1133 (8th Cir. 1994) (holding that jury instruction to consider whether directors had informed themselves of all relevant information, including credit profiles, when deciding to make loans, was proper); *O'Connell*, 1996 U.S. Dist. LEXIS 3999, at *9 (finding gross negligence where directors issued loans without obtaining credit appraisals); *Franz*, 909 F. Supp. at 1130 (denying motion to dismiss where RTC alleged that thrift directors failed to adequately analyze borrower data); *FDIC v. Abel*, 92 Civ. 9175, 1995 U.S. Dist. LEXIS 18159, at *21-*25 (S.D.N.Y. Dec. 6, 1995) (holding officers negligent for failing to analyze borrowers' credit profiles); *Schreiner*, 892 F. Supp. at 875-77 (same); *Gladstone*, 895 F. Supp. at 360-61, 369 (same); *RTC v. Gravee*, No. 94 C 4589, 1995 WL 75373, at *1, *5 (N.D. Ill. Feb. 22, 1995) (denying motion to dismiss gross negligence claim for failing to verify loan information); *RTC v. Rahn*, 854 F. Supp. 480, 491 (W.D. Mich. 1994) (holding that defendants were required to properly analyze relevant information in making loan decisions); *RTC v. Norris*, 830 F. Supp. 351, 355, 360 (S.D. Tex. 1993) (denying defendant's motion to dismiss negligence count for failing to analyze borrowers' credit profiles); *RTC v. Hess*, 820 F. Supp. 1359, 1361 (D. Utah 1993) (same); *Robertson*, 1989 U.S. Dist. LEXIS 9292, slip op. at *3, *13-20 (imposing liability for extending loans without current borrower information).

168. *See* *Schreiner*, 892 F. Supp. at 875-77 (denying summary judgment on counts concerning lax loan administration); *RTC v. Fleischer*, 826 F.Supp. 1273, 1279 (D. Kan. 1993) (declining to dismiss claims of wrongful bank director brokerage activities); *Robertson*, 1989 U.S. Dist. LEXIS 9292, slip op. at *14-19 (holding director liable for failing to establish payment schedules or monitor timely repayments); *see generally* McCoy, *supra* note 2, at 1066 (criticizing cases that failed to penalize failures to perfect security interests).

169. *See* 12 U.S.C. §§ 371(a), 1828(o) (1994). In the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 318, 108 Stat. 2160, 2223-24 (1994), Congress amended FDICIA to permit federal regulators to issue those standards either as regulations or as guidelines. *See Congress Allows FDICIA Safety & Soundness Rules To Be Guidelines: OCC Looks at Flexible Standards*, BANK BAILOUT LITIG. NEWS, Dec. 21, 1994, at 1-3.

In a few areas that were originally regulated under common-law bank director liability standards, codified standards had been instituted decades earlier. The principal examples included securities underwriting by banks, commercial real estate lending by national banks, and loan-to-one-borrower requirements. *See* McCoy, *supra* note 2, at 1041-42, 1046-47, 1050-52. Apart from loan-to-one-borrower standards, however, the overwhelming bulk of loan underwriting practices by state-chartered institutions before the passage of FDICIA was regulated solely under the common law. *See generally id.* at 1036-77; Scott, *supra* note 65, at 707-08. It is that gap that FDICIA sought to fill.

most significant impact in this regard involves a requirement that regulators adopt comprehensive regulations and guidelines on real estate loans by insured banks and thrifts.¹⁷⁰ The regulations and guidelines appeared in final form in December, 1992, and apply to federally insured banks and thrifts across the board.¹⁷¹

The December 1992 regulations and guidelines make heavy incursions into bank lending, the traditional domain of the business judgment rule in the banking industry, in two distinct ways. First, the regulations require bank and thrift directors to adopt detailed underwriting standards, violations of which are punishable by agency sanction.¹⁷² Second, the regulations and guidelines furnish a codified standard of care whose breach is actionable as negligence *per se* in common-law suits for damages.¹⁷³ Courts have been overwhelmingly receptive to the incorporation of such federal statutes and regulations into the common-law duty of care.¹⁷⁴ The only point at which courts have balked, and then only a few, has been over the propriety of assessing damages for violations of internal agency guidelines, regulatory agreements, and recommendations found in examination reports.¹⁷⁵

170. 12 U.S.C. §§ 371(a), 1828(o) (1994) (requiring bank regulators to adopt uniform federal regulations and guidelines on real estate loans).

171. 12 C.F.R. pt. 34, subpt. D, app. A (1996); *id.* pt. 208, app. C; *id.* pt. 365, app. A; *id.* pt. 563, subpt. D, app. A; 59 Fed. Reg. 29482 (1994) (codified at 12 C.F.R. §§ 34.41-34.47, 208.18, 225.61-225.67, 323.1-323.7, 545.32, 545.103 and 564.1-564.8). Under the new rules, banks and thrifts must establish loan origination and approval procedures, monitor compliance with those procedures, analyze all relevant credit factors, establish standards for the use of pre-funded interest, and draft procedures for loan administration, loan extensions, and loan forbearance. *See also* 61 Fed. Reg. 50951 (1996) (updating OTS lending rates; 61 Fed. Reg. 43948 (1996) (revised interagency asset quality guidelines).

172. *See* 12 U.S.C. § 1818 (1989 & Supp. 1994) (detailing sanctionable conduct).

173. *See, e.g.,* FDIC v. Bierman, 2 F.3d 1424, 1433 & n.9 (7th Cir. 1993) (citing cases); RTC v. Heiserman, 839 F. Supp. 1457, 1465-66 (D. Colo. 1993) ("In a *per se* claim, the standard of care is determined by statute, regulation or ordinance"). While the express words of the 1992 regulations only address real estate loans, many of the safeguards the rules require could apply by analogy to other types of loans.

174. *See* FDIC v. Stahl, 89 F.3d 1510, 1518-19 (11th Cir. 1996) (holding that supervisory agreement and FHLBB appraisal standards furnished evidence of standard of care); RTC v. Ascher, No. Civ. A. 92-B-424, 1994 U.S. Dist. LEXIS 1827, at *23 (Feb. 14, 1994), *modified on other grounds*, No. Civ. A. 92-B-424, 1994 U.S. Dist. LEXIS 2699 (Feb. 25, 1994) (same); RTC v. Norris, 830 F. Supp. 351, 354-55, 360 (S.D. Tex. 1993) (denying motion to dismiss where directors allegedly abdicated their managerial responsibilities by violating state and federal loan regulations).

175. *Compare* FDIC v. Benson, 867 F. Supp. 512, 524 (S.D. Tex. 1994) (dismissing negligence claims against bank directors who allegedly disregarded examination reports) *with* FDIC v. Stahl, 39 F.3d 1510 (11th Cir. 1996) (district court improperly granted defendant directors' JNOV motion where defendants disregarded criticisms in examination reports and made loans in violation of supervisory agreement); RTC v. O'Connell, No. 94 C 4186, 1996 U.S. Dist. LEXIS 3999, at *8 (N.D. Ill. Apr. 1, 1996) (denying motion to dismiss where director defendants allegedly failed to take corrective actions after repeated criticisms by regulators); *Ascher*, 1994 U.S. Dist. LEXIS 1827, at *23 ("[n]egligence *per se* claims may be based upon the violation of FHLBB . . . Memorandum R41-b . . .");

What makes the shift toward federal codification intriguing is that nearly all of the standards in the December 1992 real estate regulations and guidelines have their origins in common-law holdings.¹⁷⁶ The fact that the common law already condemned many of the same practices as negligent did not stop Congress or the federal banking agencies from regulating those same practices through code-based statutes and regulations.

Federal codification of the duty of care has several distinct advantages over the old system of common-law regulation. Supplanting state common-law rules with federal rules that had uniform, national application helped redress the historically spotty nature of state court policing of bank lending.¹⁷⁷ Federal bank regulators in that regard have made a concerted effort to increase

Norris, 830 F. Supp. at 354-55, 360 (refusing to dismiss negligence claims for ignoring examination reports). *Cf. In re Seidman*, 37 F.3d 911, 930-31 (3d Cir. 1994) (violating a policy statement does not form the basis for regulatory sanctions); *RTC v. Lutz*, 914 F. Supp. 1163, 1165 (E.D. Pa. 1996) (ignoring accountants' warnings that proposed loans were too large and risky constituted gross negligence; granting summary judgment).

Holding a bank director liable for violations of informal agency guidelines may pose serious notice concerns where the guidelines were not disseminated to the director or where the law treats guidelines as non-binding. This may pose a growing problem now that Congress has amended FDICIA to permit federal regulators to issue safety and soundness standards as guidelines rather than regulations. *See supra* note 169 and accompanying text.

In the case of examination reports and regulatory agreements, however, such notice concerns are generally weak. Federal examination reports, for example, are explicitly addressed to bank directors and notify them of deficiencies that need to be redressed. Directors have even less justification to assert lack of notice of regulatory agreements such as supervisory agreements and voluntary cease-and-desist orders because directors must personally sign those agreements. For this reason, a majority of courts properly holds that examination reports and regulatory agreements can furnish a standard of care. *See, e.g., Stahl*, 89 F.3d at 1520; *Bierman*, 2 F.3d at 1433 & n.9 (citing cases); *Home Savings Bank, F.S.B. v. Gillam*, 952 F.2d 1152, 1158-60 (9th Cir. 1991) (affirming grant of summary judgment where forbearance agreement was violated); *cf. FDIC v. Daniel*, No. 1:92-CV-347, 1995 U.S. Dist. LEXIS 6940, at *10 & n.7 (E.D. Tex. Apr. 11, 1995) (denying defendants' motion for summary judgment on gross negligence claim where examination reports put defendants on notice that they were engaging in imprudent banking practices).

176. Modern cases, for example, penalize the failure to adopt internal underwriting standards as negligent. Notwithstanding this common-law development, federal bank regulators adopted detailed loan underwriting requirements in the 1992 real estate lending regulations and guidelines. Other topics where recent cases and the rules converge include the perfection of security interests, the collection and analysis of borrowers' financial data, and the treatment of pre-funded interest. *See McCoy, supra* note 2, at 1063-66, 1073-76.

177. *See* 12 U.S.C. §§ 371(a), 1828(o) (Supp. 1993) (authorizing federal regulation of real estate loans); *Brudney, supra* note 17, at 1845 n.71 (citing federal banking regulations and noting that "when the temptations for stockholders to gamble especially riskily with bondholders' funds approach the unacceptable, Congress has imposed restrictions . . ."). Federal rules and statutes that apply to federally-insured state banks and thrifts preempt any state rules that are less demanding. *See Lincoln Savings & Loan Ass'n v. Federal Home Loan Bank Board*, 670 F. Supp. 449, 454 (D.D.C. 1987), *aff'd*, 856 F.2d 1558, 1562 (D.C. Cir. 1988) (FHLBB direct investment rule pre-empted similar state rule for federally-insured state thrifts).

uniformity by promulgating the regulations on a joint interagency basis.¹⁷⁸

The rush toward increased federalization of bank director standards also has been fueled by the fact that federal bank agencies have replaced shareholders, depositors, and state court receivers as the dominant plaintiff in bank director liability litigation. The vast majority of reported bank director negligence cases since 1945 has been brought by the FDIC, or its one-time sister agency, the Resolution Trust Corporation ("RTC"), either in their corporate capacities or as conservators or receivers.¹⁷⁹ One important by-product of this phenomenon is that the principal forum for bank director liability cases has shifted from state courts to federal courts, due to the federal question jurisdiction and removal powers that agency lawsuits confer.¹⁸⁰

As a result, the de facto authority for defining the scope of the business judgment rule has decisively shifted from state courts and bankers to federal bank regulators. In their dual roles as law-givers and plaintiffs, federal bank regulators now promulgate the rules that later provide the standard of care in professional negligence suits against directors. In doing so, federal bank regulators supply the banking expertise that courts formerly felt they needed (but lacked) in order to pare back the business judgment rule. The judiciary's deference to agency expertise is such that many courts regularly draw on the new, regulator-shaped law, even while maintaining the facade that state common law is the rule of decision.

The incorporation of codified federal standards into the standard of care has obvious ramifications for the debate over whether state law or federal common law should provide the rule of decision in failed bank litigation. The Supreme Court settled this issue, at least nominally, in *O'Melveny & Myers v. FDIC*,¹⁸¹ where it

178. Nevertheless, uniformity is relative at best. Even where federal banking agencies agree on uniform standards, they may disagree on how those rules are to be interpreted and administered.

179. See WILLIAM E. KNEPPER & DAN A. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* 352-56 (4th ed. 1988) (describing agencies' powers to sue); Dunne, *supra* note 139, at 296-97 (describing FDIC dominance in bank director liability suits); *The Directors & Officers Dilemma: Liability*, 41 RISK MANAGEMENT 72 (July 1994). See also *Harmsen v. Smith*, 542 F.2d 496 (9th Cir. 1976) (actions against directors and others for harm to a failed institution belong to the institution and its receiver, not to shareholders, unless the shareholders can show personal injury); *Landy v. FDIC*, 486 F.2d 139, 144 (3d Cir. 1973). The RTC went out of business on December 31, 1995 under agency sunset provisions and transferred its caseload docket to the FDIC. See 12 U.S.C. §§ 1441a(m)(1).

180. See 12 U.S.C. § 1819(b)(2) (Supp. 1993) (conferring federal subject matter jurisdiction in all FDIC actions).

181. 114 S. Ct. 2048, 2056 (1994). The issue arose in the context of an argument by the defendant law firm that under California law, the guilty knowledge of the thrift's officers had to be imputed to the thrift, and to the FDIC as receiver, so as to preclude

held that state law rather than federal common law provides the rule of decision in FDIC professional negligence cases. Nothing in *O'Melveny*, however, disturbed the traditional state law precept that violations of statutes and regulations are actionable as negligence per se. To the extent that courts hold violations of codified federal standards actionable as negligence per se under state law, it is irrelevant whether state law or federal law nominally furnishes the rule of decision.¹⁸²

But the greatest significance of the new federal, code-based standard of care lies in solidifying the shift away from the nineteenth-century norm of potential profit maximization at any cost. In contrast with the past, now the guardians of the purse—federal bank regulators—are redefining the dividing line between the duty of care and the business judgment rule in banking. Their interest in safeguarding the federal deposit insurance funds helps assure that concerns for loss avoidance will remain at the fore (at least to the extent that regulators do not embark on deregulation). Federal regulators, moreover, have extra muscle to reshape the law, both by virtue of their ability as regulators to promulgate standards of conduct and their ability as plaintiffs to press for incorporation of those standards into the common law.

In sum, bank director negligence law has experienced a fundamental shift in the last hundred years of a type scarcely imaginable in general corporate law today. In contemporary bank director negligence law, debtholder interests, comprised principally of the interests of depositors and the deposit insurance funds, have largely eclipsed shareholder interests. As this experience shows, the business judgment rule is predicated on embedded economic assumptions, particularly low debt-equity ratios and accessible pricing information, that may or may not obtain in particular industries or

proof of reliance on outside counsel's advice. *Id.* at 2052.

182. The rule of decision issue lives on in the current debate over the effect of 12 U.S.C. § 1821(k) (1989) and the issue of whether the gross negligence standard in that section preempts simple negligence standards under state law. As previously noted, lower courts are deeply divided over whether state law or federal common law applies to federally-chartered institutions and the Supreme Court recently agreed to examine this issue on *certiorari*. See *supra* note 12 and accompanying text. To the extent federal common law would apply to federally-chartered institutions, courts would likely find violations of federal statutes and regulations actionable. See *supra* note 174 and accompanying text.

Apart from the effect of § 1821(k), for the reasons just discussed, *O'Melveny* has had a negligible effect on the duty of care in negligence per se cases. But *O'Melveny* can make a difference with respect to other elements of a negligence claim such as causation and reliance, as well as affirmative defenses. In *O'Melveny* and the other case that created an inter-circuit conflict with *O'Melveny*, *FDIC v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992), the rule-of-decision debate centered on the element of detrimental reliance. Compare *O'Melveny*, 114 S. Ct. at 2052, with *Ernst & Young*, 967 F.2d at 170-71 (affirming summary judgment for accounting firm charged with negligent auditing of failed S&L's books, due to lack of detrimental reliance).

under certain economic conditions. The banking experience similarly shows that where those assumptions do not hold, and where debtholders are consequently harmed, courts may react by curtailing the business judgment rule, particularly where broad-based political interests are at stake. But that is not to say that the banking experiment succeeded. To the contrary, the checkered history of the century-long transformation in banking raises questions about the efficacy of this form of common law regulation.

III. THE NEW DUTY OF CARE APPRAISED

Bank director negligence law, as it stands today, is a strange and baffling amalgam. State law provides the nominal rule of decision, but federal, code-based standards largely define the duty of care. Additionally, federal agencies filing suit in federal courts prosecute the overwhelming majority of such claims.

This anomaly is not without its consequences. While forging the duty of care from federal standards may appear to be a triumph of debtholder interests and federal law, any victory may well be pyrrhic. That is because bank director negligence law remains burdened with old tort law doctrines from the original, shareholder-oriented era. These antiquated doctrines have increasingly been used to defeat receivership claims.

For example, bank directors have had increased success in getting negligence claims dismissed as time-barred under disparate state statutes of limitations that may have run before a federal receiver is even appointed.¹⁸³ Even more significantly, there is an emerging trend to restore the business judgment rule to its original breadth so as to excuse, at least for civil negligence purposes, breaches of federal standards of bank director care.¹⁸⁴ These latest

183. See *RTC v. Gaudet*, Civil Action No. 92-2661 Section "E"(5), 1996 U.S. Dist. LEXIS 1106, at *20 (Jan. 29, 1996); *Magistrate Rejects FDIC View That Claim 'Accrues' on Default*, BANK BAILOUT LITIG. NEWS, Mar. 18, 1996, at 1, 6 (discussing unreported opinion in *RTC v. Falk*, No. 92-591-CIV-FERGUSON (S.D. Fla. Feb. 20, 1996)); *Adverse Domination: A Survey of Recent Decisions*, BANK BAILOUT LITIG. NEWS, Apr. 26, 1995, at 10; *FDIC and RTC Challenge BBLN Tally of PL Cases, Claim Winning Records on Merits*, BANK BAILOUT LITIG. NEWS, Oct. 26, 1994, at 1-3 (citing cases) [hereinafter *BBLN Tally*]; *D&Os Win Virginia Case Based on Cocke, And Texas Case Based on State Regulator's Control*, BANK BAILOUT LITIG. NEWS, Dec. 2, 1993, at 1-3; James T. Pitts et al., *FDIC/RTC Suits Against Bank and Thrift Officers and Directors—Why Now, What's Left?*, 63 *FORDHAM L. REV.* 2087, 2109-2112 (1995).

184. See *FDIC v. Castetter*, C.A. No. 94-55974, 1996 U.S. App. LEXIS 14799, at *2-*4 (9th Cir. June 3, 1996), *modified*, Civ. Act. No. 94-55974, U.S. App. LEXIS 22366 (9th Cir. Aug. 28, 1996) (under California law, business judgment rule protects bank directors who make informed business decisions); *Starrels v. First Nat'l Bank of Chicago*, 870 F.2d 1168, 1171-72 (7th Cir. 1989) (holding that unsecured loans fell within the business judgment rule); *FDIC v. Cohen*, 95 Civ. 683 (LLS), 1996 U.S. Dist. LEXIS 2247, at *3, *30-*33 (S.D.N.Y. Feb. 28, 1996) (business judgment rule barred negligence

cases reflect growing judicial discord over the extent to which the business judgment rule in banking has been curtailed, with some courts taking the view it has not been curtailed at all. Indeed, the track record of RTC monetary recoveries against bank directors was so poor that some have questioned whether the RTC's aggregate recoveries were cost-effective.¹⁸⁵

and gross negligence claims for loans made without safe procedures); *RTC v. Acton*, 844 F. Supp. 307, 310-16 (N.D. Tex. 1994), *aff'd*, 49 F.3d 1086 (5th Cir. 1995) (granting summary judgment for directors despite evidence of lending limit violations); *RTC v. Blasdel*, 730 F. Supp. 417 (D. Ariz. 1994) (granting summary judgment for defendant directors despite evidence of lax lending policies); *FDIC v. Benson*, 867 F. Supp. 52, 520-22 (S.D. Tex. 1994) (business judgment rule protects failures to correct lax loan practices that were flagged in supervisory agreements and examination reports); *Noble v. Baum*, No. CV 89 0265 920 S, 1991 Conn. Super. LEXIS 1231, at *2, *7, *40-*41 (Conn. Super. Ct. May 6, 1991) (business judgment rule protected bank loans that lacked borrower equity); BBLN Tally, *supra* note 183, at 3-8 (listing unreported cases). *See also* STAFF OF HOUSE SUBCOMM. ON GENERAL OVERSIGHT AND INVESTIGATIONS OF THE HOUSE COMM. ON BANKING AND FINANCIAL SERVICES, 104TH CONG., 1ST SESS., STAFF REPORT ON RESOLUTION TRUST CORPORATION'S PROFESSIONAL LIABILITY PROGRAM—DALLAS, TEXAS REGIONAL OFFICE 42, 48, 276-77 (Comm. Print 1995) [hereinafter PLS REPORT] (noting testimony of RTC Associate General Counsel Thomas L. Hinder that "federal court rulings were going against RTC on the negligence cases"); Pitts et al., *supra* note 183, at 2102-06 (citing cases from various jurisdictions adopting widely disparate standards of care). *Cf.* *RTC v. Scott*, 929 F. Supp. 1001 (S.D. Miss. 1996) (granting summary judgment for defendant director on gross negligence claim despite evidence of missing appraisals).

Additionally, some states have enacted statutes limiting potential personal liability for officers and/or directors of financial institutions or imposing penalties on thrift plaintiffs who unsuccessfully bring simple negligence suits. *See Cohen*, 1996 U.S. Dist. LEXIS 2247, at *29-*33 (discussing VA. CODE § 13.1-690); *RTC v. Fleischer*, 897 P.2d 497, 498 (Kan. 1995) (discussing KAN. STAT. ANN. § 17-5831 (Supp. 1994)); *RTC v. Miramon*, Civ. A. No. 92-2672, 1994 WL 605906 (E.D. La. Nov. 3, 1994) (assessing liability against the RTC under LA. REV. STAT. ANN. § 6:786(F)); *Acton*, 844 F. Supp. at 315 n.5 (discussing the Texas legislature's enactment of House Bill 1076, providing that officers and directors may only be held liable for gross negligence); Matthew G. Doré, *Presumed Innocent? Financial Institutions, Professional Malpractice Claims, and Defenses Based on Management Misconduct*, 1995 COLUM. BUS. L. REV. 124, 179 n.190 (listing new state statutes applying gross negligence standard to actions brought by the FDIC); Ronald W. Stevens & Bruce H. Nielson, *The Standard of Care for Directors and Officers of Federally Chartered Depository Institutions: It's Gross Negligence Regardless of Whether Section 1821(k) Preempts Federal Common Law*, 13 ANN. REV. BANKING L. 169, 194-208 (1994) (same); *Utah Legislature Passes Gross Negligence D&O Standard*, BANK BAILOUT LITIG. NEWS, Mar. 25, 1993, at 6 (discussing restrictive Utah and Louisiana legislation); James J. Hanks, Jr. & Tracy A. Bacigalupo, *State Legislative Responses to the Director and Officer Liability Crisis*, in AMERICAN BAR ASSOCIATION, REPRESENTING DIRECTORS AND OFFICERS OF FINANCIAL INSTITUTIONS 79 (1991). *See generally* Theodore D. Moskowitz & Walter A. Effross, *Turning Back the Tide of Director and Officer Liability*, 23 SETON HALL L. REV. 897, 912-17 (1993).

185. *See* PLS REPORT, *supra* note 184, at 1, 3 ("Of a \$26 billion loss to taxpayers from failed S&Ls in Texas, RTC recovered only \$35 million from the officers and directors of these S&Ls," amounting to less than "\$1.50 . . . for every \$1,000 in losses."); AMERICAN ASS'N OF BANK DIRECTORS, RTC SUITS AGAINST SAVINGS INSTITUTION DIRECTOR AND OFFICERS: ARE THEY IN THE PUBLIC INTEREST? 33-37 (1995); *June Action Likely to be Pivotal on Bank Bailout Issues in Congress*, BANK BAILOUT LITIG. NEWS, June 21, 1995, at 4; Jeff Gerth, *Report on S. & L. Supervision Draws Criticism by Offi-*

As these throwback cases make clear, the business judgment rule's very elasticity makes it a potential doctrinal trump card for code-based duties of care. The classic business judgment rule is absolutist in nature: it negates the duty of care for any good-faith, disinterested banking decision that has even a negligible chance of profit, irrespective of risk. Thus, any attempt to scale back the rule is bound to spawn confusion about where liability falls, raising both fears that business innovation will be chilled and that deterrence will be inadequate.

Some maintain that the minimum rationality test used in *Hun v. Cary*¹⁸⁶ and *Litwin v. Allen*,¹⁸⁷ which effectively prohibits routine business decisions with no potential for profit on their face, preserves certainty while providing needed regulation.¹⁸⁸ In the banking industry, however, that did not prove true. After 1940, because it was so hard to pinpoint with accuracy decisions lacking profit potential, courts began to discard the minimum rationality test in banking, at least as it applied to routine decisions.¹⁸⁹ Thus, far from fostering certainty, it was *lack* of certainty that doomed the minimum rationality test.

Intriguingly, that did not cause courts to retreat from regulating bank asset decisions as a matter of common law. To the contrary, the duty of care eventually mushroomed to cover a wide variety of bank decisions with obvious profit potential. The rather extensive case law in this regard shows that, far from considering the minimum rationality test too intrusive, many courts considered it too anemic an antidote to the tilt toward risk that the business judg-

cials, N.Y. TIMES, June 20, 1995, at B8 ("Government studies have shown that while most of the intentional misconduct by savings and loan insiders took place in Texas, involving more than \$2 billion, the agency has recovered only \$36 million from former officers and directors of failed Texas institutions."); BBLN Tally, *supra* note 183, at 1; Weinstein, *supra* note 12, at 1502 (apart from a few large settlements, "there is a serious question whether the government's ultimate recoveries will exceed the millions of dollars that are now being spent on the process"); *but see RTC Reports \$517 Million In PLS Recoveries*, BANK BAILOUT LITIG. NEWS, Dec. 26, 1995, at 1, 4; *RTC Report Shows \$64 Million Recovered from D&O Cases, \$36 Million in Criminal Restitution*, BANK BAILOUT LITIG. NEWS, July 5, 1995, at 1 (RTC report shows "an overall recovery to cost ratio in excess of \$4.53 recovered for every \$1 expended"). Cf. GENERAL ACCOUNTING OFFICE, THRIFT FAILURES—ACTIONS NEEDED TO STABILIZE RTC'S PROFESSIONAL LIABILITY PROGRAM, GAO/GGD-93-105 12 (1993) (discussing RTC's record of financial recoveries and criticizing weaknesses in its professional liability program).

186. 32 N.Y. 65 (1880).

187. 25 N.Y.S. 667 (Sup. Ct. 1940).

188. See Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *FORDHAM L. REV.* 437, 442-45 (1993).

189. The court's inability to recognize the potential profitability of the subordinated debenture transaction in *Litwin* highlighted the difficulties of such endeavors. See McCoy, *supra* note 2, at 1038-39 (discussing the difficulties judges experience in conducting financial analyses in cases following *Litwin*); *supra* notes 128-30 and accompanying text (discussing *Litwin*).

ment rule creates. In recent banking cases, courts have awarded debtholder relief not only for economically irrational decisions where debtholder and shareholder interests merge, but also for potentially profitable decisions where debtholder and shareholder interests clash.¹⁹⁰ This increased judicial activism has spawned concerns that the pendulum swung too far.

What are the successes and pitfalls of this experiment? In the short term, the new, stricter case law has had some success in scaling back senseless bank risks. The new cases outlaw practices such as new loans to delinquent borrowers or premature releases of collateral that banks are hard-pressed ever to defend. Similarly, the new cases have had a distinctly heuristic effect, with risk management programs taking on new priority.

At the same time, the liability juggernaut raises the obvious question of whether the new, stricter law will make bank directors too risk-averse. The data suggest that in the short term this has been a problem. During the early 1990's and up through early 1994, there was a well-publicized shrinkage of bank credit, and increased numbers of worthwhile loan prospects were turned down.¹⁹¹ Likewise, there is evidence from that period that bank director recruitment became more difficult, as damage awards mounted and D&O liability coverage for receivership suits dried up.¹⁹²

190. See McCoy, *supra* note 2, at 1040-46 (discussing recent banking cases).

This turn of events also similarly sheds light on the argument that the duty of care is nothing but a cipher for duty of loyalty concerns. See Dooley, *supra* note 16, at 471-72 (the business judgment rule largely shields disinterested decisions); Palmiter, *supra* note 4, at 1376-85 (discussing the duty of care in relation to the duty of loyalty); cf. Bishop, *supra* note 4, at 1099 ("The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack."). That may be true for decisions that are economically irrational both from shareholders' and debtholders' perspectives, because management self-interest is normally the only plausible reason for such decisions. But, in cases involving board decisions that are plainly in shareholders' interests (because they are potentially profitable) but that expropriate wealth from debtholders, the duty of care vindicates an entirely different interest in regulating wealth distribution among shareholders and debtholders. See also *infra* note 203 (discussing a stricter duty of care standard).

191. See Keith Bradsher, *Bank Regulators Taking Close Look at Lending Risks*, N.Y. TIMES, Apr. 9, 1995, at C1 (noting credit crunch in the early 1990's); Steven Greenhouse, *Fed Chief Links Tight Credit to Slowdown*, N.Y. TIMES, Nov. 19, 1992, at D1 (discussing the reluctance of banks to lend money); Bruce G. Stevenson, *Lending Boom Echoes Past Mistakes*, AM. BANKER, May 19, 1995, at 18.

192. See Anbari, *supra* note 33, at 553-56; Robert E. Barnett, *Directors Must Be Managers As Their Responsibilities Mount*, AM. BANKER, May 27, 1993, at 4; Mark A. Hoffman, *D&O rates increasing for many types of risks; Financial institutions particularly hard hit*, BUS. INS., Oct. 21, 1991, at 75; Jeffrey Kutler, *Local Advisory Boards: Cure or Band-Aid?*, AM. BANKER, Dec. 18, 1992, at 1; Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573, 606 (1996); Michael Quint, *Bank Direc-*

In the long run, however, it is questionable whether the newer case law will continue to make bank directors too risk-averse. The credit crunch of the early 1990's was so short-lived that federal bank regulators formed a task force in April 1995 to monitor increased loan portfolio risks.¹⁹³ Similarly, bank D&O carriers are dropping regulatory exclusion clauses from their professional liability policies, making it easier to fill vacancies on bank boards of directors.¹⁹⁴ Thus, the evidence would seem to suggest that the duty of care in banking is again in the downswing of its historical cycle. If that is the case, the newest cases are as likely to recede into irrelevance as to induce undue caution.

To be sure, the latest cycle of bank director liability cases has unique characteristics that may give these cases added longevity. The latest set of stricter cases may be less subject to erosion than before, because the quantity of such cases is significantly greater. In addition, the FDIC, the predominant plaintiff in such cases today, has used its jurisdictional and removal powers to switch the principal venue from state to federal courts. Similarly, as banks diversify the asset side of their ledgers away from loans and toward other activities, directors may become apprehensive about new, uncharted bases of exposure. The possibility that shareholders might use the latest precedents during solvency to challenge failed business decisions after-the-fact could also make directors unduly cautious.

But there is little empirical evidence of long-term, undue risk aversion, in contrast with growing evidence that the newer, stricter case law is entering into a historic cycle of decline. Congress has given federal regulators the go-ahead to water down safety and soundness standards by recasting them as guidelines rather than regulations.¹⁹⁵ Similarly, the same judicial concerns responsible

tors Face Rising Risks, N.Y. TIMES, Mar. 26, 1992, at D1; Barbara A. Rehm, *Fear of Lawsuits Makes It Harder To Lure Directors*, AM. BANKER, Dec. 6, 1991, at 1; Weinstein, *supra* note 12, at 1504; *see generally* THE WYATT COMPANY, 1994 WYATT DIRECTORS AND OFFICERS LIABILITY SURVEY 42 & Table 28 (1994) [hereinafter WYATT SURVEY].

193. *See* Bradsher, *supra* note 191, at 1 (discussing increased federal regulatory interest in lending risks); *see also* FDIC, REPORT ON UNDERWRITING PRACTICES, FEBRUARY 1995 TO FEBRUARY 1996 1-2 (Feb. 1996) ("[I]n just over ten percent of the institutions being examined, recent lending standards were characterized as having 'more-than-normal' risk.").

194. *See, e.g.*, *Experts Watching Bank D&O Exposure with Interest—Conditions Could Spawn Host of Claims, Observers Say*, BUS. INS., Nov. 21, 1994, at 55; James C. Lawson, *Taming Risk in a World Full of Perils; No More Insurance Woes for D&Os*, U.S. BANKER, Dec. 1994, at 38; Monteleone & Conca, *supra* note 192, at 605-06 (discussing the effects of regulatory exclusion clauses); Terrence O'Hara, *Recruiting Directors May Be Getting Easier*, AM. BANKER, Aug. 30, 1993, at 6; *see generally* WYATT SURVEY, *supra* note 192, at 13, 14 at Table 4, 19 at Tables 8A and 8B.

195. *See supra* note 170 (noting a federal statute requiring uniform regulations).

for past declines have reared their heads again, in the form of concerns about judicial competence, undue risk aversion by bank boards, and the competitiveness of home-state institutions. In all likelihood, the latest counter-trend of permissive cases represents a judicial backlash against the perceived excesses of the FDIC and RTC, both in terms of excess agency power (in their dual capacities as lawgiver and litigant) and excess agency aversion to risk.¹⁹⁶

Thus, the banking cases present a paradox. When they are viewed from a linear perspective, debtholders' rights appear to be continuously expanding. However, this image ignores the fact that the banking cases cyclically fall into prolonged periods of judicial backlash and disuse, not to be revived until the next banking crisis comes along.¹⁹⁷ After the initial savings bank cases during the bank panic epidemic of the 1880's and 1890's were decided in Massachusetts, New Jersey, New York, and Virginia, all other states save one—Arkansas—ignored those holdings and strictly enforced the business judgment rule before the Depression. During the Depression, cases curtailing the business judgment rule resurged, but those holdings fell into virtual disuse between 1945 and 1975 because bank failures were rare. The 1980's bank and thrift crisis triggered the latest cycle of strict cases, but a judicial backlash to those holdings can already be discerned.

Given their short shelf life, the primary effect of the banking cases has been to react to past crises, rather than deter crises in the future. Even at that, the cost-effectiveness of the latest crop of cases is seriously in doubt. Hence, there are serious questions whether, over the long run, the recent surge in negligence holdings is a sufficient deterrent to asset substitution problems in banking to preserve the FDIC's cause of action in its current form.

196. With respect to the latter, see Kenneth E. Scott & Thomas Mayer, *Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform*, 23 STAN. L. REV. 857 (1971):

[W]hile the FDIC, the FSLIC, and the other supervisory agencies have an obvious interest in minimizing the frequency of failures, they have no corresponding incentive to assure that insured institutions take as much risk as they should. To protect their own status, the insuring and regulating agencies have a tendency to overdo safety; from their point of view there can hardly be too much safety.

Id. at 873 (footnote omitted).

197. As Professor Roe recently remarked in a related context: "Populist sentiment against concentrations of economic power seems to have been continuous, but for that sentiment to succeed in making law, politics also required a catalyst, such as . . . interest group demands or the Great Depression . . ." ROE, *supra* note 75, at 49.

IV. A PROPOSED FEDERAL STATUTORY CAUSE OF ACTION FOR BANK DIRECTOR NEGLIGENCE

As the preceding discussion demonstrates, the current system of state-law negligence claims against bank directors fails to achieve either of the twin goals of compensation or deterrence. To realize improvement on either score, it will be necessary to scrap the current patchwork of state-law negligence claims for a federal bank director liability claim that is conferred by federal statute.

To be worthwhile, any new cause of action must address the lack of deterrence—the most serious failing of the current liability system. Above all, a new cause of action must recognize that the principal interests served by FDIC suits against bank directors are federal in nature and consist of preventing losses to the deposit insurance funds. The current system of state-law rules serves these interests poorly. To be sure, federal courts applying state law have expanded bank director liability on the merits over time. Nevertheless, state lawmakers have strong incentives to water down bank director liability law, because liability antagonizes important constituencies while losses fall largely on the federal government. As the history of the banking cases also shows, courts periodically revive doctrines such as the business judgment rule and unreasonably short state statutes of limitation in order to immunize bank directors from liability, regardless of their underlying conduct. The cacophony of state rules compounds this situation by making uniform enforcement needlessly difficult.

Hence, any revamped claim for bank director liability must eschew state law in favor of a federal cause of action. Replacing outmoded state-law doctrines with federal standards would advance deterrence by making it harder for law-breaking directors to escape civil liability for reasons unrelated to their conduct. The business judgment rule would be eliminated as a defense to proven violations. To be effective, any new statutory claim also would have to make clear that the claim accrued to the FDIC directly, rather than to the agency standing in a failed institution's shoes. Similarly, a uniform statute of limitations would be necessary to solve the current problem in which a state statute of limitations may have run before a conservator or receiver has even been appointed. An ideal limitations statute would give the FDIC a reasonable time after appointment of a conservator or receiver—three years would suffice—during which to file suit, whether or not the institution's analogous claim had already expired.¹⁹⁸

198. Currently, a two-step limitations analysis applies to negligence claims by the FDIC on behalf of a failed institution in its capacity as conservator or receiver. *See* FDIC v. Ashley, 754 F. Supp. 179, 182 (D. Kan. 1990); FDIC v. Howse, 736 F. Supp. 1437,

To improve deterrence, a new statutory claim must also address the problem of vague standards of conduct. Many modern bank director cases have curtailed the business judgment rule in order to impose liability; other recent bank director cases have given the business judgment rule full effect. As a result, there is widespread confusion whether the business judgment rule or the duty of care takes precedence in federal negligence suits against bank directors. As this experience shows, the business judgment rule cannot be combined with a stricter duty of care without doing violence to both.

The resulting confusion is compounded by the cyclical nature of the banking industry, which makes it prone to periods of idle enforcement. Many directors probably assumed from the paucity of bank director liability cases between 1945 and 1980 that honest but mistaken lending decisions were protected from liability. But that assumption proved wrong with the sudden spate of bank director liability judgments in the past ten years. The result was a clash in expectations; bank directors thought the business judgment rule was the standard of conduct, while courts measured their conduct against an increasingly strict duty of care.¹⁹⁹

Even without the added complication of the business judgment rule, today's duty of care is so general—i.e., the care that ordinarily prudent directors would take under similar circumstances—that it is often difficult to know where liability lies. One consequence of

1440 (S.D. Tex. 1990). If the negligence claim was time-barred under the applicable state-law limitations period before the federal conservator or receiver was appointed, neither the appointment of a conservator or receiver nor the transfer of that claim to a government agency in its corporate capacity will revive the claim. *Compare* FDIC v. Former Officers and Directors of Metropolitan Bank, 884 F.2d 1304, 1309 n.4 (9th Cir. 1989), *cert. denied*, 496 U.S. 936 (1990); FDIC v. Schoenberger, 781 F. Supp. 1155, 1158 (E.D. La. 1992); *and* FDIC v. Cherry, Bekaert & Holland, 742 F. Supp. 612, 617 (M.D. Fla. 1990) with 12 U.S.C. §§ 1441a(b)(14)(E), 1821(d)(14)(C) (1996 Supp.) (reviving certain expired state claims for fraud or intentional misconduct). Assuming the negligence claim was not time-barred on that date, however, a new federal limitations period begins to run either when the government is appointed conservator or receiver or when the claim accrues, whichever is later. 12 U.S.C. § 1821(d)(14)(B) (1989 & 1996 Supp.); *see also* Schoenberger, 781 F. Supp. at 1158. The limitations period for FDIC negligence claims is the longer of three years or the period applicable under state law. 12 U.S.C. § 1821(d)(14)(A)(ii) (1989 & 1996 Supp.); *see also* 12 U.S.C. § 1441a(b)(14)(B), (C) (1996 Supp.) (modifying statute of limitations for RTC gross negligence claims).

199. A perfect illustration of clashing expectations in the bank loan area appears in the Seventh Circuit's decision in FDIC v. Vierman, 2 F.3d 1424 (7th Cir. 1993):

Despite the defendant directors' arguments that they were shielded by the business judgment rule and that the district court did no more than substitute its judgment for theirs, the court clearly, and correctly, determined that, at the time the loans were made, a reasonably prudent director would not have approved such transactions. Such a methodology . . . only imposes liability for those transactions that were unreasonable at the time that they were made.

Id. at 1434.

that generality is that bank director holdings are highly fact-contingent. This compounds uncertainty as to whether these holding are applicable to other sets of facts. Some directors intentionally exploit that uncertainty, gambling that they will not be held liable for aggressive loans. Others complain, often justifiably, that common-law standards are too vague to enable them to understand their legal responsibilities.²⁰⁰ The problem is exacerbated by bank regulators' longstanding refusal to issue specific guidelines for director conduct.²⁰¹

What is more, those clashing expectations arose in the one industry that had inched toward a stricter duty of care for years and that traditionally was associated in the public mind with conservatism and financial restraint. Nearly every bank director case this century that pared back the business judgment rule involved

200. See GARTEN, *supra* note 42, at 93; Tamar Frankel, *Corporate Directors' Duty of Care: The American Law Institute's Project on Corporate Governance*, 52 GEO. WASH. L. REV. 705, 707 (1984) (describing the vagueness of the duty of care standard); cf. Kraakman, *supra* note 44, at 887 ("Absolute liability . . . seems best suited to violations of clear-cut legal rules with little prospect of error in adjudication.").

This sequence of events is somewhat surprising in view of one prominent corporate law scholar's predictions in the general corporate context. A few years ago, Melvin Eisenberg posited that directors generally conform their conduct to the standard of due care, not the business judgment rule. At the same time, he argued, courts refuse to second-guess board decisions, using the business judgment rule as the standard of review. See Eisenberg, *supra* note 188, at 441. Eisenberg referred to the divergence between the due care standard of conduct that is addressed to directors and the business judgment rule that is addressed to lawyers and the courts as "acoustic separation." *Id.*

But bank director cases in the 1980's resulted in acoustic separation of precisely the opposite sort. If the theory of acoustic separation held true in banking, one might safely assume that most directors adhere to prudent conduct. Thus, if the standard of review was tightened, directors would not need to fear increased liability. But the opposite proved true in the S&L debacle of the 1980's. See *supra* notes 149 to 159 and accompanying text (discussing risky S&L behavior). William L. Cary and Sam Harris related the following anecdote in this regard:

Casey Stengel became director of the Glendale National Bank. . . . Well, in typical "Stengelese," Casey reported his delight in serving in that capacity and his one remark was, "It is fine. If you want to make a loan, you go into a soundproof room where no one can hear a word you're saying."

Carey & Harris, *supra* note 12, at 61.

201. See Weinstein, *supra* note 12, at 1504; FDIC, POCKET GUIDE FOR DIRECTORS (1988); U.S. COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK: THE ROLE OF A NATIONAL BANK DIRECTOR (1987); FDIC Statement Concerning the Responsibilities of Bank Directors and Officers, 5 Fed. Banking L. Rep. (CCH) ¶ 61,722(A) (Dec. 4, 1992); FDIC Statement Concerning the Responsibilities of Directors and Officers of Insured Depository Institutions, 5 Fed. Banking L. Rep. (CCH) ¶ 61,723 (Nov. 16, 1992). The most detailed guidelines for directors were issued by the Office of Thrift Supervision. See OFFICE OF THRIFT SUPERVISION, DIRECTOR INFORMATION GUIDELINES (1989). See also Gerald T. Dunne, *Legal Responsibilities of Bank Directors*, in THE BANK DIRECTOR 55 (Richard B. Johnson ed., 1974) ("[Courts] have—to borrow a phrase from former Chairman Cohen of the SEC—refused to establish 'standards for the sharp shooters to evade'" (quoting from AMERICAN BANKER (Dec. 6, 1968))).

routine loan decisions rather than extraordinary decisions, such as mergers or asset sales. Thus, recent experience suggests that serious problems arise when standards of review are tightened, without notice, for day-to-day business decisions that are not heavily lawyered, such as loan approvals. In the meantime, the message that many 1980's bank directors heard was not that liability rules were becoming stricter, but that the business judgment rule still prevailed.²⁰² Up through the 1980's, the legal and regulatory system thus abjectly failed to communicate the duty of care to bank directors and to notify them that liability was headed in a stricter direction.²⁰³

Consequently, it is time to overhaul FDIC actions against bank directors by replacing the current, vague standard of care with a statutory standard that defines proscribed conduct with greater specificity. Courts have already groped toward a solution in this regard by holding that violations of statutes, rules, supervisory

202. See authorities cited in McCoy, *supra* note 2, at 1031 n.1 (discussing the business judgement rule).

203. Academic commentary perpetuated the impression that stricter bank director cases were a thing of the past and were essentially confined to their facts. In 1968, for example, Professor Bishop commented that bank director negligence holdings were essentially "extinct." See Bishop, *supra* note 4, at 1096 n.63, 1098-99. This notion has resurfaced in the literature during the past thirty years. See Cary & Harris, *supra* note 12, at 61-62 (describing threat of bank director liability as "fictional"); Dyson, *supra* note 4, at 343-44, 354 (discussing the lack of cases involving the negligence of bank directors); Palmiter, *supra* note 4, at 1360 n.22, 1377-78 and citations therein (discussing the modern rejections of the business judgment rule); Scott, *supra* note 4, at 129 ("nearly all the decisions imposing liability . . . antedate the FDIC and FSLIC"); but see, e.g., MICHAEL P. MALLOY, *THE CORPORATE LAW OF BANKS* 230-31 & n.1 (1988) (cases cited therein); Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

Similarly, academic commentators reinforced the impression that the duty of care lacked bite by arguing that duty of care cases are nothing more than duty of loyalty rulings in disguise, due to the nearly ubiquitous presence of self-dealing. See Dooley, *supra* note 16, 190.

In banking, however, such reductionism is misplaced. As already discussed, duty of care cases in banking have an independent concern with asset substitution, over and above self-dealing concerns. See *supra* note 190. This is apparent from the bank case holdings that have condemned discrete transactions as negligent despite the absence of conflict of interest. See RTC v. Rahn, No. 1:92:CV:174, 1994 U.S. Dist. LEXIS 7932, at *35-*39 (W.D. Mich. June 6, 1994); RTC v. Ascher, Civil Action No. 92-B-424, 1994 U.S. Dist. LEXIS 1827 (D. Colo. Feb. 14, 1994), *modified on other grounds*, 1994 U.S. Dist. LEXIS 2699 (Feb. 25, 1994); RTC v. Norris, 830 F. Supp. 351, 355, 359-60 (S.D. Tex. 1993); Medford Trust Co. v. McKnight, 197 N.E. 649, 659-60 (Mass. 1935); Bailey v. O'Neal, 122 S.W. 503, 505 (Ark. 1909); Williams v. McKay, 18 A. 824, 830-31 (N.J. Eq. 1889); see also Weinstein, *supra* note 12, at 1501 ("[D]ishonesty was a contributing factor in only a minority of [S&L] failures."). Similarly, judicial pronouncements about the duty of care can have significant settlement value in cases with disputed transactions that are not infected by conflict of interest. This effect is potentially significant. Eighty-five percent or more of the professional defendants sued by the FDIC and RTC settled with the plaintiff agency before trial. See *FDIC/RTC Have Mixed Success Suing Professionals; Settlements Win Cash, But Courts Are Wary of Cases*, BANK BAILOUT LITIG. NEWS, July 7, 1994, at 2.

agreements, and orders are negligent per se. The benefit of that approach is that it uses ascertainable standards of conduct as a proxy for the old and highly elastic standard of care. The problem with that approach is that it imports code-based standards into state-law negligence claims, which are weighted down by other, often inappropriate doctrinal baggage. Therefore, to implement code-based standards in any meaningful way, they need to be transplanted into a new cause of action that is free from inappropriately broad defenses.

Hence, a new federal claim should limit FDIC bank director liability suits to losses caused by negligent, reckless, or knowing violations of state and federal rules and statutes on bank safety and soundness. Losses due to negligent, reckless, or knowing disregard of agency orders, written agency conditions, and written supervisory agreements should also give rise to damages.²⁰⁴ The business

204. In drafting such a statute, a leaf could be taken from the civil money penalty provisions of 12 U.S.C. § 1818(i)(2) (1989 & 1996 Supp.), which authorize penalties against institution-affiliated parties, including bank directors, who violate a law, regulation, certain final and temporary orders, written conditions imposed by federal bank regulators, or written agreements between institutions and federal bank regulators.

Critics of the current negligence system argue against liability based on simple negligence due to overdeterrence concerns. *See, e.g.,* Weinstein, *supra* note 12, at 1501-03. Harris Weinstein, former Chief Counsel of the U.S. Office of Thrift Supervision, has correctly pointed out that federal bank regulators can only require reimbursement of losses in cease-and-desist proceedings in case of unjust enrichment or reckless disregard. *See id.* at 1502 n.13; 12 U.S.C. § 1818(b)(6)(A). Nonetheless, simple negligence liability would be more lenient than the current Tier 1 civil money penalty provisions, which already authorize fines on a strict liability basis of up to \$5,000 per day. *See* 12 U.S.C. § 1818(i)(2)(A) (1989 & 1996 Supp.). More importantly, restricting negligence actions to violations of statutes, rules, and other written provisions would go a long way toward meeting overdeterrence concerns by providing directors with better notice of their legal obligations and penalizing them only for violations of provisions that they are required to obey in any case. Such liability would provide an important added inducement for directors to seek legal advice and institute internal controls designed to achieve compliance with the banking laws.

These other possible avenues of monetary recovery raise the important question, aired by Weinstein, whether damages claims for bank director negligence should just be eliminated as unnecessarily duplicative. *See* Weinstein, *supra* note 12, at 1502-03 (arguing that a simple negligence theory contributes nothing to efforts to ensure honesty on the part of directors). Damages liability, however, provides an important weapon in the arsenal of federal bank regulators for several reasons. First, D&O liability policies are not uniform and many policies that provide coverage for negligence exclude coverage for civil money penalties and fines. *See* Monteleone & Conca, *supra* note 192, at 598-99 (noting that most insurers exclude fines and penalties). Second, in some circumstances negligence claims may provide a fuller measure of damages than civil money penalty actions, which are capped at fixed sums per day "for each day during which [a] violation continues." *See* 12 U.S.C. § 1818(i)(2)(A). Finally, liability insurers constitute an important added monitor of bank safety and soundness. Through their pricing policies, negotiations over the renewal and contents of policies, on-site visits and risk-management training sessions, D&O insurers can exert significant pressure on insured directors to adopt adequate internal controls. These factors partially explain why in recent years, the RTC and FDIC preferred civil damages suits over administrative proceedings in many failed bank and thrift cases.

judgment rule would not furnish a defense in either case. To avoid the *Erie* doctrine's ban on federal common law, any new cause of action would have to be expressly authorized by federal statute. Only the FDIC would have standing to sue, either in its corporate capacity or as conservator or receiver.²⁰⁵ In the interest of uniformity, federal courts would have exclusive jurisdiction over such claims.

A new claim of this sort would have several virtues. It would alleviate legitimate notice concerns of bank directors by restricting liability to defined types of conduct that could be ascertained from codebooks, orders, and agreements in advance. This is not to say that code-based rules are not open to interpretation. At the very least, however, a code-based standard would represent an improvement by identifying the topics of conduct that are subject to liability. At its best, such a standard would demarcate legal and illegal acts in a clear and comprehensible fashion.

In turn, clearer conduct standards would boost deterrence in at least two ways. First, such standards would make it harder for defendant directors to evade liability by arguing that the standard of care was a matter of debate. Second, clearer standards would be easier for regulators, insurers, lawyers, and the banking industry to communicate to directors (through handbooks, workshops, advice, and the like) than the current welter of fact-bound common-law holdings.

Code-based conduct standards would have the added advantage of substituting regulators' expert judgment for the decisions of lay judges on matters affecting bank safety and soundness. Further, such standards would give regulators the flexibility they need to respond to new conditions, either through rulemaking proceedings or through legislation. Admittedly, regulators would lose flexibility to some degree because they would bear the onus to promulgate conduct rules in advance. Additionally, to trigger liability, regula-

205. One might argue that depositors should be able to sue to the extent of their uninsured losses because such suits vindicate depositors' interests in redressing asset substitution. Such suits (at least in theory) could have the benefit of fuller compensation and could exert added discipline in case FDIC enforcement became lax. On the other hand, dual standing could pose potentially serious complications. If depositors and the FDIC could proceed concurrently, the FDIC's recovery might be threatened by an ensuing rush to judgment. The costs of defending dual lawsuits might also deplete limited liability insurance proceeds if defense costs, under the policy, were defrayed from the proceeds. If, on the other hand, depositors were barred from suit unless the FDIC timely elected not to sue, there could be long delays in the commencement of litigation (as has been the experience with EEOC right-to-sue letters in Title VII employment discrimination claims). Joinder and interpleader rules, combined with a rule allowing concurrent suits, could solve some of those problems. However, those procedural devices could not fully redress the concern that individual depositors might advance interpretations of safety and soundness laws that were at odds with official interpretations by bank regulators.

tors would have to adopt conduct rules in the form of regulations rather than guidelines. The trade-off in increased deterrence, compensation, and fairness, however, would be more than worth the cost.

Importantly, the adoption of code-based standards would also inject procedural protections that would help alleviate risk aversion concerns. Under a code-based system, banks would have a political opportunity to shape conduct standards through the notice-and-comment process and through legislation. That input would serve as a brake on overly cautious rules by regulators and legislators.

Finally, a new federal cause of action would advance the twin goal of compensation by reducing the FDIC's chances of defeat for reasons unrelated to the merits. More than in many other tort contexts, full compensation probably can never be achieved in bank director liability suits as a whole.²⁰⁶ That is partially because D&O liability insurance undercoverage is endemic to the banking industry, and because directors' personal assets normally fall far short of what is necessary to compensate losses fully. Nonetheless, such policies can provide millions of dollars in recoveries and encourage the banking industry, as a whole, to spread costs. A new cause of action that was better tailored to the federal interests at stake would properly result in victories (and hence compensation) in cases that otherwise might be inappropriately lost.

This proposed solution to asset substitution problems in banking is highly specific to the banking industry and relies on the elaborate existing system of federal banking regulation as a source of standards of conduct. Because asset substitution problems are endemic to all industries, the question thus arises whether the banking experience is unique, or instead, has lessons for corporate law at large. If the latter is the case, is there one unitary solution or will solutions vary according to industry? It is to these questions that the next section now turns.

V. BROADER IMPLICATIONS FOR CORPORATE LAW

In previous writings on this issue, most writers have dismissed the banking cases as *sui generis*, and thus devoid of insights into asset substitution conflicts generally. When the reasons for the banking cases are carefully examined, however, it is evident that the banking cases have a direct (and discomfiting) bearing on debt-equity strifes at large.

206. See, e.g., Weinstein, *supra* note 12, at 1502 (noting that "[t]he current negligence-based litigation is . . . highly unlikely to recover a significant amount of money").

Until now, the reasons for the divergent path of the duty of care in banking have been the product of surmise. Professor Joseph Bishop assumed that federal deposit insurance *eliminated* any need to curtail the business judgment rule.²⁰⁷ Other commentators have suggested the same.²⁰⁸

Once the economic foundations of the business judgment rule and the historical evidence are examined, however, it is apparent that both analyses miss the mark. The fundamental force behind the contraction of the business judgment rule in banking is the heightened risk that depositors bear due to information asymmetries and highly leveraged capital structures—not federal deposit insurance. Even before deposit insurance, high debt-to-equity ratios (combined with depositors' inability to price risk premiums accurately) gave bank shareholders and directors heightened incentives to court higher risks, knowing they could foist losses onto depositors. Moreover, some courts struggled to deal with this problem decades before deposit insurance was enacted.²⁰⁹ Thus, while deposit insurance perpetuated the problem of wealth expropriation in banking (Professor Bishop's assumptions to the contrary notwithstanding), it did not create it.

That being the case, it is wrong to treat the banking precedents as special, hinging on the presence of deposit insurance. The asset substitution problem in banking goes much deeper and is based on general principles of corporate capital structure. As Professor Coffee has recognized, these problems are the same ones all corporate creditors face, be they bondholders, depositors, or trade creditors.²¹⁰ Not surprisingly, then, as average debt-equity ratios rise, the same asset substitution problems that are characteristic of banking are cropping up in the corporate world generally.²¹¹

207. In 1968, for example, in arguing that decisions imposing liability on directors for simple negligence largely were restricted to cases involving banks, Professor Bishop commented:

[This class of cases] has been virtually extinct for a quarter of a century, partly because of the Federal Deposit Insurance Corporation and other New Deal reforms, and partly, no doubt, because the trend toward fewer and larger banks has made inexperienced and gullible bank director scarcer than they used to be.

Bishop, *supra* note 4, at 1098-99; See also *id.* at 1096 n.63 (citing cases).

208. See Dyson, *supra* note 4, at 343-44, 354 (noting falloff in bank director negligence after World War II); Palmiter, *supra* note 4, at 1360 n.22, 1377-78 and citations therein (dismissing bank director negligence cases as a vestige of the period predating federal deposit insurance); Scott, *supra* note 4, at 129 (same).

209. See *supra* notes 72-119 and accompanying text.

210. Coffee, *supra* note 18, at 45-46, 67.

211. See Bratton, *supra* note 1, at 159-61 (discussing debt-equity ratios and borrowing practices); Coffee, *supra* note 18, at 20-21, 41-42 (discussing corporate financial strategies); McDaniel, *supra* note 18, at 214 (discussing debt-equity ratios).

The question, then, is whether bank depositor debt differs in some other way from long-term corporate debt that makes it more deserving of legal relief. Obviously, in the absence of deposit insurance, bank debt to depositors is the very antithesis of long-term debt. Bank deposits are normally short-term, and the bulk of those deposits are available on demand. Thus, by virtue of demand deposits, banks are peculiarly susceptible to runs in a way that industrial companies are not.

But federal deposit insurance largely solved the problem of runs that differentiated banks from other industries. As a consequence of deposit insurance, bank debt came more closely to resemble long-term corporate debt, because the principal interests at stake changed from the short-term interests of depositors to the long-term interests of the federal deposit insurance funds.²¹² If anything, deposit insurers have a much longer horizon than corporate bondholders because deposit insurance guaranties are of indefinite duration and are not traded on the secondary market.

Thus, the economic reasons for the groundswell of director liability holdings in the banking industry are increasingly characteristic of corporate America in general. In many cases, corporate bondholders have difficulty pricing the prospective risk of asset substitution. This is similarly true for the deposit insurance funds. And, as in the banking industry, increased leveraging of American companies makes asset substitution a heightened risk in the general corporate context. Insofar as these economic problems cut across most industries, it is a serious mistake to dismiss the banking cases as aberrant.

Given the common problems that debtholders in banks and other companies face, is there something distinctive about the banking context that makes the remedy—tort relief—uniquely suited to banking? In banking, market remedies are considered inadequate for reasons that also apply to the corporate context generally. Both inside the banking industry and outside, it is often difficult to build the price of future asset substitution and managerial negligence into the cost of funds with any accuracy. That pricing inability, moreover, boosts incentives to engage in asset substitution in the first place. Concededly, pricing problems are generally worse for small depositors in the banking industry, because information gathering is costly and deposit insurance provides a disincentive to demand a risk premium. This difference, however, is only one of

212. Although deposits over \$100,000 per depositor, per financial institution, are not insured, federal receivers normally favor resolution procedures that protect insured and uninsured accounts alike. See *supra* note 34 and accompanying text (discussing the government's preferred methods of bank resolution).

degree, not kind, because it does not remove the problem of *future* asset substitution.

Similarly, diversification does not provide relief, either in banking or in the market for long-term corporate bonds. The risk of expropriation cannot be "diversified away" by spreading holdings among different companies, because that risk is systemic to firms across the board.²¹³ Thus, while it is true that creditors' investments are not firm-specific, that distinction is an empty one, because expropriation is not a risk that diversification can erase.

Last to be considered is the availability of firm exit in the form of withdrawal of deposits or resale on the secondary market of corporate bonds. In banking, exit has always presented heightened concerns because demand deposits make banks uniquely susceptible to runs. Consequently, the bank regulatory system is specifically designed, through a combination of deposit insurance guarantees and resolution techniques, to discourage mass withdrawals triggering runs. In the corporate bond context, of course, runs are not a problem because the duration of bonds is usually long-term. Nevertheless, at least in theory, disappointed bondholders can achieve exit through secondary market resale. If the company is deteriorating, however, such exit may result in a loss, and exit may be impossible if the resale market has dried up.²¹⁴ Accordingly, market exit does not provide a satisfactory answer in either setting, insofar as it is undesirable in the banking industry and an incomplete remedy for corporate bondholders generally.

In evaluating the advisability of a debtholder claim for negligence, it is also important to explore other forms of legal protection. One such protection might be to provide debtholders with a direct voice in corporate governance. In America, however, bondholder participation on corporate boards has never been taken seriously.²¹⁵ As for the federal deposit insurance context, debtholder

213. Compare McDaniel, *supra* note 18, at 239 (stating that risk cannot be eliminated through diversification) with Coffee, *supra* note 18, at 50-51 (stating that creditors, unlike managers, do not deserve retroactive legal protection due to their ability to diversify).

Some might argue that there are unique countervailing policy reasons for discouraging deposit outflows from the banking industry, in view of the banking industry's key role in facilitating monetary policy and the payment system. See, e.g., E. Gerald Corrigan, *Are Banks Special?*, in FEDERAL RESERVE BANK OF MINNEAPOLIS, 1982 ANNUAL REPORT 5, reprinted in BANKING LAW AND REGULATION, *supra* note 35, at 68, 70-73. Whether that is true, it is irrelevant here because diversification would not provide significant relief for expropriation in any case.

214. See Bratton, *supra* note 1, at 150 ("[e]xit only works with slowly deteriorating issuers . . ."); see generally Triantis & Daniels, *supra* note 17, at 1079 (discussing the concept of exit).

215. Coffee, *supra* note 18, at 69-70 (noting that bondholder voting rights were inconceivable until recently). This stems from the long-established norm that the board serves shareholders interests to the exclusion of the interests of bondholders. See Mitchell, *supra*

governance would be tantamount to direct government management of banks. While the government already affects bank management significantly through supervision and regulation, outright control would cross over the line into the politically unpalatable. Another form of protection might consist of distribution rights upon bankruptcy or insolvency. But, although bondholders and federal deposit insurers have comparable priorities in the event of insolvency, insolvent estates frequently have too few assets to provide full relief.²¹⁶

Unlike depositors, bondholders do have limited rights of action for breach of trust indentures. Bondholders generally are relegated to whatever contractual rights could be negotiated in the form of trust indentures and covenants. But the efficacy of those contractual provisions has come under serious question in recent years, fueling calls for bondholder tort remedies.²¹⁷

However weak trust indentures and covenants might be, depositors traditionally have not even had the benefit of contractual protections.²¹⁸ That state of affairs helped give rise to the increasingly elaborate scheme of deposit insurance and banking regulation that we know today—a scheme that is plainly more intrusive than indentures and covenants. Yet notwithstanding this pervasive system of banking regulation, the judiciary has grafted onto that structure an impressive body of case law conferring negligence causes of action on depositors and their insurers.²¹⁹

note 6, at 1167 n.5, 1171-73.

216. See BANKING LAW AND REGULATION, *supra* note 35, at 662-63. Under FDICIA, regulators must take "prompt corrective action" whenever a bank's capital is impaired. Those provisions specifically require regulators to place institutions that have been critically undercapitalized (generally, where tangible capital is less than two percent of assets) for 270 days into receivership. 12 U.S.C. §§ 1831o(a)(2), (b)(1)(E), (c)(3), (h)(3) (Supp. 1996). While the prompt corrective action provisions reduce the danger that bank institutions will operate after insolvency, they do not eliminate it. That danger will remain where an institution suffers sudden, catastrophic losses or where an institution's disclosure statements or balance sheets mask critical losses between examinations.

217. See Bratton, *supra* note 1, at 129-30 (discussing agency theorists' critique of contractual bondholder rights); Brudney, *supra* note 17, at 1829-30 (discussing the bondholder's limited role in the negotiation of bond contracts); Mitchell, *supra* note 6, at 1168 (proposing an expansion of bondholders' rights).

218. See *supra* note 61 and accompanying text (citing cases).

219. It is no accident that regulation and expanded rights of action went hand-in-hand in the banking industry. Powerful federal interests, both on Capitol Hill and at federal banking agencies, have pushed for an overlay of common-law relief in response to public demands to recover losses incurred by federal taxpayers. In that regard, it is interesting that even though Congress did not enact an express damages cause of action in FIRREA or FDICIA, it did virtually nothing (apart from the enactment of § 1821(k), see *supra* note 12) to block the courts' phenomenal expansion of state-law duties of care. This is probably best explained by the fact that in 1989 and 1991 respectively, when FIRREA and FDICIA were passed, judicial enforcement was at an all-time high. The judiciary's activism gave Congress the enviable ability to give expanded liability the nod through the

In short, there is little if any economic reason to prefer tort relief to deposit insurers over tort relief to bondholders. Why then the judiciary's activism in the banking area, when it has been loath to extend similar rights to bondholders? The answer partly lies in differing judicial perceptions of depositors and bondholders, as well as in the political imperatives of the federal deposit insurance system itself.

Starting with the savings bank cases of the 1880's and 1890's, courts increasingly came to characterize depositors as men and women of modest means whose life savings were at stake.²²⁰ This populist image, which was distinctly at odds with traditional judicial views of corporate debtholders, began to take root when the working class joined the ranks of bank depositors through the conduit of savings banks. As a result of the democratization of bank accountholders, increasing numbers of courts came to regard depositors not as sophisticated, depersonalized investors who knowingly placed their funds at risk, but as individual men and women who shifted their savings from the mattress to the bank only on assurances of full repayment.²²¹

simple expedient of inertia, freeing it to fight more pressing battles, particularly the battle over insurance fund recapitalization.

220. The apotheosis of this view appears in *FDIC v. Philadelphia Gear Corp.*, 476 U.S. 426 (1986). In that case, the Supreme Court approvingly quoted language to the effect that "the people of the United States . . . have a right to expect . . . the establishment and maintenance of a system of banks in the United States where citizens may place their hard earnings with the reasonable expectation of being able to get them out again upon demand." *Id.* at 433 (quoting 77 Cong. Rec. 3837 (1933) (remarks of Rep. Steagall)).

221. See *Medford Trust Co. v. McKnight*, 197 N.E. 649, 655 (Mass. 1935) (bank directors "invite the confidence of the depositing public and must afford the protection thereby implied") (quotations omitted); *Gause v. Commonwealth Trust Co.*, 89 N.E. 476, 482 (N.Y. 1909) ("A banking corporation occupies a different relation to the public, in that it invites individuals to submit to it the possession and care of their money and property. All banking institutions occupy a fiduciary position."); *Jemison v. Citizens' Sav. Bank*, 25 N.E. 264, 265 (N.Y. 1890) (condemning bank securities dealing as *ultra vires* because the savings bank at issue was "designed to encourage economy and frugality among persons of small means" and was "organized with restrictions and provisions intended to secure depositors against loss"); *Hun v. Cary*, 82 N.Y. 65, 74 (1880) (bank trustees "invited depositors to confide to them their savings, and to intrust the safe-keeping and management of them to their skill and prudence."); *Williams v. McKay*, 18 A. 824, 837 (N.J. Ch. 1889) ("The object of a savings bank is . . . 'to receive and safely invest the savings of mechanics, laborers, servants, minors and others; thus affording to such persons the advantages of security and interest for their money, and in this way ameliorating the condition of the poor and laboring classes, by engendering habits of industry and frugality.' . . . The failure of a bank of this character entails suffering, produces distrust, and discourages industry and frugality.") (citations omitted); *Marshall v. Farmers' & Mechanics' Sav. Bank*, 8 S.E. 586, 590 (Va. 1889) (quoting *Hun*).

As Professor Mark Roe has noted, a similar populist strain is responsible for "rules governing the range and size of financial institutions, and their influence in corporate governance." ROE, *supra* note 75, at 29-30. In the banking context, Peter Swire concluded that state and federal governments adopted special bank insolvency rules before 1933 for somewhat different reasons, specifically concerns over bank panics and depositors' loss of

This populist image of depositors was driven by concerns about the devastating financial impact that lost savings would have on middle- and lower-income Americans. Like most such images, this image was at best a part-truth, sweeping in wealthy individuals and corporate depositors who in no way fit the bill. Yet the image has persisted, due to the pervasiveness of bank depositors in practically every walk of American life. There is no other industry where ordinary citizens so ubiquitously serve as lenders. Thus, directors' prerogatives in banking have been constrained by the most risk-averse populace of all: those who, by virtue of life circumstances, are unable to absorb financial risk.

In contrast, in the bondholder context, as Professor Bratton has pointed out, the perceptions of corporate debtholders are depersonalized to a degree that would be considered socially callous in banking. This is not to say that the perceptions of bondholders are unitary; their images range from ones of commercial lenders to impersonal investors protected by their ability to hedge and diversify.²²² But bondholders never represented the populist icon that depositors did, largely because bondholding is predominantly seen, rightly or wrongly, as the preserve of wealthy individuals and companies who have the wherewithal to hire savvy financial advisors and absorb losses.

In banking, once the issue was framed as individuals' life savings hanging in the balance, it was easier for courts to justify personal liability of potentially crushing proportions against bank directors. The rise of D&O policies made that justification easier still. In the corporate bondholder setting, the opposite balance was struck—largely because the conflict was framed in radically different terms that understated the personal harm to bondholders. By framing the conflict as one in which faceless institutional bondholders were pitted against human directors who feared personally devastating negligence exposure, there was little doubt who would win.²²³

The 1933 enactment of federal deposit insurance confirmed the populist image of bank depositors and infused that image with formidable new political power in the form of concern for the federal fisc. As the historical account shows, only a few courts curtailed the business judgment rule in banking before the Federal

access to their funds. Swire, *supra* note 27, at 490-92.

222. See Bratton, *supra* note 1, at 98-100 (discussing different conceptions of corporate debt-equity relations).

223. Compare Bratton, *supra* note 1, at 146-48 (arguing that bondholders deserve at least comparable legal safeguards) with Coffee, *supra* note 18, at 50-51 (observing that creditors, unlike managers, have the ability to protect themselves through diversification).

Deposit Insurance Act was passed.²²⁴ But after federal deposit insurance was instituted, with memories of the Depression still fresh, a clear majority of the courts that considered the issue curtailed the business judgment rule in banking and did so with respect to an ever-widening circle of bank practices.²²⁵ It was only when federal interests were at stake, in the form of financial guaranties for depositors, that the judiciary decisively shifted its solicitude from bank directors to depositors and their insurers. This shift was aided, no doubt, by the litigation muscle of the federal government, the principal new plaintiff in bank director liability cases, and by the shift of locus in such cases to federal courts.

Thus, as Professor Bratton has argued in a different context, the legal safeguards accorded corporate debtholders vary dramatically by industry, according to the political interests at stake and the forum in which those claims are heard.²²⁶ The banking experience shows that when expropriation in the form of asset substitution becomes too extreme or extracts systemic costs that are too high, the judicial system will suspend its normal deference to directors and seek to forge a solution.

Yet while the political imperatives in the banking industry are different (and populist) in origin, in today's highly leveraged financial environment, the asset substitution problems that bondholders, depositors, and deposit insurers face are often quite similar. Once that is understood, there is no real reason why today's strict banking law precedents could not be imported into the general corporate sphere. The question, then, is whether that case law *should* be replicated in cases at large of expropriation through asset substitution.

The classic fear is that an expanded duty of care benefiting bondholders would result in undue risk aversion and difficulties in recruiting directors. As the banking experience shows, such repercussions could be expected in the short term, both because of disagreements over where to draw the line between wealth maximization and loss avoidance, and because of difficulties in drawing that line.

As discussed in Part II, bondholders who complain about wealth expropriation through asset substitution have three possible grievances. First, they could complain that the directors substituted an asset with a lower, positive risk-adjusted value for one with a higher, positive risk-adjusted value. Second, they could complain that directors substituted an asset with a positive risk-adjusted value

224. See *supra* notes 73-117 and accompanying text.

225. See *supra* notes 120-35 and accompanying text.

226. See Bratton, *supra* note 1, at 159-60, 170.

for one having a negative risk-adjusted value in the shareholders' eyes. Or third, they could complain that directors invested in assets that the shareholders normally would view as having a negative risk-adjusted value, but for distorted incentives created by high leveraging.

Of these grievances, the second grievance would require the least modification to the classic business judgment rule (were it to be honored), because bondholders and shareholders both have an interest in continued corporate solvency.²²⁷ The second grievance, of course, is the situation that the minimum rationality rule in *Hun v. Cary*²²⁸ and *Litwin v. Allen*²²⁹ was designed to prevent.²³⁰ Redressing the third grievance would entail more intrusion, because it pits bondholder interests against the interests of shareholders. Nonetheless, doing so, at least in theory, would not raise risk aversion concerns because the principal interest at stake would be rescuing the company from insolvency, the same interest that *Hun* and *Litwin* protect.

By contrast, redressing the first grievance would present clear overdeterrence concerns. If the riskier investment were successful, it would boost corporate earnings. That, of course, is why the classic business judgment rule protects such investments.

If past experience is any guide, differentiating these three grievances overtaxes the competence of most courts. For instance, in the "minimum rationality" line of cases illustrated by grievance two, the judiciary's gaffes in distinguishing potentially profitable decisions from unprofitable ones made later courts wary of engaging in that inquiry at all.²³¹ Recognizing decisions that fit grievance three (decisions whose risk-adjusted value would be negative but for moral hazard effects) is trickier yet. Courts do not have the econometric tools to make these distinctions. And even if they did, attempting to make such judgments in hindsight could well exert a chilling effect on legitimate profit-seeking ventures.

But these problems do not guarantee that courts will abstain from attempts at common-law regulation of day-to-day operating decisions altogether. While that largely has been true in corporate law generally, it has not been true in banking. Rather, in banking, once the minimum rationality cases were discredited, courts resorted to structural requirements, such as activity bans and risk management techniques, as proxies for economic analysis. As a result,

227. See Mitchell, *supra* note 6, at 1187.

228. 82 N.Y. 65 (1880).

229. 25 N.Y.S. 667 (Sup. Ct. 1940).

230. See McCoy, *supra* note 2, at 1037-40 (discussing minimum rationality).

231. See McCoy, *supra* note 2, at 1038-39 (discussing problems with *Litwin*, 25 N.Y.S.2d at 709-728).

at least in certain instances, the banking cases attempt to redress all three grievances, including the first. This trend accelerated in the past half century, as courts were able to assuage their concerns about competence by shifting responsibility for selecting safeguards and standards to expert banking regulators. Thus, far from being deterred by their weak economic analytical skills, courts in banking cases imposed prophylactic rules that applied not only to decisions that were hopelessly unprofitable, but also to those with profit potential.²³²

In the general corporate context, however, adopting prophylactic rules across-the-board would be more difficult. The banking cases primarily regulate one activity in one specific industry—bank lending—and courts have tested those activity restrictions through trial-and-error for over one hundred years. Moreover, recent courts have been substantially aided in that task by the promulgation of code-based standards of conduct. Expanding the banking precedents to the general corporate context would mean developing prophylactic rules for a huge assortment of industries, a daunting task that most courts would decline. To compound matters, courts could usually not expect the same expert regulatory input that they have come to expect in the banking industry.

These difficulties allude to an even larger problem with bondholder claims: the likely possibility that much effort would be expended for a rather negligible effect in constraining irrational business risks. The same factors that caused the duty of care cases in banking to fall into disuse before the 1980's still persist in the general corporate sphere today. Traditionally, courts have been reluctant to expand bondholder rights out of concerns for judicial competence and overdeterrence of desirable business conduct.²³³ Thus, in the long run (if not the short run), centrifugal forces would likely cause a bondholder's cause of action for tort relief to disintegrate.

However, it would be a mistake to dismiss the political crosswinds for some form of debtholder relief. Already, scattered courts have expanded the banking approach to other firms or industries with capital structures similar to those in banking. This can be seen in the insurance industry, where courts have held that directors of an insolvent insurer can be held negligent for "unadvised or unintelligent" judgments in day-to-day operations.²³⁴ In

232. See McCoy, *supra* note 2, at 1040-77 (describing judicial regulation of potentially profitable bank actions).

233. See, e.g., Mitchell, *supra* note 6, at 1198 (noting American Law Institute Principles of Corporate Governance disfavor for bondholder negligence suits out of concerns that bondholders are overly risk-averse).

234. Holland v. Stenhouse, No. 87 C 3086, 1991 U.S. Dist. LEXIS 2518, at *2, *12

the investment company context, courts have allowed disappointed investors to sue their investment company directors for investments that lack a business purpose or the benefit of informed judgment.²³⁵ In another important development, courts in New York and other states have held that directors of companies approaching insolvency owe creditors a duty to preserve company assets.²³⁶

All three of these situations involve debtholders or beneficiaries whose interests resemble debt more than equity. In the first two cases, the real parties in interest—insurance policyholders and mutual fund investors—have some of the same populist attributes as depositors. Likewise, the first two situations are ones in which substantial governmental interests are at stake in the form of governmental regulation.

The near-insolvency cases are noteworthy for the entirely different reason that they show growing judicial sensitivity to the

(N.D. Ill. March 1, 1991) (directors charged with accepting high-risk business and not maintaining adequate reserves); *accord* Selcke v. Bove, 629 N.E.2d 747, 750 (Ill. App. 1994) (insurance company officers could be liable for “failure to make informed judgments” and “failure to exercise due care in arriving at those judgments”); Stamp v. Batastini, 636 N.E.2d 616, 620-25 (Ill. App. 1993) (holding that insurance company directors are liable for “failure to exercise proper care, skill and diligence”) (citations omitted); Lower v. Lanark Mutual Fire Insurance Co., 448 N.E.2d 940 (Ill. App. 1983) (holding that directors must be “diligent and careful” in the execution of their duties to be protected by the business judgment rule). *See also* Meyers v. Moody, 693 F.2d 1196, 1209-11 (5th Cir. 1982), *cert. denied*, 464 U.S. 920 (1983) (insurance company directors are held to a higher duty of care); Matter of Integrity Insurance Co., 573 A.2d 928 (N.J. App. Div. 1990) (holding that a liquidator may assert claims on behalf of creditors); Herrmann v. Cissna, 507 P.2d 144, 147-49 (Wash. 1973) (holding that in assuming the duty of rehabilitating insurance companies, Washington’s Insurance Commissioner acted for the benefit of the public at large and could sue directors of defunct insurer for negligence); James F. Johnson, 4th, *The Search for a Deeper Pocket: The Liability of Shareholders, Officers and Directors of an Insolvent Insurer*, in LAW AND PRACTICE OF INSURANCE COMPANY INSOLVENCY REVISITED 309, 320-26 (Francine L. Semaya ed., 1989) (discussing the civil liability of directors and officers of insurance companies); Vincent J. Vitkowsky & James H. Irish, *Liability of Directors and Officers and Accountants of Insolvent Insurance Companies*, in INSURANCE COMPANY SOLVENCY—CAPITAL ADEQUACY, REGULATORY DEVELOPMENTS, AND LIABILITY ISSUES 101, 120-44, 147-49 (1991).

235. *See* In re Western World Funding, Inc., 52 Bankr. Rep. 743, 770 (D. Nev. 1985), *rev’d on other grounds sub nom.* Henderson v. Buchanan, 985 F.2d 1021 (9th Cir. 1993) (business judgment rule is no bar to recovery against investment company directors for “prolonged failure to exercise informed judgment as well as supervision”); Lutz v. Boas, 171 A.2d 381, 395-96 (Del. Ch. 1961) (holding mutual fund directors grossly negligent for dereliction in managing fund).

236. *See* Lin, *supra* note 24, at 1513-14 nn. 93-97 (citing cases); Mike Roberts, *The Conundrum of Directors’ Duties in Nearly Insolvent Corporations*, 23 MEM. ST. U. L. REV. 273 (1993) (discussing the duties of directors of nearly insolvent corporation in light of then-recent cases); Gregory V. Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239 (1992) (same). *Cf.* Ann E. Conaway Stilson, *Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors’ Duties to Creditors*, 20 DEL. J. CORP. L. 1 (1995) (assessing directorial duties to creditors in light of In re Rego Co., 623 A.2d 92 (Del. Ch. 1992)).

asset substitution problems that high debt levels entail. Those cases are doubly significant because they are not confined to the financial services industry and do not involve the charged political symbolism of cases involving small investors. Although the near-insolvency cases are just one step removed from fraudulent conveyance cases in bankruptcy, their significance lies in vesting debtholders with standing before insolvency and thus before they have accrued liquidated losses. In this respect, the near-insolvency cases are even more radical than the banking cases, which limit creditor relief to instances of actual insolvency.

Thus, debtholder suits for breach of the duty of care are not the open-and-shut matter they initially seem. Courts have yielded to pressure to recognize such claims when the right political and economic factors converge, most notably in financial services industries marked by small-time investors, high leveraging, and pricing difficulties.²³⁷ The impetus for such suits is likely to be particularly strong if taxpayer interests are at stake, whether in the form of government guaranties or otherwise. Even more significantly, the near-insolvency cases show that courts are beginning to validate asset substitution concerns in situations that are not necessarily politically charged but that are nevertheless marked by worrisome levels of debt.

The slow but steady expansion of tort protection for corporate debtholders shows that the duty of care and the business judgment rule have split along political, industrial, and economic lines to an extent hitherto not recognized. The future will undoubtedly bring increased calls for debtholder relief across industry lines. If industrial companies continue to rely heavily on debt financing, and if courts begin to draw analogies to the banking cases (as some undoubtedly will), there will be mounting pressure to extend negligence relief for debtholders to the corporate world generally.

Hence, it is crucial that the spotty history of the banking cases be understood. The difficulties experienced by eliminating the business judgment rule in bank lending suggest that, over the long run, common-law negligence solutions for asset substitution concerns are likely to fail. Consequently, rather than push for a stricter state-law negligence claim whose success is equivocal at best, it is time to investigate other types of remedies that are better able to strike a satisfactory balance between shareholder and debtholder interests.

The massive task of assaying such remedies is beyond the scope of this article. Whatever the remedies, however, the banking experience suggests that across-the-board remedies for asset substi-

237. See *supra* notes 220-22, 233-35 and accompanying text.

tution will not work. Instead, such remedies may vary, depending on the unique conditions of each industry.

For example, in industries where asset substitution is more difficult to hide in advance (either because asset sales normally trigger securities disclosures, or because such sales are illiquid and thus more likely to come to analysts' attention), there may be less need for any remedy. The same may be true in industries that historically have had low levels of debt.

In industries where asset substitution is easier to hide, however, numerous factors need to be considered in order to craft relief. Does the industry have moral hazard considerations, such as government insurance, that increase incentives toward asset substitution? Are asset decisions in the industry normally lay decisions, or are they heavily lawyered? Is a regulatory system already in place, and can it police asset substitution adequately without resulting in overdeterrence? Is the industry one in which expert prophylactic rules can be formulated rather than relying on common-law courts? If not, could monitoring systems that are currently weak (such as the system of indenture trustees) be revamped to provide better protection to their intended beneficiaries? Does the industry typically feature multiple classes of debt financing, and if so, should all classes receive relief or should one class get preference? Would state law protections be adequate or should federal law take precedence? Finally, are there systemic and/or social policy considerations that favor relief to debtholders in one industry over debtholders in another?

In sum, the lessons from the banking industry are surprisingly mixed. On the one hand, the asset substitution concerns that prompted stricter negligence law in the banking industry are present in other industries across-the-board. On the other hand, there is no one solution to those concerns, and any solutions that are forged will vary across industries. The banking experience suggests that the search for a unified grand theory of corporate law may well be quixotic, at least in certain circumstances. It is worth evaluating whether corporate law should respond to unique conditions in different industries and whether, when it fails to do so, it has outlived its usefulness.

VI. CONCLUSION: METAPHORS AND MYTH

If one were to characterize the historical path of the business judgment rule in banking over the past hundred years, it might be described as the triumph of metaphor over substance. Now that federal deposit insurance has ended the threat of bank runs, there are few distinctions of any substance between the economic concerns of depositors and their insurers on the one hand and the

economic concerns of bondholders on the other. In both cases, the business judgment rule works against debtholder interests by encouraging shareholders to substitute riskier assets for safer ones, the phenomenon known as asset substitution. Debtholders stand to lose in such circumstances because if the company's investments fail, they will bear the brunt of the losses after shareholder equity is wiped out. Asset substitution is of particular concern where investments are so burdened with risk that they are statistically likely to result in losses.

Thus, the asset substitution concerns of corporate bondholders and bank depositors are quite similar. Nonetheless, the law responded to the asset substitution concerns of depositors in a radically different way than it did for corporate bondholders. Over the years, courts have increasingly sought to alleviate asset substitution problems at banks by giving deposit insurers and depositors the right to sue bank directors for breach of the duty of care. The business judgment rule in banking has been abrogated in major respects as a result.

As the banking experience shows, the business judgment rule is splintered along industrial and political lines to an extent not appreciated before. Courts are significantly more inclined to curtail the business judgment rule in industries backed by federal guarantees and in industries where debtholders are predominated by small investors, most notably financial services industries. Thus, the banking cases are shaped by a populist metaphor that corporate bondholders do not enjoy.

The banking cases also lay to rest the myth that scaling back the business judgment rule would work unmitigated harm. These cases provide a wealth of empirical data, hitherto ignored, for assessing what to now has been left to the imagination. Paradoxically, history shows that the heightened standard of care has not had the feared effect of stifling board innovation at banks, at least in the long run. But at the same time, the banking cases have had little deterrent effect against businesses practices that any rational shareholder or debtholder would deem ruinous, because these cases cyclically succumb to backlash and disuse. For cases that achieve so little, moreover, they generate enormous litigation costs. Thus, far from exerting a chilling effect, the problem with the current bank director liability rules is that they do not accomplish what they set out to do.