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Life in the Boardroom After FIRREA: A Revisionist Approach to Corporate Governance in Insured Depository Institutions

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Life in the Boardroom After FIRREA:*

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* See Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1 (1985). This Comment contends that the Financial Institutions Reform Recovery and Enforcement Act of 1989 ("FIRREA") will have a similar impact on corporate financial institution boardrooms as the *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) decision had on all corporate boardrooms in the mid-1980s. For a discussion of the effects of the *Smith v. Van Gorkom* decision on corporate governance, see Manning, *supra*.

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No one could have imagined in 1980 that the seemingly benign savings and loan industry would evolve over ten years into a monstrous problem, and that the decade of the 1990s would begin with no clear solution at hand. Yet, that is exactly what happened.

—James R. Barth & R. Dan Brumbaugh, Jr.**

If recent political and public policy developments are any indication, financial institutions, both banks and thrifts, are ready for a reassessment that will focus on community and consumer service

—M. Danny Wall.***

I. INTRODUCTION

Not since the Great Depression has the United States faced a financial disaster as grave as the savings and loan crisis.¹ Analysts estimate that the crisis will cost the Federal Government—and ultimately American taxpayers—\$500 billion dollars.² The fallout from the savings and loan disaster has stretched from Capitol Hill,³ the

** *The Road from FIRREA to Deposit Insurance Reform*, 2 STAN. L. & POL'Y REV. 58 (1990) (arguing that the fundamental cause of the savings and loan crisis is deposit insurance).

*** *The Future of the Thrift Industry*, 2 STAN. L. & POL'Y REV. 132 (1990) (suggesting an inevitable reclassification of banks and savings and loans as "community" institutions in the wake of the savings and loan crisis).

1. See Joseph A. Grundfest, *Lobby into Limbo: The Political Ecology of the Savings and Loan Crisis*, 2 STAN. L. & POL'Y REV. 25 (1990) (claiming that the savings and loan crisis is the "largest financial bailout in this nation's history").

2. See *id.* at 32. The estimated cost of the bailout varies, but the figures seem to rise with each estimate. The United States General Accounting Office estimates the cost of the thrift crisis "could be as much as \$500 billion in the next 40 years." Testimony of Assistant Comptroller General, The United States General Accounting Office, before the Committee on Banking, Housing and Urban Affairs, United States Senate, Aug. 1, 1990. At the time Congress enacted FIRREA, the Bush administration estimated that it would need \$160 billion to clean up failed institutions. F. Jean Wells, *Savings Institutions and Their Regulatory Environment Under P.L. 101-73* (Mar. 7, 1990) (on file with author). For more recent estimates, see Paulette Thomas, *Thrift Bailout to Require \$100 Billion For Next 12 Months, Bush Officials Say*, WALL ST. J., July 31, 1990, at A2.

3. See generally MICHAEL WALDMAN, WHO ROBBED AMERICA? A CITIZEN'S GUIDE TO THE SAVINGS AND LOAN SCANDAL (1990) (blaming the savings and loan crisis on

White House,⁴ and Wall Street⁵ to homeowners⁶ and depositors⁷ across the nation. William Seidman, former Chairman of the Federal Deposit Insurance Corporation, predicts over 100,000 lawsuits stemming from the crisis, many attempting to place liability on corporate officers and directors for the failure of individual thrift institutions.⁸ The literature on the crisis is voluminous, with commentators blaming industry failure on a variety of factors: deposit insurance,⁹ fickle regulatory policies,¹⁰ junk bonds,¹¹ rising interest rates,¹² brokered

Congress); Michael Waldman, *The S & L Collapse: The Cost of a Congress for Sale*, 2 STAN. L. & POL'Y REV. 47 (1990) ("Congress is in crisis. . . . Perhaps the single most important factor fueling mounting public disillusionment with Congress is the savings and loan crackup and subsequent government bailout that was enacted in 1989.").

4. The involvement of President Bush's son Neil in a controversial thrift failure has focused attention on the White House as a scapegoat for the thrift crisis. See Bob Minzesheimer & Richard Wolf, *Blame? It's Politics as Usual*, USA TODAY, July 12, 1990, at 2A; Leo M. Katz, *Neil Bush; Today, Begins Fight to Clear His Name; S&L Scandal Finds Symbol in High Place*, USA TODAY, Sept. 25, 1990, at 1A.

5. Perhaps the greatest symbol of failure on Wall Street closely related to the savings and loan crisis is the failure of Drexel, Burnham & Lambert. Federal Deposit Ins. Corp. v. Milken, 91 Civ. No. 0433 (S.D.N.Y.) ("Milken, Complaint") (on file with author).

6. In fact, one of the primary purposes of FIRREA is to provide "a safe and stable system of affordable housing finance." Pub. L. No. 101-73, § 101(1), 103 Stat. 187 (codified at 12 U.S.C. § 1811 (West Supp. 1991)).

7. A particularly poignant example of the crisis' impact on depositors is Freedom National Bank in Harlem. Freedom, a small, minority-owned bank was closed by regulators in November, 1990. Initially, the Federal Deposit Insurance Corporation refused to reimburse any depositors for accounts exceeding \$100,000. Thirty-one charities maintained accounts in Freedom in excess of the \$100,000 cap. Eventually, after much pressure, the Federal Deposit Insurance Corporation agreed to pay fifty cents on the dollar for these accounts. See Stephanie Strom, *FDIC Offers to Aid Plan for Minority Owned Bank*, N.Y. TIMES, Jan. 13, 1991, at 20.

8. Robert L. Mashek, *Seidman Sees 100,000 Lawsuits From S&L Scandal*, BOSTON GLOBE, Aug. 15, 1990, at 1.

9. See, e.g., James R. Barth & R. Dan Brumbaugh, *The Rough Road From FIRREA to Deposit Insurance Reform*, 2 STAN. L. & POL'Y REV. 58 (1990) (arguing that only deposit insurance reform will cure the problems in the savings and loan industry); Charles E. Schumer & J. Brian Graham, 2 STAN. L. & POL'Y REV. 68 (1990) (claiming that reform in the deposit insurance system is the key to preventing continued failure in the thrift industry).

10. See, e.g., Thomas Romer & Barry R. Weingast, *Congress: The Genesis of the Thrift Crisis*, 2 STAN. L. & POL'Y REV. 37 (1990) (asserting that Congress, through a policy of forbearance, permitted and even encouraged excessive managerial gambling in thrifts); R. DAN BRUMBAUGH, JR., *THRIFTS UNDER SIEGE: RESTORING ORDER TO AMERICAN BANKING* 40-49 (1988) (describing the systematic deregulation of the savings and loan industry).

11. For an emotional discussion of the role of "junk bonds" as a cause of the savings and loan crisis, see WALDMAN, *supra* note 3, at 40-44.

12. See BRUMBAUGH, *supra* note 10, at 36-40; H.R. REP. No. 101-54(I), 101st Cong. (1989), at 91. The rising interest rate market of the late 1970s to early 1980s caused "disintermediation," where depositors withdrew their accounts from limited interest paying savings and loans and placed their money in lucrative market-sensitive instruments. *Id.*

deposits,¹³ a stagnant real estate market,¹⁴ managerial abuse,¹⁵ even moral failure.¹⁶

The savings and loan crisis magnified the corporate ownership and control problem and exposed the inability of the modern financial institution to balance the competing interests of corporate actors. Management attempted to serve a variety of masters—federal regulators, depositors, home loan debtors, and shareholders—all with competing goals. The traditional model of corporate governance—driven by shareholder profit-maximization goals—was ill-equipped to respond to the many actors in the financial institution community.¹⁷ Unfortunately, management in the end failed to serve even shareholder ownership goals as thrift after thrift faced insolvency and takeover.¹⁸

At the heart of the savings and loan crisis is the debate on the structural relationship between management and ownership in modern corporations.¹⁹ Commentators have questioned the viability of the corporate form of business organization since Professors Berle and Means' famous work, *The Modern Corporation and Private Property*.²⁰ Berle and Means argued that shareholder-owners are removed from control by a distinct management wielding the majority of corporate power.²¹ They concluded that the conflicting goals of shareholders

13. See George J. Bertson, *An Analysis of the Causes of Savings & Loan Association Failures*, 3, 7 (Monograph Series, N.Y.U. 1985). According to Bertson, computer technology facilitated brokered deposits permitting savings and loans to bid for investors located outside their market areas. The increase in investor funds encouraged managerial risktaking. *Id.*

14. See NORMAN STRUNK & FRED CASE, *WHERE DEREGULATION WENT WRONG: A LOOK AT THE CAUSES BEHIND SAVINGS AND LOAN FAILURES IN THE 1980s* 100-102 (1988). By 1985, the real estate boom succumbed to overbuilding, causing defaults on many thrift loans. *Id.*

15. H.R. REP. No. 101-54(I), 101st Cong. (1989), at 95. "Poor thrift management decisions have resulted in failure for hundreds of FSLIC insured thrifts." *Id.*

16. See Patricia A. Wenge, *Introducing Morality to Thrift Decision Making*, 2 STAN. L. & POL'Y REV. 125 (1990) (discussing managerial and regulatory moral responsibility for the savings and loan crisis).

17. See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (rev. ed. 1967). The Berle and Means thesis provides the baseline structure of corporate fiduciary law that recognizes only the rights between shareholder-owners and management. See *infra* part II.A.

18. Between 1980 and 1988, over five hundred savings and loans failed. S. REP. No. 19, 101st Cong. 1st Sess., at 2 (1989).

19. For an excellent overview of the corporate law debate, see Lucian A. Bebchuck, *Foreword: The Debate on Contractual Freedom In Corporate Law*, 89 COLUM. L. REV. 1395 (1989). Bebchuck outlines the issues in the debate between those who favor mandatory corporate laws and those who favor enabling corporate laws that permit corporate actors to contract out of corporate laws. *Id.*

20. BERLE & MEANS, *supra* note 17.

21. *Id.* at 7-9.

and management naturally resulting from the separation of ownership from control created inefficiency, which affected the competitiveness of the corporate form of business organization.²²

Berle and Means, while describing the inherent conflict between the modern corporation and traditional property notions, postulated a new order where traditional property rights would give way to community obligation in a revamped corporate system. They claimed that a community-sensitive economic order would better serve the complexity of corporate relationships and its unique allocation of control over wealth.²³ Although Berle and Means' proposal for a revamped corporate system is vague, they offered two suggestions to forestall the demise of the corporate system.²⁴ First, they argued that community obligation should supersede the passive property rights of the traditional shareholder-owner.²⁵ Second, Berle and Means proposed a neutral, technocratic corporate system that balances a variety of interests dictated by public policy rather than shareholder profit-maximization goals.²⁶

Significantly, the evolution of corporate fiduciary law tended to resolve the Berle and Means conflict between management and ownership by seeking managerial accountability to shareholders rather than to other corporate actors or the community.²⁷ Concurrent with the development of corporate fiduciary law, and since the publication of *The Modern Corporation and Private Property*,²⁸ three competing theories of the corporation emerged: the coercionist model,²⁹ the contractarian model,³⁰ and the social responsibility model.³¹ The various

22. *Id.* at 9.

23. *Id.* at 311-12.

24. *Id.*

25. *Id.*

26. *Id.*

27. "Before a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist. The obvious example is stock ownership." *Simons v. Cogan*, 549 A.2d 300, 303-04 (Del. 1988).

28. BERLE & MEANS, *supra* note 17.

29. See Fred S. McChesney, *Economics, Law and Science in the Corporate Field: A Critique of Eisenberg*, 89 COLUM. L. REV. 1530 (1989). Professor McChesney uses the term "coercionist" to describe those scholars who advocate mandatory corporate laws. Coercionists claim mandatory corporate laws are necessary to prevent management in a position of power from coercing stockholder waiver of optional corporate laws designed to protect them from managerial abuse. See *infra* notes 113-122 for examples of coercionist scholarship.

30. McChesney, *supra* note 29. "Contractarian" is the term used to describe those scholars who argue that a diverse group of corporate actors should structure their relationships through private contracting, rather than as dictated by mandatory corporate laws. See *infra* notes 125-141 for examples of contractarian scholarship.

31. "Corporate social responsibility" describes the teachings of those scholars whose focus is on increasing the social responsiveness and the public accountability of the modern

theories of the corporation differ in their conceptualization of the corporation and the form by which law regulates the relationship of corporate actors.³²

The coercionist model³³ continues the Berle and Means thesis of a corporation as an entity characterized by its inherent conflict between shareholder-owners and controlling management.³⁴ Coercionist commentators argue that mandatory rules should govern management because their interests may materially diverge from

corporation. For a general overview of corporate social responsibility, see Edwin M. Epstein, *Societal, Managerial and Legal Perspectives on Corporate Social Responsibility - Product and Process*, 30 HASTINGS L.J. 1287 (1979). See *infra* notes 142-163 for examples of corporate social responsibility scholarship.

32. The coercionist, contractarian, and corporate social responsibility models are neither homogenous nor exclusive. For a description of the difficulty to identify a coherent coercionist camp, see John C. Coffee, Jr., *The Mandatory/Enabling Balance In Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 n.1 (1989). The contractarians, too, are difficult to group coherently. *Id.* at n.2. Nor are the positions taken by the contractarians and coercionists exclusive of each other. "No legal writer has suggested that corporation law is exclusively mandatory or exclusively enabling. The issue is rather whether they see the glass of water as half full or half empty." *Id.* Corporate social responsibility theorists, however, are distinct from both coercionists and contractarians. At one extreme, free market contractarians disagree with corporate social responsibility for its potential regulation of business. See Robert Hessen, *A New Concept of Corporations: A Contractual and Private Property Model*, 30 HASTINGS L.J. 1327 (1979); Robert W. Hamilton, *Response*, 30 HASTINGS L.J. 1351 (1979). Corporate social responsibility, with its recognition of community based on public policy, presupposes a diverse group of actors affected by the business of corporations. This recognition is similar to the contractarians' recognition of the multiplicity of actors in corporations. Yet, coercionist mandatory accountability is sympathetic to corporate social responsibility goals. Coercionists, however, presume managerial accountability only to socially desirable shareholder ends. By contrast, corporate social responsibility theorists presume managerial accountability to the community. "The basic question of corporate social responsibility is . . . whether it is socially desirable for corporations organized for profit voluntarily to identify and pursue social ends where this pursuit conflicts with the presumptive shareholder desire to maximize profit." David Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1, 3 (1979). Furthermore, corporate social responsibility theorists debate their own objectives. "The people who say they are discussing corporate social responsibility are by no means all interested in the same questions, and they often seem to be talking past each other." *Id.*

33. Advocates of the coercionist model include Professor Victor Brudney, Professor Melvin Eisenberg, Professor John C. Coffee, Jr., Professor William Cary, and Professor Deborah DeMott. See Victor Brudney, *Corporate Governance, Agency Costs and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989); John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759 (1987); John C. Coffee, Jr., *The Mandatory/Enabling Balance In Corporate Law*, *supra* note 32; William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Deborah DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, DUKE L.J. 879 (1988). For a detailed examination of the coercionist scholarship, see *infra* notes 113-122 and accompanying text.

34. BERLE & MEANS, *supra* note 17, at 7-9.

shareholder interests.³⁵ Underlying the coercionists' proposal for mandatory rules is a belief that market forces are insufficient to safeguard shareholder interests from self-interested management, which without mandatory accountability rules, would not maximize shareholder wealth.³⁶ Therefore, coercionist scholars advocate legislative or judicial rules aimed at alleviating the conflict inherent in the corporate structure by compelling managerial accountability, forcing management to act in the best interests of shareholder-owners.

The contractarian model³⁷ rejects the traditional separation between ownership and control.³⁸ Instead, contractarians envision the corporation as a bundle of contractual arrangements among the various actors comprising the corporation.³⁹ A contractarian analysis of corporate ownership interests considers not only the interest of shareholders-owners, but also the interests of bondholders, employees, and other creditors who form the corporation through contractual arrangements.⁴⁰ Rather than imposing mandatory accountability rules, contractarian scholars advocate a system of enabling rules that permit the contracting parties to opt out of corporate default laws.⁴¹ The contractarians argue that because the contracting parties will agree unanimously to the contractual arrangement that maximizes firm wealth, market forces will resolve any potential conflict between controlling management and the variety of corporate investors.⁴²

35. Top management has little incentive to constrain their exercise of corporate control. Management may seek to maintain and enhance their own positions at the expense of shareholder profits. In a mandatory rule regime, the legislature would set and courts would enforce strict rules mandating management accountability to shareholders. In such a regime, management could coerce shareholder waiver of corporate accountability rules. Eisenberg, *The Structure of Corporate Law*, *supra* note 33, at 1141-42.

36. Management would rather enhance their own power and position. *Id.*

37. The leading advocates of the contractarian model are Judge Frank Easterbrook and Professor Daniel Fischel. See Frank Easterbrook & Daniel Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Frank Easterbrook & Daniel Fischel, *Voting in Corporate Law*, 26 J.L. AND ECON. 395 (1983); Frank Easterbrook & Daniel Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989). For a detailed examination of the contractarian scholarship, see *infra* notes 125-141 and accompanying text.

38. BERLE & MEANS, *supra* note 17, at 7-9.

39. Contractarians argue that corporations are comprised of diverse agreements among a variety of economic actors related to the corporate business. The sum of the contractual actors equals the corporation under the contractarian vision. Easterbrook & Fischel, *The Corporate Contract*, *supra* note 37, at 1426-27.

40. Contractarians argue that actors other than shareholders—creditors—are as much “owners” of the corporation as are shareholders. Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 37, at 396.

41. An enabling rule regime would recognize managerial accountability to a variety of contractually related corporate actors. Easterbrook & Fischel, *The Corporate Contract*, *supra* note 37, at 1418.

42. Contractarians argue that courts and legislatures are inefficient regulators of the

Corporate federalism is the major battleground in the debate between the contractarians and coercionists.⁴³ The federalism debate pits the coercionists, who advocate federal minimum corporate standards, against the contractarians, who argue that market forces dictate the most efficient corporate laws.⁴⁴ Coercionists favor federal minimum standards because they argue that state corporate laws are a "race to the bottom" among states to enact progressively permissive corporate laws.⁴⁵ As a result, individual states enact laws responsive to management, but unresponsive to the goal of wealth maximization.⁴⁶ Coercionists advocate mandatory federal minimum laws to prevent the states' enactment of exceedingly forgiving corporate laws, contrary to shareholders' interests.⁴⁷ Contractarians, however, believe that market forces obviate the need for federal minimum standards.⁴⁸ They argue that corporate managers, like owners, "have strong incentives to maximize the market value of their services."⁴⁹ Market incentives—compensation packages, stock option plans, mergers, and tender offers—motivate managers to avoid agency costs, leading to the maximization of shareholder wealth.⁵⁰ The contractarians thus favor state enabling regulations that permit the development of the most efficient contractual arrangements between corporate owners and management.⁵¹

While the coercionists and the contractarians have dominated the corporate scholarship debate, a third model, corporate social responsibility, has emerged.⁵² This model, grounded in the famous dialogue between Berle and E. Merrick Dodd⁵³ and the conclusions

relationship between corporate actors. Free-market contracting, according to the contractarians, dictates the most efficient relationships between corporate actors. *Id.*

43. See Coffee, *The Mandatory/Enabling Balance In Corporate Law: An Essay on the Judicial Role*, *supra* note 32, at 1618-19. For a detailed examination of the corporate federalism debate, see *infra* note 122 and accompanying text.

44. *Id.*

45. See Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, *supra* note 33.

46. *Id.*

47. See Eisenberg, *The Structure of Corporation Law*, *supra* note 33, at 1741-42.

48. See *supra* note 42.

49. Daniel Fischel, "The Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 NW.U. L. REV. 913, 919 (1982).

50. *Id.*

51. See, e.g., Easterbrook & Fischel, *The Corporate Contract*, *supra* note 37.

52. The corporate social responsibility model is explained *infra* text accompanying notes 142-163.

53. The dialogue between Berle and Dodd took place in the Harvard Law Review. See Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Adolf A. Berle, *For Whom Corporate Managers are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932). For an overview of the dialogue, see Joseph L. Weiner, *The Berle-Dodd Dialogue on*

reached by Berle and Means in *The Modern Corporation and Private Property*,⁵⁴ envisions corporations governed by social responsibility. Berle and Means postulated a revamped corporate system where traditional property rights would give way to community obligation.⁵⁵ They suggested that a system of "community obligation" and a "neutral technocratic" management would divert corporate power from service to the traditional shareholder property right to the "larger interests of society on the basis of public policy."⁵⁶ In the years since the publication of the Berle and Means thesis, the social responsibility school has proposed an increase in the "social responsiveness and public accountability" of the modern corporation.⁵⁷ Yet, despite the contribution of social responsibility scholars, few courts or legislatures have recognized this model as a viable theory of corporate governance. Instead, the primary objective of corporate law has been to assure the accountability of management to shareholders.⁵⁸

Courts and legislatures have developed corporate fiduciary law from the Berle and Means "separation of ownership from control" thesis. The development of the duty of care,⁵⁹ the business judgment rule,⁶⁰ and the duty of loyalty⁶¹ reflects judicial and legislative concern for the potential conflict between the control aspirations of management and the ownership goals of shareholders. The duty of care seeks to ensure management's responsible and cautious utilization of shareholder wealth in conducting the affairs of the corporation. The duty of loyalty protects shareholders from potentially self-interested dealings by management. The business judgment rule operates as a check on the duty of care, preventing undesirable restraints on managerial exercise of good faith business decisions. Although the corporate fiduciary regime sought to alleviate the conflict between management and shareholders, the opportunity for managerial abuse remained. Responding to perceived excessive managerial autonomy, the Delaware Supreme Court worked a major shift in the corporate

the Concept of the Corporation, 64 COLUM. L. REV. 1458 (1969). For a detailed examination of this debate, see *infra* notes 145-160 and accompanying text.

54. See BERLE & MEANS, *supra* note 17, at 311-12.

55. *Id.*

56. *Id.*

57. See generally Epstein, *supra* note 31. Professor Epstein provides "an analytical overview and framework on the concept of social responsibility." *Id.* at 1287.

58. See *Simons v. Cogan*, 549 A.2d 300, 303-04 (Del. 1988).

59. For an exposition of the duty of care, see *infra* part III.B.1.

60. For an exposition of the business judgment rule, see *infra* part III.B.2.

61. For an exposition of the duty of loyalty, see *infra* part III.B.3.

fiduciary regime with its 1985 decision in *Smith v. Van Gorkom*⁶² ("*Trans Union*").

In *Trans Union*, the Delaware court eviscerated the business judgment rule, and for the first time permitted judicial review of management's good faith business decisions.⁶³ The *Trans Union* court ruled that management, in the exercise of a corporate decision, must avail itself of all readily available information.⁶⁴ *Trans Union* effectively required Delaware courts to review the steps management had taken to acquire relevant information in making its business decisions, thus permitting the courts to second-guess managerial decisions.⁶⁵ In response to *Trans Union*, rising damage awards in corporate fiduciary litigation, and difficulties in the corporate insurance market, liability insurers for directors and officers raised premiums to exorbitant levels and placed a moratorium on the issuance of new policies.⁶⁶ As a result of the *Trans Union* liability crisis, the Delaware legislature enacted Title 8, section 102(b)(7) of the Delaware Code,⁶⁷ permitting Delaware corporations to limit directors' liability for breaches of care in their corporate charters.⁶⁸ In a new "race to the bottom," a majority of states followed Delaware's lead and enacted similar liability limitation statutes.⁶⁹

While state statutory regimes returned corporate management to the uninhibited decisionmaking days before *Trans Union* by eliminating excessive managerial liability, the fickle economic market of the late 1970s and 1980s wreaked havoc on corporate financial institutions.⁷⁰ Savings and loans, traditionally a conservative regulated industry, suffered dramatically, as the portrait of the thrift heyday changed from Frank Capra's *It's A Wonderful Life*⁷¹ to the free-wheeling failure of Gordon Gekko in *Wall Street*.⁷² As federal takeovers and the number of insolvent thrifts increased, the cost of the

62. 488 A.2d 858 (Del. 1985). For a detailed examination of *Trans Union* and its effects, see *infra* part III.C.1.

63. *Trans Union*, 488 A.2d at 872.

64. *Id.*

65. *Id.*

66. See Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 36-42 (1989) (discussing the Delaware legislative reaction to *Trans Union*).

67. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986).

68. *Id.* For a detailed examination of state statutory limitations on managerial liability, see *infra* part III.C.2.

69. See *infra* notes 313-321.

70. See BRUMBAUGH, *supra* note 10, at 36-56; STRUNK & CASE, *supra* note 14, at 98-106. For a detailed discussion of the development of the savings and loan crisis, see *infra* part IV.

71. IT'S A WONDERFUL LIFE, (Republic Studios 1947).

72. WALL STREET, (CBS/Fox 1987).

federal bailout of the savings and loan industry soared.⁷³ Taxpayer resentment of the bailout and the concurrent political scandals⁷⁴ sent politicians searching for a solution.

In 1989, Congress enacted the Financial Institutions Reform Recovery and Enforcement Act ("FIRREA").⁷⁵ FIRREA implements a new regulatory framework designed to resurrect the thrift industry by creating a safe and stable fiscal environment for depository institutions.⁷⁶ However, FIRREA abolishes the post-*Trans Union* state statutory regimes that protected corporate management⁷⁷ from potentially enormous liability. Now, with potentially great liability under FIRREA, the viability of effective corporate leadership is once again in question in the limited, though important, context of federally insured depository institutions.⁷⁸ Perhaps most significantly, FIRREA marks a dramatic departure from traditional corporate governance law founded on the Berle and Means thesis.⁷⁹ FIRREA's fiduciary and regulatory framework dismisses the conflict between shareholders and controlling management as the dominant corporate relationship.⁸⁰ In its place, FIRREA creates a regulated management whose primary fiduciary duties are no longer owed to traditional owners.⁸¹ In fact, FIRREA's fiduciary obligations motivate managerial interests that conflict directly with the goal of shareholder wealth maximization.⁸² FIRREA's corporate governance regime takes a revisionist approach to the coercionist and contractarian models and implicitly recognizes the community based goals of the corporate

73. Recent estimates place the cost of the Federal bailout at nearly \$500 billion. See G. Christian Hill, *A Never Ending Story: An Introduction to the S&L Symposium*, 2 STAN. L. & POL'Y REV. 23 (1990) (calculating the cost of the crisis based on Reports by the Office of Management and Budget, the General Accounting Office and the U.S. League of Savings Institutions).

74. Bob Minzesheimer & Jim McTague, *S&L Mess: How Deep is the Anger: Politicians 'Scrambling for Cover'*, USA TODAY, July 13, 1990, at 1A; Peter Riddell, *Bush Starts to Suffer From the Political Fall-Out; Savings and Loan Crisis*, FINANCIAL TIMES, Aug. 4, 1990, at I7; Jacqueline Frank, *Savings and Loan Crisis Erupts into Political Warfare*, REUTERS, July 15, 1990; Nathaniel C. Nash, *Politics and the Crisis in the Savings and Loan Industry*, N.Y. TIMES, June 21, 1990, at D19, col. 3.

75. Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified in scattered sections of 12 & 15 U.S.C.).

76. For the "purposes" of FIRREA, see *id.* § 101, 103 Stat. 187 (1989) (codified at 12 U.S.C. § 1811 Note (West Supp. 1992)). For a general overview of FIRREA, see *infra* part V.

77. See FIRREA § 212(k), 103 Stat. 243 (1989) (codified at 12 U.S.C. § 1821(k) (West Supp. 1992)). For a detailed examination of FIRREA's fiduciary regime, see *infra* part V.B.

78. See *infra* part V.

79. See *infra* part VI.

80. See *infra* part VI.

81. See *infra* part VI.

82. See *infra* part VI.

social responsibility model.⁸³

This Comment contends that the new fiduciary regime established under FIRREA, albeit a laudable attempt to harness managerial impulses through community obligation, is a flawed solution to corporate governance problems in financial institutions. It constrains corporate decisionmaking by holding management to an unreasonable standard of care that inevitably deters qualified directors from serving on corporate boards. Finally, by departing from traditional shareholder wealth maximization goals and imposing community obligation on the management of savings and loan institutions, FIRREA's fiduciary principles place thrifts at a competitive disadvantage in relation to other financial service corporations, despite a recent trend in corporate law obligating managerial sensitivity to community goals.

Part II of this Comment introduces the Berle and Means' thesis and the theories of corporate governance that have emerged from it: the coercionist model, the contractarian model, and the corporate social responsibility model. The Berle and Means conflict between ownership and control in the modern corporation forms the underlying premise for the debate amongst the proponents of these theories. Part II also considers another conflict in corporate structure: the conflict between shareholder-owners and creditor-"owners." Although ownership conflict was a dominant theme in the contractarian and corporate social responsibility models, the fiduciary regime prior to FIRREA did not recognize ownership rights other than those of shareholders.

Part III discusses the traditional corporate governance regime which has focused almost exclusively on the conflict between management and shareholders. Part III outlines the duty of care and the duty of loyalty, fiduciary obligations that emerged to hold directors and officers accountable to shareholders. The business judgment rule, also discussed in Part III, traditionally has ensured discretion in managerial decisionmaking. To illustrate the significance of the business judgment rule in corporate governance, Part III analyzes the Delaware Supreme Court's evisceration of the business judgment rule in *Trans Union* and the immediate state legislative responses limiting director liability.

Part IV reviews the evolution and decline of the thrift industry that led to the enactment of FIRREA. It also discusses the new regulatory structure under FIRREA, culminating with an exposition of FIRREA's fiduciary provisions.

83. See *infra* part VI.

Part V critiques FIRREA, within the traditional separation of banking and commerce, and the theories of corporate governance that have evolved since the Berle and Means' thesis. FIRREA's fiduciary provisions acknowledge corporate actors other than managers and shareholders and impose fiduciary duties owed to the community based on public policy. Part V concludes that Congress' attempts in FIRREA to hold the management of savings and loans to a community fiduciary standard hinders the resurrection of a viable thrift industry. Savings and loans will not be able to attract qualified directors, inevitably limiting efficient competition with other unconstrained institutions.

Finally, Part VI considers alternative fiduciary standards that might better promote the revival of the savings and loan industry. This Comment concludes by identifying and discussing a trend in corporate law that perhaps realizes the Berle and Means prophecy of an economic order based on public policy and community rather than individual shareholder profit goals.

II. COMPETING THEORIES OF CORPORATE GOVERNANCE

A. *The Berle and Means Thesis, the Modern Corporation, and the Separation of Ownership and Control*

Nearly sixty years ago, Adolf Berle, Jr.⁸⁴ and Gardiner C. Means⁸⁵ described the impact of the modern corporation on traditional notions of private property in *The Modern Corporation and Private Property*.⁸⁶ Building upon the classical economic assumption that individual property owners, with the incentive of personal profit and a fear of loss, will allocate their property to its most efficient use,⁸⁷ Berle

84. Adolf Berle, Jr., at the time a professor at Columbia University Law School, was appointed research director for a project to investigate the modern corporation's impact on society. The Social Science Research Council of America funded the project in coordination with the Columbia University Law School. BERLE & MEANS, *supra* note 17, at XXXIX.

85. Gardiner Means' contribution underscores the interdisciplinary nature of Berle and Means' work. Means, an economist, provided a statistical and economic analysis of the impact of large modern corporations on society. Berle explains his decision to hire Means: "the theory being that a lawyer and an economist working hand in hand might secure a more fertile result than either working alone." *Id.*

86. *Id.*

87. Berle and Means describe the traditional utilization of property as driven by self-interest:

[T]he organization under the system of private enterprise has rested upon the self-interest of the property owner It has been assumed that, if the individual is protected in the right both to use his own property as he sees fit and to receive the full fruits of its use, his desire for personal gain, for profits, can be relied upon as an effective incentive to his efficient use of any industrial property he may possess.

and Means argued that large-scale public corporations,⁸⁸ by separating ownership and control,⁸⁹ will not use private property efficiently.⁹⁰ Management in control of corporate wealth does not have a significant ownership interest; it merely allocates corporate property as a conglomerate of individual shareholder wealth.⁹¹ Because managers do not experience ownership risk/reward effects, they have at best a marginal incentive to maximize shareholder wealth.⁹² "The separation of ownership from control produces a condition, where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear."⁹³ Berle and Means' recognition of the structural inefficiency of the modern corporation formed the basis for the debate over a corporate governance resolution to the ownership and

Id. at 9.

88. Essential to the Berle and Means thesis is their characterization of the new corporate economy. According to Berle and Means, the new corporate form of business organization differed drastically from the traditional business venture. Prior to the advent of the modern corporation, private enterprise was historically limited by the purse of individual owner/managers. Berle and Means defined the modern corporation as "great aggregations in which . . . workers and property . . . are combined through the corporate mechanism into a single producing organization under unified control and management." *Id.* at 4.

89. Berle and Means argue that the new corporate system results in a "fundamental change . . . in the economic relationships which rest upon" changes in the traditional notion of property. *Id.* at 8. "Physical control over the instruments of production has been surrendered in ever growing degree to centralized groups who manage property in bulk, supposedly . . . for the benefit of the security holders." *Id.* As a result, Berle and Means claim that the corporate economy visits "the dissolution of the old atom of ownership into its component parts, control and beneficial ownership." *Id.*

90. Berle and Means suggest that the modern corporate economy subverts the individual property ownership profit incentive.

Those who control the destinies of the typical modern corporation own so insignificant a fraction of the company's stock that the returns from running the corporation profitably accrue to them in only a very minor degree. The stockholders, on the other hand, to whom the profits of the corporation go, cannot be motivated by those profits to a more efficient use of the property, since they have surrendered all disposition of it to those in control of the enterprise. The explosion of the atom of property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use. It consequently challenges the fundamental economic principle of individual initiative in industrial enterprise.

Id. at 9.

91. *Id.* at 4.

92. *Id.* at 7. Berle and Means state that the traditional logic of property does not apply to the modern corporation with its separation of ownership and control. In the corporate form of business organization the "two functions of risk and control are, in the main, performed by two different groups of people." *Id.* at 300-01. As a result "one group of individuals . . . performs the function of risktakers and suppliers of capital, while a separate group exercises control and ultimate management." *Id.*

93. *Id.* at 7.

control problems in the modern corporate economy.⁹⁴

The ownership and control split led Berle and Means to question the extent to which corporate law should protect the interests of owners who have surrendered control of their wealth to management.⁹⁵

Must we not, therefore, recognize that we are no longer dealing with property in the old sense? Does the traditional logic of property still apply? Because an owner who also exercises control over his wealth is protected in the full receipt of the advantages derived from it, must it necessarily follow that an owner who has surrendered control of his wealth should likewise be protected to the full?"⁹⁶

While Berle and Means suggest a corporate reality where ownership wealth is unprotected from potent corporate control powers, they do not advocate full protection of shareholder property rights.⁹⁷ Instead, Berle and Means foretell a future where public policy and community obligation would constrain management.⁹⁸

94. See Thomas G. Moore, *Introduction*, 26 J.L. & ECON. 235 (1983) (discussing the influence of the Modern Corporation and Private Property on the literature of capitalist economics).

95. Berle and Means ask whether the traditional purpose and direction of ownership profit requires a societal or legal pressure compelling corporate business goals for the benefit of shareholders. Because of the temptation for management to act in self-interest to the detriment of shareholders, Berle and Means question whether "social and legal pressure should be applied" in an effort to insure corporate operation primarily in the interests of the 'owners' or whether such pressure shall be applied in the interests of some other or wider group. BERLE & MEANS, *supra* note 17, at 293.

96. *Id.* at 297-98 (emphasis in original).

97. *Id.* at 310-11. In fact, Berle and Means argue that shareholder-owners are inappropriate monitors of management. Nonetheless, Berle and Means acknowledge the possibility of a trusteeship role for corporate management, and in the absence of other protection, they favor its use to prevent corporate plundering. To Berle and Means, a corporate trustee relationship is the "lesser evil" of a choice between protecting shareholders and granting management untrammelled authority.

Choice between strengthening the rights of passive property owners, or leaving a set of uncurbed powers in the hands of control therefore resolves itself into a purely realistic evaluation of different results. We might elect the relative certainty and safety of a trust relationship in favor of a particular group within the corporation, accompanied by a possible diminution of enterprise. Or, we may grant the controlling group free rein, with the corresponding danger of a corporate oligarchy coupled with the probability of an era of corporate plundering.

Id. This passage presumably provides the basis for which corporate governance has sought to protect ownership from management vested with fiduciary obligation. For a discussion of the corporate trusteeship theory, see *infra* part II.A.2. Still, Berle and Means claim that a coherent system of community obligation would best resolve the separation of ownership and control. *Id.* at 312. See *infra* note 98.

98. The separation of ownership and control facilitates a system of community obligation, because passive shareholder-owners relinquish their property and managers operate the corporation not exclusively for the shareholder owners. *Id.* at 311-12. Both ownership and

Neither the claims of ownership nor those of control can stand against the paramount interests of the community Rigid enforcement of property rights as a temporary protection against plundering by control would not stand in the way of the modification of these rights in the interest of other groups. *When a convincing system of community obligations is worked out and is generally accepted, in that moment the passive property right of today must yield before the larger interests of society*⁹⁹

Hence, in order to achieve an effective corporate economy responsive to community obligation, Berle and Means proposed that management act as corporate "foremen" directing the allocation of corporate wealth in the interests of public policy.¹⁰⁰

It is conceivable, — indeed it seems almost essential if the Corporate System is to survive, — that the "control" of the great corporations should develop into a purely *neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity.*¹⁰¹

Despite Berle and Means' prediction that management would inevitably evolve into a "neutral technocracy" serving the interests of the

control "have cleared the way for the claims of a group far wider" in application. As a result "[t]hey have placed the community in a position to demand that the modern corporation serve not alone the owners or the control but all society." *Id.*

99. *Id.* (emphasis added).

100. As "foremen," corporate managers would conduct the business of the corporation not solely for the benefit of shareholder-owners but for a diverse set of interests. In such a corporate system, community interests would largely subsume the interests of shareholder-owners.

Should the corporate leaders, for example, set forth a program comprising fair wages, security to employees, reasonable service to their public, and stabilization of business, all of which would divert a portion of the profits from the owners of passive property, and should the community generally accept such a scheme as a logical and human solution of industrial difficulties, the interests of passive property owners would have to give way. Courts would almost of necessity be forced to recognize the result, justifying it by whatever of the many legal theories they might choose.

Id. For a discussion of FIRREA's imposition of a "foreman" model of management based on community obligation, see *infra* part IV.C.2.

101. *Id.* at 312-13 (emphasis added). In conclusion, Berle and Means analogized the rise of the modern corporation and the resulting concentration of economic power to small quasi-states. Berle and Means claim:

The rise of the modern corporation has brought a concentration of economic power which can compete on equal terms with the modern state—economic power versus political power, each strong in its own field. . . . The law of corporations, accordingly, might well be considered as a potential constitutional law for the new economic state, while business practice is increasingly assuming the aspect of economic statesmanship.

Id. at 313.

community rather than those of individual shareholders, corporate fiduciary law developed to protect shareholders from potential abuse or negligence by controlling management.¹⁰²

Since the publication of *The Modern Corporation and Private Property*,¹⁰³ scholars have grappled with the extent to which fiduciary and other corporate laws should protect shareholder wealth from the potential abuse of corporate managers.¹⁰⁴ Three competing schools of thought evolved: the coercionist school, the contractarian school, and the corporate social responsibility school.¹⁰⁵ The coercionist school¹⁰⁶ and the contractarian school¹⁰⁷ each propose a different role for corporate law in the governance of modern corporations.¹⁰⁸ They also disagree on the answer to the Berle and Means rhetorical question: whether corporate law should protect the rights of shareholders who voluntarily surrender ownership decisionmaking to the corporation's controlling managers.¹⁰⁹ The third vision of corporate governance, corporate social responsibility,¹¹⁰ builds upon Berle and Means' prophecy of corporate community obligation served by a neutral technocratic management.¹¹¹ The corporate social responsibility school conceives of a system in which societal and community obligation constrains both managerial control and the economic power of the

102. Seemingly, corporate law chose the lesser of two evils. See *supra* note 97. Courts have attempted to reconcile the relationship between corporate management and ownership since at least the mid-eighteenth century. See *Charitable Corp. v. Sutton*, 26 Eng. Rep. 642 (1742) where the court described corporate management as one "of a mixed nature Committee men are most properly agents . . . and . . . are within the case of common trustees." *Id.* at 644-45. An early American case imposing fiduciary duties on management is *Percy v. Millaudon*, 8 Mart. (N.S.) 68 (L.A. 1829). For an excellent historical examination of *Charitable Corp.*, *Percy*, and the fiduciary law governing corporate management, see Marcia M. McMurray, *An Historical Perspective on the Duty of Care, the Duty of Loyalty and the Business Judgment Rule*, 40 VAND. L. REV. 605 (1987). See also *infra* part III.B.

103. BERLE & MEANS, *supra* note 17.

104. See Bradley & Schipani, *supra* note 66, at 4. Bradley and Schipani query the survival of the modern corporation. "There has always been a certain tension among students of the modern corporation as to whether legal rules or economic forces are more responsible for the corporation's continued existence."

105. These "schools" are simplified categories of general scholarship and are by no means perfectly homogeneous. See *supra* note 32. Nonetheless certain general observations can be made to facilitate the study of corporate organization.

106. See *infra* part II.A.1.

107. See *infra* part II.A.2.

108. For an overview of the coercionist-contractarian debate, see Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989); see also Coffee, *The Mandatory Enabling Balance in Corporate Law*, *supra* note 32, for an overview of the scholarship debate. Professor Coffee also attempts to reconcile the two schools based on the judicial role in the debate. *Id.* at 1621.

109. See *supra* note 17.

110. See *infra* part II.A.3.

111. See *supra* part II.A.

modern corporation.¹¹²

1. THE COERCIONIST MODEL

Coercionist scholars¹¹³ view the corporate structure traditionally, as an entity with two sets of actors—shareholders and managers—engaged in an inherent conflict.¹¹⁴ The coercionists recognize, as did Berle and Means, the tension created by the conflicting interests of ownership and control.¹¹⁵ In response to the Berle and Means' rhe-

112. See *infra* part II.A.3.

113. Advocates of the coercionist model include Professor Victor Brudney, Professor Melvin Eisenberg, Professor John Coffee, Jr., Professor William Cary, and Professor Deborah DeMott and Robert C. Clark. See ROBERT C. CLARK, AGENCY COSTS VERSUS FIDUCIARY DUTIES IN PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS (J. Pratt & R. Zeckhauser eds. 1985); Robert C. Clark, *Contracts, Elites and Traditions in the Making of Corporate Law*, 89 COLUM. L.REV. 1703 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989); Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989); Brudney, *supra* note 33; Eisenberg, *The Structure of Corporation Law*, *supra* note 33; John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward de Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 789 (1987); Coffee, *The Mandatory/Enabling Balance in Corporate Law*, *supra* note 32; Cary, *supra* note 33; DeMott, *supra* note 33.

114. See Brudney, *supra* note 33; Eisenberg, *The Structure of Corporation Law*, *supra* note 33; Clark, *Contract, Elites and Traditions*, *supra* note 113. Professors Brudney, Eisenberg and Clark repudiate the contractual analysis and focus on the structural conflict between shareholders and management.

The prevailing structure of corporate governance gives corporate management substantial discretion to reward itself and to satisfy—that is, to limit its input at the cost of realizable corporate wealth. . . . [M]anagement's discretion remains significant in terms of its power to divert assets to itself, and more than trivial in terms of its power to refrain from maximizing shareholder wealth.

Brudney, *supra* note 33, at 1443-44. Professor Eisenberg asserts that corporate law protects shareholders from management. "In short, corporation law taken as a whole . . . contains a significant number of core mandatory rules to govern divergences of interest between top managers and shareholders." Eisenberg, *The Structure of Corporation Law*, *supra* note 33, at 1485. Professor Clark analyzes corporate governance in the context of traditional rulemaking. Clark, *Contract, Elites and Traditions*, *supra* note 113, at 1704. He argues that the contractarians' failure to acknowledge the non-contractual basis for legal rules is "misguided." *Id.* at 1746. "In the practice of law and in the actual generation of proposals for legal change, the role of elite groups is decisive . . . Moreover, both judicial and legislative lawmaking activities are intensely traditional in character." *Id.* Professor Clark's recognition of the importance of the "elites" and "traditional" models of rule-making implicitly recognizes the ownership/control conflict as both models rely on the shareholder-management dichotomy as the basis for rule-making. For Professor Clark's identification of the various methods of rulemaking, see *id.* at 1712.

115. Professor Eisenberg identifies several conflicts between shareholders and management.

As in any principal-agent relationship . . . the interest of shareholders and managers also diverge. All agents have a potential interest in working at a slack pace and in avoiding the effort and discomfort involved in adapting to changed circumstances This is the problem known as *shirking*. All agents have a

torical question, coercionist commentators such as Professor Victor Brudney and Melvin Eisenberg answer "yes," and propose core fiduciary rules unalterable by management.¹¹⁶ They therefore advocate corporate laws that safeguard shareholder-owners from potential abuse by managers vested with power to control corporate strategy.¹¹⁷

To protect shareholders, Brudney, Eisenberg, and others favor a body of corporate law composed of mandatory rules.¹¹⁸ They argue that corporate management, if left to make its own rules, would maxi-

potential interest in diverting the principal's assets to their own use through unfair self-dealing. This is the problem of *traditional conflicts of interest*.

Eisenberg, *supra* note 33, at 1471.

Professor Brudney also warns of the divergence of interest between ownership and management. "Not even those who believe the separation of ownership and control in the modern corporation to be the unfolding of a grand scheme of efficiency doubt the . . . significant conflicts between management's interest and the investors interest in maximizing share values." Brudney, *supra* note 33, at 1426-27 (footnotes omitted).

Even Professor Gordon, while explicitly rejecting the rationale of investor protection for mandatory corporate law, claims that mandatory corporate law will protect shareholders from the coercive forces of management. He argues that "investor protection no longer justifies mandatory corporate law, because in well-functioning capital markets sophisticated investors get what they pay for and unsophisticated investors can free ride. Nevertheless, mandatory terms can guarantee a *certain level* of shareholder protection." Gordon, *supra* note 113, at 1570-71. Furthermore, Gordon suggests the need for mandatory laws "to protect investors" from abusive managerial amendment of the corporate charter. "[I]nsiders can exploit their advantages to obtain approval even for wealth-reducing amendments. From this flows an argument for mandatory corporate law . . ." *Id.* at 1374-75.

116. Eisenberg answers with an authoritative "yes" to the Berle and Means rhetorical question:

[T]op managers of publicly held corporations have little incentive to adopt rules that put constraints on their own positions. The core fiduciary and structural rules that govern material divergences of interest of top managers in publicly held corporations, therefore, should be neither determined nor subject to material variation by the action of managers or managerial organs. The reason for this principle . . . is that in this as in other areas of law, agents whose interests may materially diverge from the interests of their principals should not have the power to unilaterally determine or materially vary the rules that govern those divergences of interest.

Eisenberg, *supra* note 33, at 1473-74. Professor Brudney also answers "yes" and observes and questions the efficacy of the shift in corporate law away from mandatory rules. "Certainly, the effect has been to offer investors considerably less protection against diversion of assets by management than would the classic law of agency." Brudney, *supra* note 33, at 1435.

117. See *supra* note 116.

118. Professor Eisenberg defines mandatory rules as those governing "defined issues in a manner that cannot be varied by corporate actors." Eisenberg, *supra* note 33, at 1461. Mandatory rules, according to Eisenberg, differ from enabling rules which "give legal effect to rules that corporate actors adopt in a specified manner" . . . and from default rules which "govern defined issues unless corporate actors adopt other rules in a specified manner." *Id.* Historically, mandatory laws have been a fundamental component of corporate laws. See generally LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW*, 511-25 (2d ed. 1985). Prior to the enactment of FIRREA, however, state corporate law had increasingly evolved to reflect the "enabling" approach suggested by the contractarians. For a discussion of the contractarian approach, see *infra* part II.A.2.

mize managerial power rather than shareholder wealth.¹¹⁹ Without mandatory accountability, management—vested with economic power and superior information—effectively could coerce shareholder waiver of constraints on managerial power. Managers would thereby enhance their own position rather than shareholder wealth.¹²⁰ A mandatory rule regime, according to coercionists, would protect shareholders from management's unconstrained bureaucratic rulemaking, and would impose shareholder wealth maximization goals on management.¹²¹

Some coercionist scholars advocate federal minimum corporate governance standards.¹²² Federal standards, they claim, are needed to

119. See *supra* notes 114-116. Professor Gordon defines four types of mandatory corporate rules: (1) Procedural rules, the housekeeping provisions of corporate law, which include provisions such as notice of shareholder meetings; (2) power allocating rules, which govern the balance of power between directors and shareholders. Examples include rules that define the managerial role of the board, shareholder voting rights, and shareholder removal rights; (3) economic transformative rules, which provide for a mandatory statutory approach to mergers, sale of assets, and corporate dissolution; and (4) fiduciary rules, which govern the relationship among controlling shareholders and officers and directors. Gordon, *supra* note 113, at 1591-93. This Comment focuses on Professor Gordon's "category 4," fiduciary rules. However, for fear of oversimplification through categorization, it is perhaps best to view the fiduciary rules discussed in this Comment within the context of Professor Gordon's categories 1-3. After all, procedural rules may mold the relationship and knowledge of the respective corporate actors. Professor Gordon's power allocating category is particularly important because the role of the board of directors and shareholder voting rights are the main playground for the fiduciary relationships of corporate organization. Furthermore, Professor Gordon's economic transformative category is usually the center of abuse of fiduciary relationships where the corporate actors, particularly management, seek to derive economic gain at the expense of the corporation. Therefore, for the purpose of this Comment, the core corporate rules governing the relationship of corporate actors are fiduciary duties, understood within the context of other rules governing the respective roles and relationships of shareholders and officers and directors.

120. Eisenberg identifies three types of conflicts of interest. The first two, "shirking" and "traditional conflicts of interest" are discussed *supra* note 115. The third and most significant conflict of interest, which Eisenberg defines as "positional conflicts," occurs when managers subordinate shareholder power to aggrandize their own managerial power.

Because of . . . [their] . . . relative autonomy, and the range of discretion that it leads to, top corporate managers have the power to give expression to still a third potential divergence of interest; an interest in maintaining and enhancing their positions even at the shareholders' expense. I will refer to instances of this type of divergence of interest as *positional conflicts*.

Eisenberg, *supra* note 33, at 1471-72 (footnotes omitted). Eisenberg identifies several manifestations of positional conflicts. For instance, managers may restrict the monitoring of their performance and limit the facility of their removal from office. In addition, managers may seek to increase the corporate size to the detriment of shareholder wealth as a means of increasing and perpetuating their managerial power. Managers may also attempt to maximize certain corporate resources over which they exercise control, notwithstanding shareholder wealth maximization goals. Eisenberg, *supra* note 33, at 1472.

121. Historically, state legislatures provided the impetus for enactment of corporate laws protecting shareholders from unrestrained managerial power. See *infra* part III.C.2.

122. The basis for the federalism debate in corporate law is the seminal article by Professor

curb the "race to the bottom" among states to attract large corporations (and their tax revenue) by enacting permissive corporate laws favoring management over shareholders.¹²³ Federal minimum standards would provide a baseline for state enactment of corporate laws and would safeguard shareholders from the abusive power of managers whose accountability diminishes as states seek to outdo each other in attracting tax revenue.¹²⁴

2. THE CONTRACTARIAN MODEL

Contractarians reject the Berle and Means' thesis of the separation of interest between managers and shareholder-owners in the modern corporation.¹²⁵ Instead, they envision a corporation com-

Cary setting forth his "race to the bottom" thesis. He claimed that states compete for firm incorporation—and thus corporate tax returns—by enacting corporate laws favorable to management. The question raised by Cary is whether this state statutory responsiveness to management maximizes firm and ownership wealth. Professor Cary and others suggest the need for national corporation laws to constrain state legislatures from favoring management power rather than shareholder wealth. Cary, *supra* note 33, at 664, 696-701. Although reaction to Cary's article was generally favorable, others rejected his thesis. Professor Ralph Winter, for example, claimed that competitive markets would constrain managers from incorporation in states adverse to shareholders interest because the per-share value of stock in corporations found in permissive states would decline. Shareholders, alienated by managerial decisions against their interests, would question the job ability of management. Fear for their positions would therefore lead management to a statutory environment favoring shareholders. Ralph K. Winter, *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). Other market proponents suggest that "product, capital and labor markets—constrain managers to further shareholders' interests. Accordingly, in their view, conflict between investors and managers over the content of state laws is largely illusory, and the laws that are promulgated can best be explained as mechanisms for maximizing equity share prices." Roberta Romano, *The State Competition Debate In Corporate Law*, 8 CARDOZO L. REV. 709, 711 (1987) ("Winter's critique is devastating to Cary's analysis because Cary completely overlooked the interaction of markets on manager's incentives."). The market critics of the "race to the bottom" thesis are close allies of the contractarian scholars discussed *infra* part II.A.2.

Professor Coffee declared the debate between Professors Cary and Winter a victory for Cary's support of corporate federalism. In 1987, he observed that new federal minimum national standards were developing to regulate corporations, replacing the old state standards. John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759 (1987) (discussing corporate federalism in the context of federal tender offer rules and "poison pills").

123. See Cary, *supra* note 33, at 668-670.

124. *Id.* at 701-702. FIRREA implements a federal minimum fiduciary regime for financial institutions. For a discussion of FIRREA's preemption of state corporate fiduciary law, see *infra* part IV.C.2.

125. Although the coercionists' response to the Berle and Means dilemma has dominated the corporate scene since 1932, in the last two decades contractarian scholarship has gained prominence. See Lucian A. Bebchuk, *Forward, The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1396-99 (1967) (discussing the "freedom-to-opt-out challenge to corporate law theory"). For an overview of the growth of economic analysis in law, see generally Ronald H. Coase, *Economics and Contiguous Disciplines*, 7 J. LEGAL STUD.

prised of many actors—shareholders, managers, employees, bondholders, and other creditors—related to the corporation by formal or

201, 207-08 (1978); Henry G. Manne, *Intellectual Styles and the Evolution of American Corporation Law in ECONOMIC IMPERIALISM; THE ECONOMIC APPROACH APPLIED OUTSIDE THE FIELD OF ECONOMICS* 291 (G. Radnizky & P. Bernholz eds. 1987). For a detailed discussion of the contractual view of the corporation, see Anthony T. Kronman, *A Comment on Dean Clark*, 89 COLUM. L. REV. 1748 (1989); Jonathan R. Macey, *Courts and Corporations: A Comment on Coffee*, 89 COLUM. L. REV. 1692 (1989); Fred S. McChesney, *Economics, Law and Science in the Corporate Field: A Critique of Eisenberg*, 89 COLUM. L. REV. 1530 (1989); Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599 (1989); Winter, *supra* note 122; Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526 (1989). See also RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 372 (3d ed. 1986); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Training*, 35 STAN. L. REV. 857 (1983); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 271-79, 283-99 (1986); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984); Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 37. The contractual theory of the corporation is derived from the work of Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* (No. 3) 386 (1937). For modern economic views of the corporation, see N. WOLFSON, *THE MODERN CORPORATION: FREE MARKET VS. REGULATION* (1984); Armen A. Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U. L. REV. 99 (1989); Steven N.S. Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1, 3-6 (1983); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Benjamin Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521 (1982); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); Henry G. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427 (1964); Oliver O. Williamson, *Corporate Governance*, 98 YALE L.J. 1197 (1984). For a critical analysis of the contractual approach to the modern corporate form, see William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989); William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989). Rather than focusing on the structure and governance of corporations, some economists focus on the definition and extent of the corporate form. They question the makeup of the firm and theoretically analyze its structure. See, e.g., Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1758-68 (1989). Contractarians envision the Berle & Means separation of ownership and control as an agency problem of modern labor markets.

Those who have wealth can employ it productively even if they are not good managers, those who can manage but lack wealth can hire capital in the market.

Investors bear most of the risk of business failure, in exchange for which they are promised most of the rewards of success.

Easterbrook & Fischel, *The Corporate Contract*, *supra* note 37, at 1425. An unwanted side effect of the efficient division of labor is a corresponding rise in agency costs. Accordingly, for a corporation to flourish, the success and profits created by the division of labor must exceed the rise in agency costs. *Id.*

informal contractual arrangements.¹²⁶ First articulated by Professors Jensen and Meckling,¹²⁷ and continued by Judge Easterbrook and Professor Fischel,¹²⁸ the "nexus of contracts" approach conceives of the corporation as a complex web of contracts created voluntarily through bargaining.¹²⁹ The result is a corporate model unique as "a statement of capital contributions as formal claims against the firm's income that are distinct from participation in the firm's productive activities."¹³⁰

Contractarian scholars maintain that market forces dictate the most efficient arrangements for each individual corporation. Market forces reduce corporate agency costs while allocating the payment of claims on capital contributions to the firm.¹³¹ Contractarian scholars

126. See, e.g., Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 37. In discussing the voting rights of corporate owners, Easterbrook and Fischel argue that many actors in the corporation are as much "owners" in the corporation as shareholders, each investing their own specialized capital to the firm. Furthermore, contractarians describe the relationships amongst corporate actors as far more dynamic than the static ownership and control model. The multiplicity of corporate actors "negotiate contracts, explicitly or implicitly, with the other participants. . . ." *Id.*; see *infra* notes 135-138 and accompanying text.

127. Professors Jensen and Meckling coined the term "nexus of contract." See Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, *supra* note 125, at 310-11.

128. Easterbrook and Fischel state that "[c]orporations are a subset of firms." Easterbrook & Fischel, *The Corporate Contract*, *supra* note 37, at 1425.

129. Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, *supra* note 125, at 310-11.

130. Easterbrook & Fischel, *The Corporate Contract*, *supra* note 37, at 1425. Easterbrook and Fischel characterize the variety of corporate actors as investors bearing the risk of failure and the profits of success. The only distinction they find between individual investors is the type of investment claim. *Id.* "Equity investors are paid last, after debt investors, employees, and other investors with (relatively) 'fixed' claims. These equity investors have the 'residual' claim" *Id.*

131. Corporations, to the contractarians, divide labor efficiently, thereby effectively serving the needs of large-scale capital economies.

Shareholders and bondholders provide firms with needed capital in exchange for an expected rate of return generated by cash flows from the firm's assets. Different groups provide other factors of production: employees supply labor, managers supply managerial talent necessary for coordinating the various inputs, and suppliers supply goods. The publicly held corporation, therefore, is a type of firm that facilitates the organization of production which is particularly effective when a large amount of capital is required.

Fischel, *The Corporate Governance Movement*, *supra* note 125, at 1262 (footnotes omitted). Furthermore, according to Professor Fischel, shareholders and managers serve the division of labor as well. Shareholders may participate in large-scale business ventures even though they lack managerial ability. In turn, managers may participate in large-scale corporate business despite the lack of personal wealth by employment of their managerial skills.

Judge Easterbrook and Professor Fischel, applying this understanding of the firm, argue that because of the individual identity of firms and their particular needs, market forces, not legal rules, are the best "regulators" of efficient corporate business. "The way in which corporations run the business, control agency costs, raise money, and reward investors will change

acknowledge Berle and Means' concern that inefficiency results from the separation of ownership and control, but they argue that contractual bargaining between shareholders and managers achieves the optimum reduction of agency costs.¹³² To Berle and Means' rhetorical question, contractarians respond in the negative: corporate law need not protect shareholders from managerial plundering.¹³³ They reason that corporate laws intended to protect shareholders would ill serve the variety of corporate actors and the particularized needs of the individual firm in the "nexus of contracts" approach.¹³⁴

Contractarians repudiate the traditional notion of shareholders as sole owners of the corporation.¹³⁵ Easterbrook and Fischel, in their understanding of the modern corporation, state that "shareholders are no more the 'owners' of the firm than are bondholders, other creditors, and employees who devote specialized resources to the enterprise"¹³⁶ According to contractual theory, shareholders, bondholders, creditors, and others in contractual relationships with the firm infuse into the corporation the necessary capital in exchange for an expected rate of return.¹³⁷ From an economic perspective, both stockholders and creditors "invest" in the firm and expect to receive a return.¹³⁸

The contractarian model leaves the protection of all corporate

from business to business and from time to time within a firm." Easterbrook & Fischel, *The Corporate Contract*, *supra* note 37, at 1427 (footnotes omitted). Easterbrook and Fischel warn with Darwinian allusions that the inefficiency of corporate legal regulation will cause the demise of the modern corporation. Inevitably, they conclude the failure of the modern corporation will visit disaster on those capitalist economies attempting corporate regulation. "The history of corporate law has been that states attempting to force all firms into a single mold are ground under as well." *Id.*

132. Judge Easterbrook and Professor Fischel argue that the Berle and Means ownership and control problem is an unavoidable agency cost in corporate governance. Yet, where "Berle and Means thought they had diagnosed a fatal disease . . .," the contractarians "do not envision this agency problem as fatal." Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 37, at 397. Professor Fischel also, independently downplays the ownership and control problem because "[a]gency costs are an inevitable consequence of every agency relationship and are outweighed by the gains resulting from an efficient division of labor." Fischel, *The Corporate Governance Movement*, *supra* note 125, at 1266 (footnotes omitted).

133. *See supra* note 96.

134. *Supra* note 96; *see supra* notes 125-132.

135. *See supra* part II.A.

136. Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 37, at 396.

137. Easterbrook & Fischel, *The Corporate Contract*, *supra* note 37, at 1425; *see also* Fischel, *The Corporate Governance Movement*, *supra* note 125, at 1262.

138. *See supra* note 130. The contractual theory of the firm is attractive when applied to modern economic markets where debt and equity securities have grown increasingly similar. However, creditor and stockholder interests may clash because creditors "have prior but fixed claims on a firm's assets while stockholders have limited liability for the firm's debt and unlimited claims on its remaining assets" *See* BAYLESS MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL 8 (2d ed. 1981).

actors—including shareholders—to contractual relationships and market forces.¹³⁹ Mandatory corporate rules are both unnecessary and inefficient to prevent managerial plundering, as market forces ensure the most efficient check on managerial power.¹⁴⁰ Thus, contractarians propose a legal system that permits corporate actors to contract out of statutory or judicial rules to best serve the individual needs of each corporation.¹⁴¹

3. THE CORPORATE SOCIAL RESPONSIBILITY MODEL

Corporate social responsibility theorists conceive of a corporate regime based on community obligation.¹⁴² Such community obliga-

139. Contractarians envision corporate law as a standard form contract designed to reduce bargaining costs. They argue that the individual nature of the firm makes it virtually impossible for corporate law to identify ideal corporate relationships. To the contractarians, corporate law is not a unanimous ideal for the multiplicity of corporate relationships; rather, it is a starting point. "To the extent . . . [corporate law] . . . anticipate[s] the desires of the contracting parties, these off-the-rack principles reduce the number of items to be negotiated and the costs of negotiating them." Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 37, at 401.

Because it is impossible for a single legal regime to respond to the needs of each individual corporation, contractarians advocate a corporate law code that acts as a baseline provision for corporate actors to accept, or contract out of, at their choosing.

On many occasions the legal rules will not be sufficiently detailed. The standby rule of corporate law, the fiduciary principle, requires actors to behave in the way that they would have agreed to do by contract, if detailed contracts could be reached and enforced at no cost. Yet, the structural rules and the fiduciary principle together cover only the outlines of the relations among corporate actors. Something must fill in the details.

Id. (footnotes omitted). Easterbrook and Fischel conclude that "[o]n this view corporate law supplements but never displaces actual bargains—save in situations of third-party effects or latercomer terms. . . ." Easterbrook & Fischel, *The Corporate Contract*, *supra* note 37, at 1445.

140. *See supra* note 139.

141. Contractarians describe baseline corporate laws as "enabling" statutes. As Judge Easterbrook and Professor Fischel claim, "[t]he corporate code in almost every state is an enabling statute." Easterbrook & Fischel, *The Corporate Contract*, *supra* note 37, at 1417. Enabling statutes permit individual corporate establishment of "systems of governance without substantive scrutiny from regulators and without effective restraint on the permissible methods of corporate governance." *Id.*

142. For an excellent overview of corporate social responsibility theory, see Edwin M. Epstein, *supra* note 31. For the various approaches and the difficulty in achieving consensus among corporate social responsibility theorists, see Engel, *supra* note 32. Corporate social responsibility scholarship proliferated in the 1970s. *See, e.g.*, JAMES W. HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970* (1970); HENRY G. MANNE & H. WALLICH, *THE MODERN CORPORATION AND SOCIAL RESPONSIBILITY* 37-52 (1972); RALPH NADER ET AL., *TAMING THE GIANT CORPORATION* (1976); CHRISTOPHER STONE, *WHERE THE LAW ENDS* (1975); RATIONALITY, LEGITIMACY, RESPONSIBILITY: THE SEARCH FOR NEW DIRECTIONS IN BUSINESS AND SOCIETY 52 (E. Epstein & D. Votaw eds. 1978); Kenneth Arrow, *Social Responsibility and Economic Efficiency*, 21 PUB. POL'Y 303 (1973); Luis A. Baumol, *Business Responsibility and Economic Behavior*, in ALTRUISM, MORALITY, AND ECONOMIC THEORY 45 (E. Phelps ed. 1975); Martin Bronfenbrenner, *The Consumer*, in SOCIAL RESPONSIBILITY AND THE BUSINESS

tion—despite its potential conflict with shareholders' wealth goals—would constrain managerial abuse of economic power.¹⁴³ Berle and Means allude to a model of corporate responsibility in *The Modern Corporation and Private Property*.¹⁴⁴ Although the community obligation language in *The Modern Corporation and Private Property* provided some impetus for the development of corporate social responsibility theory, the famous dialogue between Berle and E. Merrick Dodd, Jr. on the trusteeship role of corporate management is the basis for the current corporate social responsibility scholarship.¹⁴⁵

The Berle-Dodd dialogue began in 1931, when Berle authored *Corporate Powers as Powers in Trust* in the Harvard Law Review.¹⁴⁶ Somewhat surprisingly, given his ensuing suggestion of community obligation in *The Modern Corporation and Private Property*,¹⁴⁷ Berle initially argued that all corporate power should be entrusted in con-

PREDICAMENT 169 (J. McKie ed. 1974); Marvin A. Chirelstein, *Corporate Law Reform*, in SOCIAL RESPONSIBILITY AND THE BUSINESS PREDICAMENT 41, 76 (J. McKie ed. 1974); Alfred F. Conard, *Response: The Meaning of Corporate Social Responsibility, Variations on a Theme of Edwin M. Epstein*, 30 HASTINGS L.J. 1321 (1979); Alfred F. Conard, *Reflections on Public Interest Directors*, 75 MICH. L. REV. 941, 942-43 (1977); Robert A. Dahl, *Governing the Giant Corporation*, in CORPORATE POWER IN AMERICA 10, 15 (R. Nader & M. Green eds. 1973); Jerome Rothenberg, *The Physical Environment*, in SOCIAL RESPONSIBILITY AND THE BUSINESS PREDICAMENT 191, 200-04, 207, 211-15 (J. McKie ed. 1974); Donald E. Schwartz, *Towards New Corporate Goals: Co-Existence With Society*, 60 GEO. L.J. 57, 63-64 (1971); A.A. Sommer, Jr., *The Struggle For Corporate Responsibility*, 8 CARDOZO L. REV. 795 (1987).

143. For one definition of corporate social responsibility, see Engel, *supra* note 32, at 5-6. "The term is most useful if taken to denote the obligations and inclinations, if any, of corporations organized for profit, voluntarily to pursue social ends that conflict with the presumptive shareholder desire to maximize profit." *Id.* (footnotes omitted). Another definition of corporate social responsibility also focuses on the structure of the corporation. "[T]he public policy debate about whether and how to increase the social responsiveness and public accountability of the contemporary large business corporation in the 1980s, will, most likely, revolve around the interconnected issues of corporate structure and corporate government." Epstein, *supra* note 31, at 1287. *But cf.* Fischel, *Corporate Governance Movement*, *supra* note 125, at 1269. Professor Fischel argues that the contractarian model of the corporation is closely allied with the goals of corporate social responsibility. Because the contractarian approach favors the profit goals of all corporate actors, a successful corporate business venture benefits many providing jobs, goods and service to the community. In fact, Professor Fischel argues that firm success is imperative to effectively serve social goals because during periods of low profitability, management is most likely to first sacrifice social goals during cost cutting. Therefore, he concludes that profitability is not only consistent with social goals but also a prerequisite. *Id.*

144. See *supra* note 99 and accompanying text.

145. For an overview of the Berle-Dodd dialogue, see Joseph L. Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458 (1964); see also Wilber G. Katz, *Responsibility and the Modern Corporation*, 3 J.L. & ECON. 75, 76-78 (1960).

146. Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931).

147. See *supra* note 99 and accompanying text. Berle initially offered contradictory resolutions of the shareholder-management conflict. Compare ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) with Adolph A. Berle, *Corporate Powers as Power in Trust*, 44 HARV. L. REV. 1049 (1931). For a

trolling management for the direct benefit of shareholders.¹⁴⁸ Berle continued, arguing for constraints on managers when they deviate from shareholder profit maximization goals.¹⁴⁹ "[A]ll powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears."¹⁵⁰

Although Dodd agreed with Berle's "power in trust" thesis, he responded in *For Whom Are Corporate Managers Trustees?*¹⁵¹ that corporations should serve society, not just shareholders.¹⁵² According to Dodd, increased shareholder protection, although a "laudable purpose," should not subvert the evolution of the modern corporation as an institution of social service.¹⁵³ Shareholder protection in the form of a trust relationship would undermine corporate social goals by placing an even greater emphasis on "shareholder" profit goals.

Dodd argued that as a new economic order evolved, corporations would have to modify shareholder profit maximization goals to effectuate a corporate economy responsive to public opinion.¹⁵⁴ The inevi-

discussion of Berle's changing position on managerial accountability to shareholders or community, see Weiner, *supra* note 145.

148. Berle, *Corporate Powers as Power in Trust*, *supra* note 147, at 1049.

149. *Id.*

150. *Id.* Berle proposed two tests to ensure the faithfulness of managerial action to shareholders. The first, based on technical rules, would guide the "existence and proper exercise" of managerial power. *Id.* In the second test, Berle offered "equitable rules somewhat analogous to those which apply in favor of a cestui que trust to the trustee's exercise of wide powers granted to him in the instrument making him a fiduciary. *Id.* Thus, Berle argued for a trust relationship between management and shareholders, launching the debate with Professor Dodd. Berle analyzed five "corporate powers" supporting his thesis demanding the protection of a trust relationship because "through the very nature of the corporate entity, responsibility goes with power." *Id.* at 1050. After analyzing examples of corporate power, Berle concluded with a plea for the imposition of a trust relationship with the dubious assertion that powers are entrusted to management for the benefit of *all* corporate participants. *Id.* at 1073. However, Berle finally admitted his true allegiance and claimed that "it necessarily follows that: . . . whenever a corporate power is exercised . . . its use must be judged . . . with a view toward discovering whether . . . the result fairly protects the interest of shareholders." *Id.* at 1074. Berle would also have permitted the courts to use all equitable remedies to protect shareholders based on the circumstances of the individual case. *Id.* To ensure shareholder protection, Professor Berle advocated a mandatory set of corporate rules, unamendable in the corporate charter. *Id.* After all, he claimed an individual corporation's amendment of the corporate laws "would be to defeat the very object and nature of the corporation itself." *Id.*

151. 45 HARV. L. REV. 1145 (1932).

152. Professor Dodd expressed his "sympathy with Mr. Berle's efforts to establish a legal control which [would] more effectually prevent corporate managers from diverting profit into their own pockets from those of stockholders, and agree[d] with many of the specific rules which . . . [Berle] deduce[d] from his trusteeship principle." *Id.* (citations omitted).

153. *Id.* at 1143-46.

154. Dodd forecasted that even though shareholder wealth maximization goals at times coincide with public policy, community goals ultimately would prevail. He assumed that "a

table modification of the existing economic order would instill an awareness of community needs in management and force individual managers to keep pace with public opinion and fulfill their obligation to society.¹⁵⁵ Dodd thus advocated corporate laws compelling managerial responsiveness to the community.¹⁵⁶

Berle was quick to criticize Dodd's communitarian corporate regime.¹⁵⁷ On corporate social responsibility, Berle stated "[I]t is theory, not practice."¹⁵⁸ Berle considered a model of corporate governance based on community obligation unworkable because he believed that the legal regime should not destroy shareholder control over management without another coherent system ready to take its place.¹⁵⁹ Until such a scheme evolved, Berle maintained that corporate laws had to compel managerial accountability to shareholders.¹⁶⁰

Since the trusteeship debate, scholars have built upon the com-

planned economic order [would] ultimately result[] in a more stabilized system of production and employment . . ." As a result, community obligation would supplant the "maximum-profit-for-the-stockholders-of-the-individual-company formula." *Id.* at 1152.

155. Dodd expected that corporate managers would be swept up in the changing political/economic order because "it is natural to expect that this change of opinion will have some effect upon the attitude of those who manage business." *Id.* at 1153.

156. "The principal object of legal compulsion might then be to keep those who failed to catch the new spirit up to the standards which their more enlightened competitors would desire to adapt voluntarily." *Id.* Corporate business, Dodd claimed, would become a social service, with corporate laws prodding the laissez-faire tradition of any lingering capitalists. Professor Dodd then suggested that corporate business would become communitarian (concerned for all of society) rather than individualistic (concerned only for shareholders). He explained: "Business might then become a profession of public service, not primarily because the law had made it such but because a public opinion shared in by business men themselves had brought about a professional attitude." *Id.* (citations omitted).

The motivation for Dodd's proposed evolution to corporate communitarianism lies in the tremendous power vested in corporate managers. "Modern large-scale industry has given to the managers of our principal corporations enormous power over the welfare of wage earners and consumers, particularly the former. Power over the lives of others tends to create on the part of those most worthy to exercise it a sense of responsibility." *Id.* at 1157.

157. See Adolph A. Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932); Weiner, *supra* note 145 (commenting on Berle's prompt but unfavorable reaction to Dodd).

158. Berle, *supra* note 157, at 1367.

159. *Id.* To Berle, community obligation was an as yet unrealized ideal because the corporate manager as

[t]he industrial 'control' does *not* now think of himself as a prince; he does *not* now assume responsibilities to the community; his bankers do *not* now undertake to recognize social claims; his lawyers do *not* advise him in terms of social responsibility. Nor is there any mechanism now in sight enforcing accomplishment of . . . [Dodd's] . . . theoretical function.

Id.

160. *Id.* Berle argued for continuing managerial obligation to maximize shareholder owners until such time as a suitable alternative to the shareholder group is identified. *Id.* "Now I submit that you can not abandon emphasis on the view that business corporations exist for the sole purpose of making profits for their stockholders until such time as you are

munity obligation theory.¹⁶¹ Although the corporate social responsibility scholarship is diverse, its common goal is to impose social control on modern corporations.¹⁶² A socially responsible corporation balances shareholder interests against the interests of the community's legitimate claims on the firm.¹⁶³ However, difficulty emerges in balancing divergent interests because each corporate actor has distinct goals.¹⁶⁴ The practical inability to balance these competing interests explains why courts and legislatures have not yet adopted a comprehensive corporate social responsibility regime.

B. *Ownership Conflict in the Corporate Form*

Corporate law traditionally focuses on the conflict between two sets of actors: shareholders and management. Inevitably, the primary goal of corporate law is to protect shareholders from the vagaries of managerial control.¹⁶⁵ Yet, as contractarians and corporate social responsibility theorists recognize, other actors exist, with interests conceptually similar to shareholder-owners.¹⁶⁶ These scholars challenge the traditional assumption of corporate law—that shareholders are the exclusive owners of the corporation—because they see little difference between the “investment” of shareholders and that of other corporate actors.¹⁶⁷ In fact, creditors may contribute to the cor-

prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else.” *Id.*

161. See sources cited *supra* note 142.

162. See Thomas M. Jones, *Corporate Governance: Who Controls the Large Corporation*, 30 HASTINGS L.J. 1261 (1979) (“The broad issue . . . is the social control of business or corporate social responsibility.”).

Professor Engel suggests that the basic issue of corporate social responsibility is “whether it is socially desirable for corporations organized for profit voluntarily to identify and pursue social ends . . .” and ultimately whether “this pursuit conflicts with the presumptive shareholder desire to maximize profit.” Engel, *supra* note 32, at 3.

163. Community claims on the corporation vary from pollution control to requests for charitable donations. See, e.g., Epstein, *supra* note 31, at 1302 (listing goals of a socially responsible corporation). Social responsibility can be divided into two levels in the corporate context. Much of the corporate social responsibility scholarship focuses on the corporation's obligation to community. Individual managerial responsibility focuses on the individual's obligation to community. While this distinction may blur in the corporate decisionmaking context, it is important because corporate social responsibility primarily focuses on the corporation's obligation. See Joseph Grundfest, *Corporate Responsibility: Panel Response*, 8 CARDOZO L. REV. 817 (1917). Significantly FIRREA mandates individual corporate responsibility by creating a fiduciary regime sensitive to community obligation similar to the “neutral technocracy” of Berle and Means. See *infra* part IV.C.

164. See *supra* note 163.

165. See, e.g., *Simons v. Cogan*, 549 A.2d 300, 303-04 (Del. 1988) (“Before a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist. The obvious example is stock ownership.”). But see *infra* note 190.

166. See *supra* parts II.A.2 and II.A.3.

167. See *supra* part II.A.2.

poration much like shareholders do.¹⁶⁸

Therefore, while the separation of ownership and control has dominated the corporate governance scholarship, at least *two* structural tensions afflict corporate law: the traditional conflict between managers and shareholders,¹⁶⁹ and the conflict between shareholders and creditors. Dean Bayless Manning explains in *A Concise Textbook on Legal Capital* that "[t]he interests of creditors . . . and . . . shareholders of a corporation are likely to conflict whenever assets of shareholders are to be committed to the corporate treasury."¹⁷⁰ Corporate fiduciary law has largely ignored the latter conflict.¹⁷¹ Instead, it has left corporate creditors to their contractual wiles to safeguard against the usurpation of their investment in the firm.¹⁷² As a result, corporate creditors' investments—conceptually identical to shareholders' investments¹⁷³—do not receive the same protection and benefits as shareholder investments.

Creditors and shareholders, while both benefiting from a profitable, efficiently managed corporation, nonetheless have disparate investment goals.¹⁷⁴ Creditors seek repayment of a corporate debt obligation and therefore aspire to preserve substantial corporate assets.¹⁷⁵ Shareholders, by contrast, expect frequent distribution of

168. See *supra* part II.A.2.

169. See *supra* part II.A.

170. BAYLESS MANNING, *A CONCISE TEXTBOOK ON LEGAL CAPITAL* 1 (1977).

171. See discussion *infra* this part; but see *infra* note 190.

172. Only by bargaining in contract and to some extent by corporate asset distribution statutes is creditor investment protected. See MANNING, *supra* note 170. Dean Manning argues that only managerial decisions incurring additional debt or distributing corporate assets are "proscribed or limited by contract or by general law." *Id.* at 7-8. Although conceptually similar, creditors do not share in stockholder fiduciary protection. Ultimately, the shareholder creditor neither has "protection against such commercial risks except his own skill in predicting whether an enterprise will or will not make enough" to ensure a return on investment. *Id.*

173. "The investor who buys shares of the incorporated enterprise, is, as a matter of economics, engaged in the same kind of activity and is motivated by the same basic objectives" as creditors. MANNING, *supra* note 170, at 8. Some scholars suggest that it is unrealistic to hold management accountable to both creditors and shareholders. See Walter H. Cabot, *The Free Market Promotes Long-Term Efficiency That Benefits All Stakeholders*, 21 STETSON L. REV. 245 (1991); James J. Hanks, Jr., *Playing With Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97 (1991); Nell Minow, *Shareholders, Stakeholders, and Boards of Directors*, 21 STETSON L. REV. 197 (1991) for different approaches to nonshareholder constituency statutes all favoring the traditional corporate fiduciary obligation to shareholders alone. See *infra* note 632 for a discussion of non-shareholder constituency statutes.

174. "The ideal world as conceived by the creditor of the corporation is a world that is normally wholly unacceptable to the shareholder." MANNING, *supra* note 170, at 8.

175. "The creditor of the corporation desires that the enterprise have large quantities of

corporate assets in return for their equity investment.¹⁷⁶

Notwithstanding contractual and limited statutory protection,¹⁷⁷ creditors are still subject to the "risk of the basic commercial vicissitudes of the debtor enterprise."¹⁷⁸ Because corporate fiduciary law does not speak to this risk, creditors can lose their investment, without fiduciary redress, through managerial risktaking in corporate business ventures.¹⁷⁹

The difference between creditor investment and shareholder investment is that shareholders hope for ever increasing returns, whereas creditors receive a fixed rate of return and priority of claim.¹⁸⁰ The shareholder's "riskier" investment return is the periodic dividend payment and an increase in the value of their equity share after payment to all fixed-rate creditors.¹⁸¹ Shareholders often seek income on their investment in the form of dividends, liquidation distributions, and stock buy-ins.¹⁸² Any such distribution of corpo-

assets against which the only other claimants are those who rank junior to him, i.e. the shareholders." *Id.* at 14.

According to Dean Manning, the creditor has several objectives for the debtor corporation: the preservation of substantial corporate assets, the prevention of the incurrence of additional debt to other general creditors, the unencumbrance of the corporation of any lien interest by a secured creditor, and the prevention of distribution of corporate assets to junior creditors prior to redemption of the creditors' debt. *Id.* at 7.

176. Shareholders "would like to have as little as possible of their own assets tied up in the enterprise and exposed to the jeopardy of creditors' claims." *Id.*

177. *Id.* at 8. See *supra* note 172.

178. *Id.* at 7. Each creditor bears a market risk equal in extent to the amount of their debt entitlement. As Dean Manning describes the failure of the corporation's product or the drop in the market value of its assets, such events could leave the creditor in a position only to "whistle for his claim." *Id.*

179. *Id.* Corporate fiduciary law does, however, contemplate duties to creditors in insolvent institutions. See 12A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS 7889 (Rev. perm. ed. 1981). See discussion *infra* note 189. Shareholders, by contrast, would have redress, assuming managerial risk did not fall within the parameters of the business judgment rule. The business judgment rule is discussed *infra* part III.B.2.

180. Dean Manning characterizes the investment difference between creditor and shareholder as a "calculated economic judgment" between priority of claim on interest and "a fixed principal payment on maturity," and between the potential for a greater capital gain, uncertain dividends and the residual claim to corporate assets. *Id.* at 8-9.

181. Dividend payments are the most common distinction between creditor and shareholder returns. *Id.* at 9.

182. *Id.* Dean Manning defines other forms of shareholder payments beside the standard dividend payment mentioned *supra* note 181. Liquidation distributions occur when and "[i]f it is decided that an incorporated enterprise should be broken up, or that some of its assets or separable operations should be sold for cash . . ." *Id.* at 10. A "cash buy in" is "a transaction that pays assets out of the corporate treasury to shareholders but brings in to the corporation nothing but pieces of paper in the hands of the corporation." *Id.* The corporation may distribute corporate assets as shareholder compensation although the distribution exceeds the reasonable value of shareholder services. Furthermore, the corporation may loan, sell, or lease corporate assets at rates lower than market value. *Id.* at 11.

rate assets to the shareholder is in direct conflict with creditor goals of maintaining the corporate treasury.¹⁸³

As Dean Manning's reference to the "uncontrollable inherent commercial risk of the enterprise"¹⁸⁴ implies, the conflict between shareholders and creditors intensifies in corporations approaching failure.¹⁸⁵ Floundering corporations are more apt to engage in high-risk business ventures because of the need of a high rate of return.¹⁸⁶ Because corporate law historically has required management to act in shareholders' best interests, managers of a failing firm may take drastic strategic measures, too risky under normal circumstances, in a final effort to maximize shareholders' equity investment.¹⁸⁷

Implicit in the corporate fiduciary law that recognizes only the duty to maximize shareholder wealth is the recognition of the Berle and Means separation of ownership and control. As a result, corporate fiduciary duties are designed to alleviate conflict between shareholder-owners and management, while creditor-owners are left to other means to protect their investment. An exposition of the common law and of state statutory corporate fiduciary law will facilitate an understanding of the relationship of all corporate investors to the mostly autonomous corporate management.

III. THE CORPORATE FIDUCIARY REGIME

Management has not evolved into a neutral technocracy serving the interests of the community rather than individual shareholders, as Berle and Means had hoped.¹⁸⁸ To reconcile the ownership-control

183. *Id.*

184. *See supra* note 125.

185. Stephen K. Halpert, *The Separation of Banking and Commerce Reconsidered*, 13 J. CORP. L. 481, 512-13 (1988). As Professor Halpert discusses, super-optimal risktaking is particularly pronounced in insured depository institutions approaching insolvency. *Id.* at 509-13. For a discussion of insured depository institutions and risktaking, see *infra* part VI.C.

186. *Id.* Also, management of corporations no longer exhibits risk-averse behavior as institutions approach insolvency. Because managers have an employment/financial stake in the successful firm, they are normally more likely to be risk-averse to the degree shareholders favor risktaking. The agency costs of the separation of ownership and control is discussed at length in much of the contractarian literature identified *supra* note 125. As an institution approaches insolvency, however, managers have little to lose in risktaking and much to gain. Therefore, management goals in failing institutions are in conflict with goals of creditors as well because managers are willing to risk the remaining corporate assets, thereby preserving their own employment and furthering shareholder goals. Any assets subsequently lost hurt only the priority creditors, while management, and to a lesser extent shareholders, have little to lose.

187. *See supra* note 185. Some case law suggests that when a conflict arises between bondholders and shareholders, the corporation owes a fiduciary—or at least good faith—duty to both. *Aladdin Hotel Co. v. Bloom*, 200 F.2d 627 (8th Cir. 1953). *See infra* note 189.

188. *See supra* note 101 and accompanying text.

conflict, courts and legislatures have developed corporate fiduciary laws to protect shareholders from managerial abuse and negligence.¹⁸⁹ Despite recent trends in fiduciary law considering the fiduciary rights of nonshareholders, the vast majority of case law reflects corporate fiduciary law's goal of maximizing shareholder wealth.¹⁹⁰ The duty of care evolved as a check on risky managerial decisionmaking. The business judgment rule operates in tandem with the duty of care to counteract the potential for excessive managerial liability under the

189. For cases discussing management's duties to shareholders, see *Simons v. Cogan*, 549 A.2d 300, 303-304 (Del. 1988); *Revlon Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986); *Hartford Fire Ins. Co. v. Federated Dep't Stores*, 723 F. Supp. 976 (S.D.N.Y. 1989); *Metropolitan Life Ins. Co. v. RJR Nabisco Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1984). See also *Katz v. Oak Indus.*, 508 A.2d 873, 879 (Del. Ch. 1986) (stating that the only duty to creditors is contractual in nature). The traditional fiduciary model changes however when institutions become insolvent. Insolvent corporation management, in the majority of jurisdictions, owe fiduciary duties to creditors. See *In re STN Enterprises*, 779 F.2d 901, 904-05 (2d Cir. 1985); *In re Mortgage America Corp.*, 714 F.2d 1266 (6th Cir. 1983); *Federal Deposit Ins. Corp. v. Sea Pines Co. Ltd. v. Shaheen*, 660 F.2d 506 (2d Cir. 1982); *Robinson v. Watts Detective Agency, Inc.*, 685 F.2d 729 (1st Cir. 1982), *cert. denied*, 459 U.S. 1105 (1983) (Massachusetts law); *Clarkson Co. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981), *cert. denied*, 455 U.S. 990 (1982) (New York law); *Brown v. Presbyterian Ministers Fund*, 484 F.2d 998, 1005 (3d Cir. 1973) (Pennsylvania law); *In re Delorean Motor Co.*, 49 B.R. 900, 907 (Bankr. E.D. Mich. 1985) (Michigan law); *Pennsylvania Co. For Insurances on Lives & Granting Annuities v. South Broad St. Theater Co.*, 174 A. 112, 116 (Del. 1934); *In re F&C Servs., Inc.*, 44 B.R. 863, 874 (Bankr. S.D. Fla. 1984) (Florida law). For the changing role of fiduciary duties based on institution solvency, see Lewis W. Davis, Jr., et al., *Corporate Reorganization in the 1990s: Guiding Directors of Troubled Corporations Through Uncertain Territory*, 47 BUS. LAW. 1 (1991). For an analysis of the shifting fiduciary duties based on the solvency of the corporation and for a proposal for fiduciary duties to creditors prior to insolvency, see Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625 (1991).

190. In *Paramount Communications v. Time Inc.*, 571 A.2d 1140 (Del. 1989), the Delaware Supreme Court shifted away from the traditional notion of maximization of shareholder wealth by recognizing a fiduciary obligation to "the corporation" as comprised of other constituencies. At least in the takeover context, *Time* may stand for the proposition of managerial fiduciary duties to all actors in the corporate enterprise. *Id.* at 1150. For a discussion of the fiduciary obligations found in *Time*, see Trevor S. Norwitz, 46 BUS. LAW. 377 (1991). Furthermore, in the Delaware Court of Chancery's recent opinion in *Credit Lyonnais Bank N.V. v. M.G.M. Pathe Communications*, Civ. 12150, 1991 Del. Ch. Lexis 215 (Dec. 30, 1991), Chancellor William Allen extended the fiduciary rights of creditors to a period prior to insolvency. "At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residual risk bearers, but owes its duty to the corporate enterprise . . ." Slip op. at 83. See *infra* part IV.D. For an excellent overview of *Credit Lyonnais*, see John C. Coffee, *Court Has a New Idea on Directors' Duty*, NAT. L.J., Mar. 2, 1992, at 18 [hereinafter "Court Has a New Idea"]; see also *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488 (Bankr. N.D. Ill. 1988) (action alleging breach of fiduciary duty to creditors survives 12(b)(6) motion to dismiss); Elliott Goldstein, *Will Directors Have a Duty to Consider Bondholders?*, 12 BUS. LAW. UPDATE 9 (1992). Furthermore, the recent growth of "other constituency" statutes may provide the "hook" for a court to hang a creditor fiduciary right. For a discussion of "other constituency" statutes, see Morey McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121 (1991). Examples of "other constituency" statutes may be found *infra* at note 632.

duty of care. In addition to the duty of care, the duty of loyalty developed to prevent managers from using their positions to maximize their self-interest to the detriment of shareholders. Both the duty of care and the duty of loyalty attempt to limit managerial autonomy and the exploitation of shareholder wealth. Part III.B discusses the fiduciary duty of care, the business judgment rule, and the duty of loyalty.

Exacerbating the difficulty of fiduciary issues is the complexity of corporate management itself. Management is not a homogenous group. Part III.A explores the function of the board of directors, the dichotomy between inside and outside directors, and the varying degrees of care owed to the corporation.

A. *The Board of Directors*

1. THE RESPONSIBILITIES OF THE BOARD OF DIRECTORS

Corporate boards are responsible for choosing chief executive officers and top management.¹⁹¹ They regularly audit the accounting of the corporation and advise upper level management in corporate business planning.¹⁹² Also, despite the formalities of shareholder elections, the board of directors usually determines the new members of the board.¹⁹³ The directors further determine the executive management compensation level, including incentive packages based on the performance of the corporation.¹⁹⁴ The board of directors also evalu-

191. Robert W. Hamilton, *Reliance and Liability Standards for Outside Directors*, 24 WAKE FOREST L. REV. 5, 12 (1989). "First [the monitoring model] must assure that the corporation has in place a functioning management." *Id.*

192. According to Professor Hamilton, the board of directors ensures proper "accounting and accountability mechanisms" that conform to both legal and ethical standards as well as provide a formal advisory function. *Id.* As advisors, "directors are essential to provide the 'fresh look' or 'independent points of view' desired by management." *Id.* at 13.

193. Professor Hamilton claimed that although shareholders technically elect a board of directors, management usually offers a slate of candidates that receives shareholders' rubber stamp approval. *Id.* at 12. Shareholders, though absent from the everyday management of the corporation, do exercise some influence over corporate managers largely through their voting rights: the election and removal of directors. Furthermore, shareholders may align their votes in proxy contests or sell their shares to a party attempting a takeover bid. Shareholders may further influence corporate affairs by approving or rejecting corporate by-laws or amendments to the by-laws. Major corporate transactions—transactions not in the usual course of ordinary business—need shareholder approval as well. In large corporations, shareholders may inform and therefore empower their vote by using corporate information which the Securities Exchange Act of 1934 requires the corporation to release. For an overview of shareholder voting rights in corporate law, see Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 37. See also *Bohannon v. Corporation Commission*, 313 P.2d 379 (Ariz. 1957).

194. Special board committees of outside directors usually determine compensation and incentive based packages for senior management. Hamilton, *supra* note 191, at 13-14. See also The Subcommittee on Executive Compensation of the Committee on Employee Benefits and

ates corporate transfers of control such as merger proposals or cash tender offers.¹⁹⁵ In addition, directors review transactions for potential conflicts of interest.¹⁹⁶ Finally, the board declares shareholder dividends, proposes amendments to corporate bylaws, and presents recommendations for corporate action requiring shareholder approval.¹⁹⁷ The responsibilities of the board of directors are the focus of the fiduciary duty legal regime which requires managerial conduct consistent with the goals of shareholding ownership.¹⁹⁸

2. INSIDE AND OUTSIDE DIRECTORS: MANAGERS AND MONITORS

The traditional corporate board *managed* the corporation.¹⁹⁹ The growth and complexity of modern corporations, however, has forced corporate directors—especially directors unaffiliated with the corporation—to become monitors or supervisors of hired managers.²⁰⁰ The monitoring role of modern boards suggests varying levels

Executive Compensation, *Executive Compensation: A 1987 Road Map for the Corporate Advisor*, 43 BUS. LAW. 187 (1987).

195. *Id.*

196. Conflict-of-interest transactions usually require ratification by a majority of disinterested directors. For the outside directors role in ratification of conflict of interest transactions, see *id.*

197. *Id.* at 15.

198. Both directors and officers have fiduciary duties to the corporation. Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2090 (1978). Officers need not also serve on the board of directors of the corporation. In fact, each state's corporate law provides for the appointment of officers by the board of directors. The duties of the officers are set by the corporation in its bylaws or by the board of directors. WILLIAM E. KNEPPER & DAN A. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* § 1.08 at 15 (4th ed. 1988). Professors Eisenberg and Cary consider executives (officers and "inside" directors) the real managers of the modern corporation because of practical constraints on the board of directors. WILLIAM L. CARY & MELVIN A. EISENBERG, *CORPORATIONS* 207 (6th ed. 1988). Cary and Eisenberg identify three constraints on outside directors. Because outside board members spend only five to ten working days a year "managing" the corporation, time constraints severely limit outside directors. Outside directors face constraints on the information they receive because they rely on corporate officers and their staffs for the compilation and dissemination of information. Furthermore, many board members, both "inside" and "outside," are related to the Chief Executive Officer or other executives either financially or socially, which provides ample constraint on the decisionmaking process. For the purposes of this paper, officers and "inside" directors are used interchangeably to designate boardmembers who also serve the corporation in an everyday managerial capacity, with more hands-on contact than unaffiliated "outside" directors. Officers are responsible for the daily operation and management of the corporation and prepare the reports and financial statements on which directors rely in formulating corporate policy and in advising management. *Id.* at 207.

199. *Id.* In the traditional model "the board of directors manages the corporation's business and makes business policy; the officers act as agents of the board and execute its decisions . . ." *Id.*

200. The modern corporate board has evolved simultaneously with the large scale

of accountability to the corporation. Members of the board are distinguished based on individual knowledge of and contact with the corporation.²⁰¹

A typical board of directors consists of inside directors and outside directors.²⁰² Outside directors, who are not employees of the corporation, perform a monitoring role.²⁰³ They bring objectivity to corporate decisionmaking because they "have no immediate accountability for short-range financial results [which] assures greater detachment and a better focus on longer-range corporate interests."²⁰⁴ Because of their objectivity, outside directors often serve on executive compensation and corporate audit committees.²⁰⁵ Inside directors,

corporation. As corporations grew, concerns about economic concentration have grown as well.

The operation of the market and of competition, the requirements for large aggregations of capital and for aggregations of technological and managerial capabilities, have led in turn to the development of the large publicly-held corporation. . . .

It is appropriate, however, that the public and its elected representatives should be concerned that private business organizations like government itself be subject to checks and balances, to constraints on excessive power.

Statement of the Business Roundtable, *supra* note 198, at 2090. The complexity of the modern corporate economy has invariably led to change in the role of the board of directors. "It has become increasingly clear . . . that in practice the board rarely performs either the management or the policymaking functions." CARY & EISENBERG, *supra* note 198, at 207. "Modern boards of directors have practically nothing to do with the day-to-day business of the corporation." Hamilton, *supra* note 191, at 9. Because of the size and scope of many modern corporations, "business decision-making is diversified and diffused." *Id.* Courts also have acknowledged the changing role of the board of directors. "Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies." *Francis v. United Jersey Bank*, 432 A.2d 814 (1981).

201. In effect, individual board members serve in a division of labor based on their committee service and their relationship to the everyday business of the corporation. A central question in shareholder litigation becomes, in essence, which director had access to the information that forms the basis of the alleged fiduciary breach. *See* Hamilton, *supra* note 191, at 5.

202. *See generally* Hamilton, *supra* note 191 (describing the evolution of the modern corporate board and its greater emphasis on "outside" directors); Statement of the Business Roundtable, *supra* note 198 (suggesting an "outside" director majority composition for a corporate board of directors).

203. A corporation usually invites an outside director to sit on its board because she has expertise to offer the corporation. *See* Marshall L. Small, *The Evolving Role of the Director in Corporate Governance*, 30 HASTINGS L.J. 1353, 1356-57 (1979).

204. Statement of the Business Roundtable, *supra* note 198, at 2108. "It seems to us that outside directors . . . can perform a very valuable service to the corporation. They are windows on the world who provide a protection against insularity and lack of vision." *Id.* at 2107.

205. The desirability of outside directors is enhanced by "certain board responsibilities—notably setting top management compensation, and the audit function—performed by directors who have neither a stake nor a prior involvement in the matters they are reviewing or resolving." *Id.* at 2108.

Corporate board committees permit an enhanced role for outside directors whose service

who are employees of the corporation and usually corporate executives, participate in everyday corporate decisionmaking. Though they do not have the objectivity of outside directors, their constant contact with corporate affairs provides them with a level of awareness essential for an effective board of directors.

Because of their greater knowledge and participation in the everyday business of the corporation, inside directors are held to a greater standard of care than outside directors.²⁰⁶ Some commentators go one step further in advocating state legislation reflecting varying degrees of care for directors based on their relation to the corporation.²⁰⁷ Generally, however, the flexible state statutory due-care standards hold inside and outside directors liable for not acting as reasonable persons would in like circumstances.²⁰⁸

Outside directors have become increasingly important to the modern corporation.²⁰⁹ As corporate governance evolves through the 1990s, outside directors will continue to constitute the majority on most boards.²¹⁰ The objectivity of outside directors and their moni-

is only "part-time." Furthermore, board committees allow outside directors to "focus on a particular problem" as well as to apply "specialized knowledge and experience" to board service. *Id.* at 2109. See also Scott V. Simpson, *The Emerging Role of the Special Committee—Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest*, 43 BUS. LAW. 665 (1988).

206. "The standards applied to . . . [nondirector officers and inside directors] . . . are high and reflect their greater responsibilities and their obligation of greater familiarity with the affairs of the corporation." KNEPPER & BAILEY, *supra* note 198, at 15. See *Bates v. Dresser*, 251 U.S. 524 (1920). In *Bates*, the court held that a bank president owed a greater degree of care because he controlled the bank's business affairs and that a director who did not have significant involvement with the daily business operations did not owe as high a degree of care. *Id.* at 529-31. However, the state legislation limiting director liability does not in most cases offer the same protection to corporate officers. See *infra* part III.C.2.

207. State corporation laws do not generally provide separate standards for different classes of board service. Yet, as commentators argue, "[i]f . . . nondirector officers are expected to assume responsibilities commensurate with their familiarity with the corporation's affairs, the same rule should apply to inside directors who are officers or employees of the corporation." KNEPPER & BAILEY, *supra* note 198, at 18. For a discussion of the duty of care and business judgment rule, see *infra* parts III.B.1 and III.B.2. For the state statutory fiduciary enactments, see part III.C.2.

208. See *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

209. Hamilton, *supra* note 191, at 6. The enhanced role and growth of the outside directorship evolved "on a de facto basis, without legal compulsion or a great deal of fanfare." As a result "outside independent directors comprise the majority of most boards of directors of publicly held corporations." *Id.* (citations omitted). The growth of the outside directors' role is directly attributable to a belief that the majority of board members should not have a direct relationship with everyday management and the realization of the importance of outside directors in critical corporate decisions. *Id.* at 7.

210. The modern corporation will assuredly continue to flourish under the monitoring model and the auspices of outside directors. What remains to be seen is whether financial

toring role inspires managerial fidelity to the corporation.²¹¹ It is precisely this monitoring role that has enhanced the value of the outside directors to the corporation. At the same time, however, the monitoring role creates the unfortunate side effect of complicating the already controversial corporate fiduciary regime.

B. *Managerial Accountability: The Duty of Care, the Business Judgment Rule, and the Duty of Loyalty*

Directors and officers have been the corporate decisionmakers for over one hundred years.²¹² Yet only recently, with the *Trans Union* liability explosion of the mid-1980s,²¹³ have issues of director and officer liability gained prominence.²¹⁴ Because of the *Trans Union* decision and subsequent liability growth, qualified members of corporate boards—outside directors in particular—resigned or refused to serve in directorial positions to avoid liability.²¹⁵

Fiduciary law reflects courts' and state legislatures' concern that corporations attract and keep qualified directors.²¹⁶ Fiduciary doctrine therefore attempts to achieve a balance between managerial autonomy and accountability to shareholders. The recognition of this basic conflict in corporate governance has led to a body of law that attempts to reconcile the competing interests of management and ownership. An exposition of the evolution of the director's duty of care, duty of loyalty, and the business judgment rule will facilitate an understanding of the traditional corporate governance model and the

institutions can survive in a regulatory environment which hampers their ability to attract the same outside directors so crucial to the modern corporation. See *infra* part VI.

211. Corporate Directors Guidebook, 33 BUS. LAW. 1591 (1978). "If the board of directors is to function effectively . . . , a significant number of its members should be able to provide independent judgment regarding the proposals under consideration." *Id.* at 1619.

212. For an early American case discussing the relationship between shareholders and management, see *Percy v. Millaudon*, 8 Mart. (N.S.) 68, 74-75 (La. 1829). The most notable early Supreme Court recognition of the fiduciary duties of management to the corporation and its shareholders is *Pepper v. Litton*, 308 U.S. 295, 306 (1939) (stating that "[a] director is a fiduciary"). See also McMurray, *supra* note 102, at 605.

213. See *infra* discussion in Part III.C.

214. See Jesse A. Finkelstein, *Introduction, Symposium: Director and Officer Liability and Indemnification*, 24 WAKE FOREST L. REV. 1 (1989) ("Over the past decade, a great deal of judicial and scholarly attention has been focused upon issues of director liability."); *Introduction, Special Project: Director and Officer Liability*, 40 VAND. L. REV. 601 (1989).

215. See Bradley & Schipani, *supra* note 66 (compiling and analyzing empirical evidence on the effects of *Trans Union* liability on corporate governance); Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985). Outside directors, in particular, who often serve on corporate boards for nominal salaries, will not accept positions if they face substantial liability for "bad" decisions.

216. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986); *Joy v. North*, 692 F.2d 880 (2d Cir. 1982).

potential effect of expanded director liability on the corporate form of business organization.

1. THE DUTY OF CARE

Since the early 1800s, courts have required corporate managers to exercise due care and diligence in managing the corporation's business affairs.²¹⁷ Most courts have found that corporate managers owe some duty of care, but have disagreed on a uniform standard of care for corporate directors.²¹⁸ As a result, three common law standards of care have evolved: (1) the degree of care to avoid gross negligence;²¹⁹ (2) the degree of care that an ordinarily prudent person would exercise in conducting personal business affairs;²²⁰ and (3) the degree of care that an ordinarily prudent person would exercise under like circumstances.²²¹ Although each standard contemplates some form of negligence, the expectations of behavior are different under each. Like negligence law, fiduciary law holds managers liable only when their breach of duty is the actual and proximate cause of the damage claimed.²²²

For the most part, managers of financial institutions have been held to the same fiduciary standard as other corporate managers.²²³

217. See McMurray, *supra* note 102, at 605.

218. *Id.* at 607.

219. *Id.* McMurray cites *Godbold v. Branch Bank*, 11 A.L.A. 191, 200 (1847), for the proposition that "bank directors are liable only for errors of the grossest kind," and *Percy v. Millaudon*, 8 Mart. (N.S.) 68, 74-75, 78 (La. 1829) for the proposition that "bank directors must devote only ordinary care and attention to their jobs in order to avoid making gross errors." *Id.*

220. McMurray, *supra* note 102, at 607 (citing *Berkhart v. Smith*, 157 A. 299, 301 (Md. Ct. App. 1931) and *Marshall v. Farmers & Mechanics' Sav. Bank*, 8 S.E. 586, 590 (1889)).

221. McMurray, *supra* note 102, at 607 (citing *Briggs v. Spaulding*, 141 U.S. 132, 152 (1891); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963)). For a thorough discussion of all three common law standards of care, see KNEPPER & BAILEY, *supra* note 198, Sec. 2.3, at 43-47.

222. Compare *United States v. Carroll Towing Co.*, 159 F.2d 169 (2nd Cir. 1947) (Hand, J.) with *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924) (Hand, J.).

As Judge Learned Hand concludes in *Barnes*, liability attaches only where the breach of care results in damage to the corporation.

When the corporate funds have been illegally lent, it is a fair inference that a protest would have stopped the loan, and that the directors' neglect caused the loss, but when a business fails from general mismanagement, business incapacity, or bad judgment, how is it possible to say that a single director could have made the company successful or how much in dollars he could have saved?

Id. at 616. See also American Law Institute Prin. of Corp. Gov. § 7.16 ("an omission that constitutes a breach of the [duty of care or loyalty] is the legal cause of loss incurred by the corporation . . . if the plaintiff proves that . . . the performance of the duty would have been a substantial factor in averting the loss. . . ."); RESTATEMENT 2D OF TORTS § 886(A).

223. CARY & EISENBERG, *supra* note 198, at 516.

Although several early bank embezzlement cases suggested that bank directors might owe a higher standard of care than other corporate managers,²²⁴ on the theory that "the reasonable person standard" presupposes greater care for directors handling large liquid assets, modern courts have not imposed higher standards on bank directors.²²⁵ State and federal legislatures, however, have subjected managers of financial institutions to a variety of civil liabilities.²²⁶

The decisions most frequently cited for duty of care/business judgment language are *Bates v. Dresser*,²²⁷ *Graham v. Allis-Chalmers Manufacturing Co.*,²²⁸ *Kamin v. American Express Co.*,²²⁹ *Francis v. United Jersey Bank*,²³⁰ and *Joy v. North*.²³¹ In *Bates*, the United States Supreme Court discussed the liability of the directors and the president of a national bank for the depletion of the bank's assets resulting from employee theft.²³² Justice Holmes found that the directors of the bank had not breached their duty of care where they relied on the bank cashier's statement of the assets and liabilities.²³³ Furthermore, the court concluded that the bank president's "daily presence" at the bank justified the other directors reliance on his assurances and that the directors could not be "bound by virtue of the office gratuitously assumed by them" ²³⁴ Justice Holmes found the bank's president liable based on his "insider" role in the bank.²³⁵ Because of his daily presence in the bank and his direct influence on the everyday business of the bank, the court expected the bank presi-

224. *Id.* (citing *Greenfield Sav. Bank v. Abercrombie*, 97 N.E. 897, 899 (Mass. 1912); *Cosmopolitan Trust Co. v. Mitchell*, 136 N.E. 403, 408 (Mass. 1922); *Litwin v. Allen*, 25 N.Y.2d 667, 678 (1940)).

225. *Id.* (citing *McDonnell v. American Leduc Petroleum, Ltd.*, 491 F.2d 380, 383 (2d Cir. 1974); A.L.I., *Principles of Corporate Governance* Sec. 4.01, introductory note, cmt. c (draft no. 4, 1985)). The flexible application of the duty of care suggests differences between the fiduciary duties of financial and nonfinancial corporate officers and directors. Since financial corporations typically engage in business with "the regular receipt of cash or property" and the maintenance of large liquid assets, the risk and temptation for mishandling or self-dealing is greater than with other corporations. Furthermore, the various state and federal enactments dealing with financial institutions "may impose special obligations" on directors. CARY & EISENBERG, *supra* note 198, at 517.

226. See *infra* part IV.C for a discussion of FIRREA's imposition of civil liability.

227. 251 U.S. 524 (1920).

228. 188 A.2d 125 (Del. 1963).

229. 383 N.Y.S.2d 807 (N.Y. App. Div. 1976).

230. 432 A.2d 814 (N.J. 1981).

231. 692 F.2d 880 (2d Cir. 1982).

232. *Bates*, 251 U.S. at 526-28.

233. *Id.* at 529-30.

234. *Id.* at 530 (citing *Briggs v. Spaulding*, 141 U.S. 132 (1891) and *Warner v. Penoyer*, 91 F. 587 (2d Cir. 1898)).

235. *Id.* at 530-31.

dent to react to indications of wrongdoing.²³⁶

In *Graham*,²³⁷ directors of a manufacturing company faced a stockholder derivative suit alleging due care liability for damage to the company resulting from price fixing and other federal antitrust violations by four company employees.²³⁸ The stockholders claimed that the directors should have taken action to learn of and prevent the employees' violations.²³⁹ The court refused to hold the directors liable because of the size, complexity, and decentralized management of the corporation.²⁴⁰ As the court explained, the "nature of the enterprise" ensured that the "company's directors could not know personally all the company's employees," which effectively limited the board to "broad policy decisions"²⁴¹ The court concluded that the directors properly relied on corporate records and reports and could not be found liable where there was no warning or hint of wrongdoing.²⁴²

Stockholders in *Kamin*²⁴³ claimed that corporate directors negligently permitted the declaration of stock dividends instead of selling the dividend stock on the open market, which would have saved nearly eight million dollars in corporate taxes.²⁴⁴ In finding that the directors had not breached their duty of care, the court assumed that decisionmaking errors could not form the basis of liability because "the powers of those entrusted with corporate management are largely discretionary."²⁴⁵ Furthermore, the court held, liability does not result from an imprudent decision.²⁴⁶ As the court explained: "To allege that a director negligently permitted the declaration and

236. *Id.* As Justice Holmes explained, "[t]he position of the president is different. Practically he was the master of the situation. He was daily at the bank for hours, he had the deposit ledger in his hands at times and might have had it at any time. He had hints and warnings" *Id.* at 530.

237. 188 A.2d 125 (Del. 1963).

238. *Id.* at 127.

239. *Id.*

240. *Id.* at 130.

241. *Id.* Allis-Chalmers employed "in excess of 30,000 persons aid extended over a large geographical area." *Id.*

242. *Id.* The Delaware court permitted the directors "to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong." *Id.* at 130. The court intimated that were there hints of wrongdoing, the directors would potentially be subject to liability. *Id.* However, the court was wary to impose a "duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." *Id.*

243. 383 N.Y.S.2d 807 (N.Y. App. Div. 1976).

244. *Id.* at 812.

245. *Id.* (citations omitted).

246. *Id.* ("It is not enough to allege . . . that the directors made an imprudent decision. . . . More than imprudence or mistaken judgment must be shown.").

payment of a dividend without alleging fraud, dishonesty or nonfeasance, is to state merely that a decision was taken with which one disagrees."²⁴⁷ The court concluded that through neither nonfeasance nor malfeasance the directors overlooked facts within their attention.²⁴⁸

In *Francis*,²⁴⁹ the New Jersey Supreme Court found a decedent director's estate liable for breaches of her duty of due care in the oversight of a reinsurance company.²⁵⁰ The deceased director, the largest shareholder of the company, acquiesced in the behavior of the other directors—her two sons—including their misappropriation of funds, which caused damage to the company.²⁵¹ The court found that the director's neglect of her duty of care contributed to the climate of corruption and that her failure to act contributed to her sons' corruption.²⁵² The court identified the minimum guidelines that a director must follow to discharge her duty of care:

[1] [A] director should become familiar with the fundamentals of the business in which the corporation is engaged.

...

[2] Directors are under a continuing obligation to keep informed about the activities of the corporation.

...

[3] Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies.

...

[4] While directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of financial statements.

...

[5] The review of financial statements . . . may give rise to a duty to inquire further into matters revealed by those statements. Upon discovery of an illegal course of action, a director has a duty to object and, if the corporation does not correct the conduct, to resign. . . .

[6] Sometimes a director may be required to seek the advice of counsel . . . [or] . . . in any appropriate case . . . threaten . . . suit . . .

247. *Id.* at 813.

248. *Id.* at 813-14.

249. 432 A.2d 814 (N.J. 1981).

250. *Id.* at 825-26. The court concluded that the decedent had breached her basic duty of "knowledge and suspension of the business . . ." *Id.* at 826. The extent of her obligation included review of financial statements and "reasonable attempts at detection and prevention of the illegal conduct of other officers and directors. *Id.*

251. *Id.* at 818-19.

252. *Id.* at 825-26.

to prevent illegal conduct by co-directors.²⁵³

The court concluded that the decedent had acted merely as a figure-head director, in violation of the New Jersey Business Corporation Act.²⁵⁴

In *Joy*,²⁵⁵ a stockholder brought a derivative suit alleging that bank directors had breached their duty of care when they made unsecured loans to a construction company.²⁵⁶ The court allowed the stockholders to maintain their action, noting that "the loss to City Trust resulted from decisions which put the bank in a classic no-win situation."²⁵⁷ The court, however, outlined the role of the duty of care in corporate governance before reaching its conclusion.²⁵⁸ Whereas tort law negligence attaches liability for errors in judgment, corporate negligence rarely holds a director liable for bad decisions made within the scope of the director's responsibility.²⁵⁹ Though the court leaned toward a lenient duty of care standard, the loan at issue "smelled" of impropriety.²⁶⁰ The court thus found that outside directors who approved the loan would be responsible if they had abdicated their directional responsibility in approving the insiders' presentation of the loan agreement.²⁶¹

The majority of states codify one of the common law standards of care.²⁶² Most of these state statutes, patterned after section 8.30 of the Revised Model Business Corporation Act,²⁶³ adopt the "ordinarily prudent person in like circumstances" standard. Other state stat-

253. *Id.* at 821-23 (citations omitted).

254. *Id.* at 825-26.

255. 692 F.2d 880 (2d Cir. 1982).

256. *Id.* at 884.

257. *Id.* at 896.

258. *Id.* at 885.

259. *Id.* at 885-86. "[T]he fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment . . ." because of the business judgment rule. *Id.* See *infra* part III.B.2.

260. See *id.* at 894-95.

261. *Id.* at 896 ("Directors who willingly allow others to make major decisions affecting the future of the corporation wholly without supervision or oversight may not defend on their lack of knowledge, for that ignorance itself is a breach of fiduciary duty.").

262. For a discussion of state corporate fiduciary laws, see KNEPPER & BAILEY, *supra* note 198, § 2.02, at 38.

263. Section 8.30 of the Revised Model Business Corporation Act provides that

(A) A director shall discharge his duties as a director . . . :

- (1) in good faith;
- (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
- (3) in a manner he reasonably believes to be in the best interests of a corporation.

Revised Model Business Corp. Act § 8.30 (1983).

utes adopt different common law standards.²⁶⁴ Omitting any direct statutory reference to a duty of care, these state statutes enumerate certain acts for which directors will be held liable.²⁶⁵ Delaware and twelve other states did not enact the Revised Model Business Corporation Act or *any* other due care standards, permitting the courts to develop due care standards.²⁶⁶

2. THE BUSINESS JUDGMENT RULE

Although the duty of care doctrine closely resembles negligence doctrine in tort law, the business judgment rule limits courts from holding corporate directors liable for many seemingly negligent actions.²⁶⁷ The business judgment rule precludes liability where a director, in an informed business decision, acts in good faith and in the belief that such a decision is in the best interest of the corporation.²⁶⁸ However, under a duty of care gross negligence regime, the business judgment rule does not protect managers from egregious uninformed business decisions.²⁶⁹ The practical effect of the business judgment rule is that, short of directorial gross negligence, courts refrain from finding a director liable for what ultimately turns out to be a poor business decision.²⁷⁰ Courts generally will not second-guess

264. See KNEPPER & BAILEY, *supra* note 198, § 2.02, at 40.

265. *Id.* § 2.02, at 40 n.14.

266. JOHN F. OLSON & JOSIAH O. HATCH, III, DIRECTOR AND OFFICER LIABILITY INDEMNIFICATION AND INSURANCE, §§ 1.06(4) at 1-28 (1990). However, Delaware did adopt provisions permitting directors to rely on records and presentations by other officers or employees of the corporation where the officer or employee "ha[d] been selected with reasonable care by or on behalf of the corporation." *Id.* citing Del. Gen. Corp. Law § 141(e), amended by 66 Del. Laws, C. 136 (1987 Interim Supp.). Delaware's change toward the Revised Model Business Corporation Act standard with the reliance statute prompted the other twelve states to adopt similar due care statutory provisions. *Id.* at 1-29. Many of the state statutory enactments were amended in the wake of the liability crisis of the mid-1980s to limit director and officer liability after *Trans Union*. See *infra* part III.C.2.

267. For a comprehensive overview of the business judgment rule, see KNEPPER & BAILEY, *supra* note 198, § 6.01-6.17, at 179-208. See also OLSON & HATCH, *supra* note 266, at 1-8. For a discussion of the operation of the business judgment rule before *Trans Union*, see Stuart R. Cohn, *Demise of the Directors' Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591 (1983).

268. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (emphasizing that the business judgment rule protects directors who act "on an informed basis, in good faith, and in the honest belief that [a business decision] was in the company's best interest). See also A.L.I., Principles of Corporate Governance: Analysis and Recommendations, draft no. 11, § 4.01, at 176-77 (hereinafter "A.L.I.") ("A director or officer has a duty to [her] corporation to perform [her] functions in good faith, in a manner that [she] reasonably believes to be in the best interests of the corporation. . .").

269. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); and *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1983), discussed *infra* part III.C. The gross negligence standard of FIRREA is discussed *infra* part IV.C.

270. See Cohn, *supra* note 267, at 591 (arguing that the business judgment rule has

the viability of a business decision as long as the directors made the decision in good faith and without self-dealing.²⁷¹

The business judgment rule recognizes that managers need autonomy in decisionmaking in order to exercise individual business acumen based on a particular corporation's needs.²⁷² As a result, the business judgment rule encourages creative corporate decisionmaking, which in turn maximizes corporate (shareholder) profits.²⁷³ Judicial review of directorial business decisions is perceived as both incompetent and inefficient because courts are insulated from market restraints that check the activities of corporate directors and, as such, are inept decisionmakers in a competitive business environment.²⁷⁴

superseded the duty of care as a fiduciary standard). For discussion of the dearth of cases finding managerial negligence despite the business judgment rule, see Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1360 n.21 (1989); and Bradley & Schipani, *supra* note 66, at 22 n.137. See also KNEPPER & BAILEY, *supra* note 198, § 6.01, at 181. Knepper and Bailey list the "essential components" for the successful operation of the business judgment rule:

- (1) the absence of personal interest or self-dealing;
- (2) an informed decision, attributable to a rational business purpose, based on a reasonable effort to learn the facts;
- (3) a reasonable belief that the decision is in the best interests of the corporation; and
- (4) good faith.

Id. (citing Joseph Hinsey IV, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 610 (1984)).

271. Delaware courts traditionally found decisions to be in good faith when attributed to "any rational business purpose." *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971); Palmiter, *supra* note 270, at 1359 n.17; *but see* *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

272. See *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983). The *Joy* court noted that the nature of the corporate business enterprise oftentimes demands "quick decisions based on less than perfect information." *Id.* The role of the corporate board is to balance risk, uncertainty and profitability in arriving at a business decision. The ineffectiveness and inefficiency of reconstructing this balance makes "after-the-fact litigation . . . a most imperfect device to evaluate corporate business decisions." *Id.*

273. Without the business judgment rule, the corporate fiduciary regime would stifle decisionmaking to the detriment of shareholder/ownership. "Because potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions." *Id.* at 886. A fiduciary suppression of risktaking would ruin the opportunity for portfolio diversification, and would deprive the shareholder of the opportunity to spread risk and choose less or more risky investments based on profit incentive. *Id.* The *Joy* court's single-minded consideration of shareholder profit goals supports the judiciary's adoption of the traditional model of the corporation. See *supra* part II.

274. See Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1288 (1982) (asserting that courts not subject to the constraints of market forces make inferior decisions); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management In Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1196-97 (1981) (arguing that market restraints are a better regulator of corporate decisionmaking than the courts).

Commentators have argued that the business judgment rule swallows the duty of care by permitting directors to escape liability for bad business decisions.²⁷⁵ However, the business judgment rule does not completely eviscerate the duty of care because directors must still generally prove that their decisions were not motivated by self-interest and were informed by all reasonably available, material information.²⁷⁶ Furthermore, the business judgment rule does not protect management from breaches of loyalty to the corporation.²⁷⁷

3. THE DUTY OF LOYALTY

To ensure directorial decisionmaking devoted to the interests of the corporation, corporate fiduciary law imposes upon management a duty of loyalty to the corporation.²⁷⁸ The duty of loyalty prohibits fraud and self-interested corporate decisionmaking.²⁷⁹ The underlying premise is that management's primary obligation is to the corporation and that managers should not use their positions of trust to further personal interests.²⁸⁰

Duty of loyalty litigation focuses primarily on five areas of direc-

275. Perhaps the most widely cited commentary on the power of the business judgment safe harbor to overcome claims of negligence is by Professor Joseph W. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968) ("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.").

276. The emasculation of the business judgment rule in the mid-1980s, particularly in the *Trans Union* decision and the resulting liability crisis, inspired statutory responses limiting managerial liability in much the same way the business judgment rule traditionally protected management. The statutes all generally include a requirement of good faith and informed decisionmaking. For a discussion of the statutory responses to *Trans Union*, see *infra* part III.C.2.

277. See *Lewis v. S.L. & E., Inc.*, 629 F.2d 764, 769 (2d Cir. 1980) ("[T]he business judgment rule presupposes that the director has no conflict of interest.").

278. The duty of loyalty mandates management's "undivided and unselfish loyalty to the corporation . . . [without] conflict between duty and self interest." *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939). But perhaps the most famous articulation of the duty of loyalty is found in the partnership context:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden by those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928).

279. The American Law Institute terms the duty of loyalty "the duty of fair dealing." In an introductory note, the drafters of Part V of the Principles of Corporate Governance offer "the duty of fair dealing . . . [as] . . . a minimum number of rules in cases where a director, officer, or controlling shareholder acts with a pecuniary interest in a matter." A.L.I., *supra* note 268, at 259.

280. See OLSON & HATCH, *supra* note 266, at 1-4.

tor malfeasance.²⁸¹ First is the self-dealing transaction where the director stands to gain personally from a transaction under board consideration.²⁸² The second area of duty of loyalty litigation is executive and director compensation.²⁸³ Courts will find a breach of loyalty when the compensation does not bear some minimal relation to services rendered.²⁸⁴ A third way for officers and directors to breach their duty of loyalty is by usurping a business opportunity that might have benefited the corporation.²⁸⁵ To avoid corporate opportunity lia-

281. *Id.* For an overview of duty of loyalty litigation, see KNEPPER & BAILEY, *supra* note 198, 81-25; CARY & EISENBERG, *supra* note 198, at 556-719; JESSE H. CHOPER, ET AL., CASES AND MATERIALS ON CORPORATIONS, at 268-333.

282. See A.L.I., *supra* note 268, § 5.02, at 273-74. The drafters of the Principles of Corporate Governance describe the requirements for a director to fulfill in a transaction with the corporation. The duty of fair dealing is met if:

- (1) disclosure concerning the conflict of interest and the transaction is made to the corporate decisionmaker who authorizes in advance or ratifies the transaction; and
- (2) (A) the transaction is fair to the corporation when entered into; or
(B) the transaction is authorized in advance, following such disclosure, by disinterested directors . . . who could have concluded that the transaction was fair to the corporation at the time of such authorization; or
(C) the transaction is authorized or ratified, following such disclosure, by disinterested shareholders, and does not constitute a waste of corporate assets at the time of the shareholder action.

Id. (citations omitted). See also *Globe Woolen v. Utica Gas & Electric Co.*, 121 N.E. 378 (N.Y. 1918) (interested director had a duty to warn by disclosure of the unfair nature of a contract in addition to the unexpected disclosure of interest and abstention from voting); *Lewis v. S.L. & E.*, 629 F.2d 764 (2d Cir. 1980) (the defendant director has the burden to prove the fairness of the transaction once a conflict of interest is found); *but c.f. Eliasberg v. Standard Oil Co.*, 92 A.2d 862 (Del. Ch. 1952) (court shifting the burden of proof to the plaintiffs to prove unfairness); see also *Alcott v. Hyman*, 208 A.2d 501, 507 (Del. 1965) (noting that if stockholders ratify a transaction, interested directors must only prove that the decision to proceed with the transaction was based on sound business judgment).

283. Compensation levels generally fulfill the duty of loyalty/fair dealing if:

- (1) the compensation is fair . . . ; or
- (2) authorized in advance or ratified by disinterested directors or . . . authorized in advance by a disinterested superior, in a manner that satisfies the standards of the business judgment rule; or
- (3) the compensation is authorized in advance or ratified, by disinterested shareholders, and does not constitute a waste of corporate assets

A.L.I., *supra* note 268, § 5.03, at 313.

See, e.g., *Rogers v. Hill*, 289 U.S. 582 (1933) (refusing to justify bonuses approved by shareholders where they constitute a sum so large as to amount to a spoilation or waste of corporate property); *Michelson v. Duncan*, 407 A.2d 211 (Del. 1979) (stock options given to director challenged in stockholder derivative suit); *Beard v. Elster*, 160 A.2d 731 (Del. 1960) (requiring a reasonable relationship between the value of stock options granted to directors and the benefit derived by the corporation by granting the options); *Heller v. Boylan*, 29 N.Y.S. 2d 653 (Sup. Ct. 1941) (noting the difficulties involved in resolving the "entangled economic problems" of compensation and concluding that courts should not resolve such issues).

284. See *supra* note 283.

285. A director or officer may not take a corporate opportunity unless she first "offers the opportunity to the corporation" with complete disclosures, the corporation rejects the

bility, managers have to offer the opportunity with full disclosure to the corporation and a majority of disinterested directors must reject it.²⁸⁶ Directors also may usurp a corporate opportunity when they compete unfairly with the corporation upon termination of their services.²⁸⁷ A fourth type of loyalty breach can arise during a fundamental change in corporate control.²⁸⁸ Some courts have also held that directors and majority stockholders owe a fiduciary duty to both the corporation and the minority shareholders not to derive a personal gain or cause harm to the corporation through a windfall stock sale of control or office.²⁸⁹

opportunity, and the rejection is "fair to the corporation or authorized by disinterested directors, executives or shareholders. A.L.I., *supra* note 268, at § 5.05(a). Corporate opportunity is any business opportunity arising in connection with a director's or officer's service to the corporation which she believes the offeree expects to be offered to the corporation or believes to be of interest to the corporation. *Id.* at § 5.05(b)(1). Furthermore, any senior executive usurps a corporate opportunity when she engages in a business activity "closely related" to the corporation or "in which the corporation is engaged or expects to engage." *Id.* at § 5.05(b)(2).

286. Courts have articulated several variations of the corporate opportunity doctrine. The interest/expectancy test finds the taking of a corporate opportunity where an officer or director engages in a business activity in which the corporation has an existing interest or an expectancy of interest. Another judicial measure, the line of business test, determines a corporate opportunity where the corporation has a "fundamental knowledge, practical experience, and an ability to pursue" a business activity that is readily adaptable to a corporation's "needs and aspirations for expansion." *Guth v. Loft, Inc.*, 5 A.2d 503, 514 (Del. 1939). The fairness test focuses on the individual business taking fairness to the interests of the corporation. *See E.G. Durfee v. Durfee & Canning, Inc.*, 80 N.E.2d 522 (Mass. 1948). Yet, another test combines the line of business and fairness analyses. *See Miller v. Miller*, 222 N.W.2d 71 (Minn. 1974); *Kliniki v. Lundgren*, 695 P.2d 906 (Or. 1985). For a discussion of the corporate opportunity standards, see CARY & EISENBERG, *supra* note 198, at 640-42.

287. Corporate directors and officers unfairly compete with the corporation except where "there is no reasonably foreseeable harm to the corporation," where the benefits to the corporation outweigh such harm, or where the competition is authorized or ratified by disinterested directors, a disinterested superior, or disinterested shareholders. A.L.I., *supra* note 268, at § 5.06(a). *See, e.g., Karpinski v. Inglasci*, 268 N.E.2d 751 (N.Y. 1971) (court will uphold covenants not to compete only if they are limited to a reasonable area, line, and scope); *Aero Drapery of Kentucky, Inc. v. Engdahl*, 507 S.W.2d 166 (Ky. Ct. App. 1974) (court held that a corporate fiduciary may not set up a competitive enterprise or resign and take key personnel for the purpose of operating a competitive enterprise).

288. In a transfer of control, one or more directors or officers are interested, the interested party[s] must prove the fairness of the transaction to the shareholders of the corporation unless, after full disclosure, the transfer of control receives disinterested approval, where the party asserting the breach bears the burden of proving a "waste of corporate assets." A.L.I., *supra* note 268, at § 5.15, at 465-66.

289. *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962) (Purchasers of a controlling block of stock, in the absence of a showing of detrimental effect to the corporation, are permitted to take control of office); *Perlman v. Feldman*, 219 F.2d 173 (2d Cir. 1955) (A director owes fiduciary duties to both the corporation and minority shareholders); *Zahn v. Transamerica*, 162 F.2d 36 (3d Cir. 1947) (A majority shareholder breached his fiduciary duty to the minority shareholders by initiating a share redemption that denies the minority shareholders a higher redeemable value while ensuring himself the higher redeemable value);

The duty of loyalty, like the duty of care, evolved from the tension in the corporate structure created by the separation of ownership and management.²⁹⁰ Central to the Berle and Means thesis is management's potential exploitation of ownership wealth.²⁹¹ The duty of loyalty attempts to reconcile the ownership and control conflict by ensuring that managers subordinate their own transactional interests to those of the corporation, under threat of personal liability.

C. *Expanded Liability and Fear*

Despite the imposition of the duty of care and the duty of loyalty, the ownership/control debate flourished. In 1985, the Delaware Supreme Court significantly changed the corporate fiduciary doctrine in a decision that heightened managerial accountability to shareholder-ownership. *Smith v. Van Gorkom* ("*Trans Union*")²⁹² redefined the relationship between the duty of care and the business judgment rule. Extensive literature²⁹³ and subsequent sweeping state

DeBaun v. First Western Bank & Trust Co., 120 Cal. Rptr. 354 (1975) (where a purchaser of control looted a corporation, the seller was held liable for the corporation's lost net worth, lost going concern value, and unpaid debts because the Seller became aware of facts that would have alerted a prudent person that the buyer was likely to loot the corporation.); *Brown v. Halibert*, 76 Cal. Rptr. 781 (1969) (Holding controlling shareholder/director liable for diverting a purchaser from a merger with the corporation to the purchase of the director's stock only, at a higher price); *Jones v. Ahmanson & Co.*, 460 P.2d 464 (Cal. 1969) (Controlling shareholders cannot use their position to contrive a marketing scheme benefitting them alone while subordinating the value of the minority shares. Majority shareholders have a duty to use their power in a fair, just and equitable manner); *Caplan v. Lionel Corp.*, 198 N.E.2d 908 (N.Y. 1964) ("The underlying principle is that the management of a corporation is not the subject of trade and cannot be bought apart from actual stock control . . . where there has been a transfer of the majority of stock, or even such a percentage as gives working control, a change of directors . . . is proper"); *Carter v. Muscat*, 21 A.D.2d 543, 251 N.Y.S.2d 378 (1964) (Noting that working control through an acquisition of stock is required to affect control of the Board of Directors absent a stockholder election with full knowledge of the director's accession to the board, approving the director's membership on the board); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (1941) (Director/shareholders had a duty to insure that the corporation would not be left in jeopardy after a corporate sale of control and director resignation.). The majority of case law does however permit the sale of a controlling share of stock at a premium. See *Zetlin v. Housan Holdings, Inc.*, 397 N.E.2d 387 (N.Y. 1979) (Noting that it has been settled law that, absent looting of corporate assets, conversion of a corporate opportunity, fraud or other acts of bad faith, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price); cf. *Seagrave Corp. v. Mount*, 212 F.2d 389, 395 (6th Cir. 1954); *Doleman v. Meiji Mut. Life Ins. Co.*, 727 F.2d 1480 (9th Cir. 1984).

290. For an overview of the historical evaluation of the duty of loyalty, see McMurray, *supra* note 102, at 623-28.

291. See BERLE & MEANS, *supra* part II.A.

292. 488 A.2d 858 (Del. 1985).

293. See, e.g., Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985); Leo Herzel & Leo Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187 (1986); Bayless Manning, *Reflections and*

statutory reforms²⁹⁴ document the significance of *Trans Union* and presage the potential effects of FIRREA on the corporate boardrooms of insured depository institutions.

1. *TRANS UNION* AND THE NEW FIDUCIARY REGIME

In *Trans Union*, shareholders claimed that the corporation's directors had breached their duty of care in an attempted cash-out merger proposed by Jerome Van Gorkom, chairman of *Trans Union*, and Jay Pritzker, a corporate takeover specialist.²⁹⁵ Van Gorkom offered to sell *Trans Union* to Pritzker for fifty-five dollars per share,²⁹⁶ a price on the low end of the fair-market value range for the company.²⁹⁷ Van Gorkom did not disclose to the board of directors that the fifty-five dollar price was low, and left the board to assume that Van Gorkom and Pritzker had negotiated the price.²⁹⁸ After Van Gorkom gave a twenty-minute presentation about the merger, the board discussed the merger for two hours and ratified the proposal without further review.²⁹⁹ Furthermore, the board approved amendments based primarily upon Van Gorkom's oral representations and later approved additional amendments to the merger agreement "sight unseen," again based on Van Gorkom's representations.³⁰⁰

The Delaware Supreme Court held that the board of directors had breached its duty of care by failing to make an informed business decision on the merger proposal.³⁰¹ Although the court did not abolish the business judgment rule's application to corporate transactions, it concluded that the rule applied only after a board had shown that it based its business decision on all information reasonably available.³⁰² *Trans Union* thus altered the relationship between the duty of care and the business judgment rule by requiring directors to prove that they were not negligent in the decisionmaking process before receiving the protection of the business judgment rule. This requirement

Practical Tips on Life in the Boardroom After Van Gorkom, 41 BUS. LAW. 1 (1985); William T. Quillen, *Trans Union, Business Judgment and Neutral Principles*, 10 DEL J. CORP. L. 465; Stephen A. Radin, *The Director's Duty of Care Three Years After Smith v. Van Gorkom*, 39 HASTINGS L.J. 707 (March 1988).

294. See *infra* part III.C.3.

295. 488 A.2d at 863.

296. *Id.* at 866-67.

297. *Id.* at 867 n.6.

298. *Id.* at 868.

299. *Id.* at 868-69. When officers of *Trans Union* balked at the merger and threatened to resign, Van Gorkom and Pritzker agreed to amend the proposal to ensure the continued employment of dissident officers.

300. *Id.* at 869.

301. *Id.* at 884.

302. *Id.* at 872.

effectively extended the duty-of-care negligence standard to the process of deliberative decisionmaking, compelling stricter diligence for directors before they reached the safe harbor of the business judgment rule.³⁰³

2. LEGISLATIVE RESPONSES TO *TRANS UNION*

Corporate communities in Delaware and across the nation soon felt the impact of *Trans Union*. The cost of liability insurance became prohibitive as premiums soared.³⁰⁴ Potential directors declined corporate positions to avoid liability and existing corporate directors resigned.³⁰⁵ Both feared extraordinary personal liability from decisions made in corporate service in exchange for frequently nominal compensation. Fearing the demise of Delaware's "corporate cradle" as a result of *Trans Union* and the liability insurance crisis it generated, the Delaware legislature enacted section 102(b)(7) of title 8 of the Delaware Code.³⁰⁶ The Delaware legislature sought to alleviate the director and officer liability crisis by limiting directors' liability in section 102(b)(7).³⁰⁷ Other state legislatures, following Delaware's lead, enacted a variety of measures limiting director liability to attract capable and qualified persons to board service.³⁰⁸

303. In effect, under *Trans Union*, courts could second-guess managerial business judgment as to the method and choice of business deliberation.

304. Andrea Bennett, *Losses Spur Spate of Suits Against Managers*, AM. BANKER, Aug. 8, 1985, at 1; Frank A. Beranek, *Outlook for Blanket Bonds and Directors' and Officers' Liability*, AM. BANKER, Oct. 15, 1985, at 4; *Insurer's Failure to Insure Directors Could Ensure Them Some Worries*, WALL ST. J., Sept. 22, 1983, at 23; Kenneth Labich, *Showdown Over Insuring Corporate Officers—When Chase and BankAmerica Tried to Collect Big Damages by Suing Their Employees, the Insurance Companies Cried Foul*, FORTUNE, Dec. 9, 1985, at 70; Robin Schatz, *Focus on Corporate Boards—Directors Feel the Legal Heat*, N.Y. TIMES, Dec. 15, 1985, at F12; see also Daniel Hertzberg, *Insurers Beginning to Refuse Coverage On Directors, Officers in Takeover Cases*, WALL ST. J., Jan. 20, 1986, at A3.

305. See Bradley & Schipani, *supra* note 66, at 47.

306. 1986 DEL. LAWS ch. 289 amending DEL. GEN. CORP. LAW § 102(b)(7) (Supp. 1986). The Delaware statute permits corporations to include in the articles of incorporation:

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, . . . (iv) for any transaction from which the director derived an improper personal benefit.

Id.

307. See *supra* note 304.

308. For a discussion of the variety of state statutory proposals and enactments, see James J. Hanks, *Evaluating Recent State Legislation on D&O Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988). Hanks summarizes the liability limitation enactments as follows:

Section 102(b)(7) permits corporate charters to circumscribe damages for breaches of directors' duty of care not involving bad faith or intentional misconduct.³⁰⁹ It limits liability in shareholders' direct or derivative litigation, but not in suits by governmental agencies and other third parties.³¹⁰ As a result of section 102(b)(7), many firms that previously were deterred from incorporation by *Trans Union*, again "raced" to incorporate in Delaware.³¹¹ Arguably, under section 102(b)(7), the Delaware Supreme Court would exonerate the *Trans Union* directors from liability for failing to inform themselves adequately absent a showing of bad faith or intentional misconduct.³¹²

Other state legislatures have enacted statutory provisions limiting director liability.³¹³ Certain states have employed liability limita-

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- (1) Authorizing charter provisions eliminating or limiting personal liability for money damages ("charter option statutes");
 - (2) Changing the standard of liability for money damages to require more than gross negligence ("self-executing statutes");
 - (3) Capping on liability for monetary damages;
 - (4) Expanding the corporation's right to indemnify against judgments, settlements, and expenses in derivative suits;
 - (5) Expanding nonexclusivity provisions;
 - (6) Expanding the criteria that directors may consider in reaching decisions "other constituency statutes"; and
 - (7) Authorizing reimbursement from sources other than conventional insurance.

Id. at 1210. The vast majority of states had enacted liability limitation statutes by the end of the 1980s in response to "both the realities, and the business community's perceptions of the liability crisis . . ." OLSON & HATCH, *supra* note 266, at § 5.01, at 5-2.

309. See *supra* note 306.

310. See *supra* note 306.

311. See Cary, *supra* note 33, for a discussion of the "race to the bottom" as states seek to attract prospective corporations through permissive corporate laws. For an excellent empirical analysis of the effect of the *Trans Union* decision, see Bradley & Schipani, *supra* note 66.

312. The Delaware court found that the board members were grossly negligent for failing adequately to inform themselves. 488 A.2d at 874. Given the absence of bad faith, breaches of loyalty, intentional misconduct or violations of law in the opinion, a 102(b)(7) corporate provision would either "limit" or "eliminate" monetary liability for breaches of fiduciary duty depending upon the particular language of the corporate charter. See Bradley & Schipani, *supra* note 66, at 43. In fact, Justice McNeilly in the *Trans Union* dissent argued for the application of the business judgment rule because of the directors expert ability to make corporate decisions such as the sale of the corporation. 488 A.2d at 894-95 (McNeilly, J., dissenting).

313. Reviving the debate in the corporate governance scholarship between the coercionists and contractarians on mandatory or default corporate laws, the various state provisions limiting director liability in the wake of *Trans Union* are either mandatory changes in the due care standard or optional charter amendment provisions. The charter amendment provisions permit a corporation, at the choice of its stockholders, to amend the corporate charter to reflect a limitation on due care liability. See ALASKA STAT. § 10.06.210(1)(N) (Supp. 1989) (optional/charter amendment); ARIZ. REV. STAT. ANN. § 10-054(A)(9) (Supp. 1989) (optional/charter amendment); ARK. CODE ANN. § 4-27-202(B)(3) (Supp. 1989) (optional/

tion methods different from Delaware's charter-option statute.³¹⁴

charter amendment); CAL. CORP. CODE §§ 204(a)(10) and 204.5 (West Supp. 1990) (optional/charter amendment); COLO. REV. STAT. §§ 7-3-101(u) and 7-2-102(1.5)(d) (Supp. 1988) (optional/charter amendment); CONN. GEN. STAT. § 33-290(c)(2) (1987) (optional/charter amendment); DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988) (optional/charter amendment); FLA. STAT. ANN. § 607.0831 (West Supp. 1990) (mandatory/self enacting); GA. CODE ANN. § 14-2-202(b)(4) (1989) (optional/charter amendment); HAW. REV. STAT. § 415-48A (1985) (optional/charter amendment); IDAHO CODE § 30-1-54(2) (Supp. 1989) (optional/charter amendment); IND. CODE ANN. § 23-1-35-1(e) (Burns Supp. 1989) (mandatory/self enacting); IOWA CODE §§ 491.5(8), 496A.49(13) (Supp. 1989) (optional/charter amendment); KAN. STAT. ANN. § 17-6002(b)(8) (1988); KY. REV. STAT. ANN. § 271B.2-020(2)(d) (Michie/Bobbs-Merrill 1989) (optional/charter amendment); LA. REV. STAT. ANN. § 12:24(C)(4) (West Supp. 1989) (optional/charter amendment); ME. REV. STATE. ANN. tit. 13-A, § 716 (West Supp. 1988) (mandatory/self enacting); MD. CORPS. & ASS'NS CODE ANN. §§ 2-104(b)(8) and 2-405.2 (Supp. 1989) (optional/charter amendment); MASS. GEN. LAWS ANN. ch. 156B, § 13(b)(1 1/2) (Mich. Supp. 1989) (optional/charter amendment); MICH. COMP. LAWS ANN. § 450.1209(c) (West Supp. 1989) (optional/charter amendment); MINN. STAT. ANN. §§ 302A.111(u) and 302A.251(4) (West Supp. 1990) (optional/charter amendment); MO. REV. STAT. § 351.345 (Supp. 1990) (mandatory/self enacting); MONT. CODE ANN. § 35-202(e) (1987) (optional/charter amendment); NEB. REV. STAT. ANN. § 21-2035(2) (Supp. 1988) (optional/charter amendment); NEV. REV. STAT. § 78.037 (Michie Supp. 1989) (optional/charter amendment); N.H. REV. STAT. ANN. § 293-A:54(I-a) (1987) (optional/charter amendment); N.J. REV. STAT. ANN. § 14A:2-7(3) (West Supp. 1989) (optional/charter amendment); N.M. STAT. ANN. § 53-12-2(E) (Michie Supp. 1988) (optional/charter amendment); N.Y. BUS. CORP. LAW § 402(b) (McKinney Supp. 1990) (optional/charter amendment); N.C. GEN. STAT. § 55-7(11) (Supp. 1989) (optional/charter amendment); OHIO REV. CODE ANN. § 1701.59(D) (Baldwin Supp. 1985) (mandatory/self enacting); OKLA. STAT. ANN. tit. 18, § 1006(B)(7) (West Supp. 1990) (optional/charter amendment); OR. REV. STAT. § 60.047(2)(c) (1988) (optional/charter amendment); PA. CONS. STAT. tit. 15, § 1721(e) (Supp. 1989 and 1989 Special Pamphlet) (optional/charter amendment); R.I. GEN. LAWS § 7-1.1-48(a)(6) (Supp. 1988) (optional/charter amendment); S.C. CODE ANN. § 33-2-102(e) (Laws Co-op. Supp. 1988) (optional/charter amendment); S.D. CODIFIED LAWS ANN. § 47-2-58.8 (Supp. 1989) (optional/charter amendment); TENN. CODE ANN. § 48-12-102(b)(3) (1988) (optional/charter amendment); TEX. CORPS. & ASS'NS ANN., § 1302-7.06 (Vernon Supp. 1990) (optional/charter amendment); UTAH CODE ANN. § 16-10-49.1 (Supp. 1989) (optional/charter amendment); VA. CODE ANN. § 13.1-692.1 (1989) (mandatory/self enacting); VA. CODE ANN. § 13.1-692.1 (1989) (optional/charter amendment); WASH. REV. CODE § 23A.12.020(10)(d) (Supp. 1989) (optional/charter amendment); WIS. STAT. ANN. § 180.307 (West Supp. 1989) (mandatory/self enacting); WYO. STAT. § 17-1-202(C) (Supp. 1987) (optional/charter amendment). For a discussion of these statutes, see KNEPPER & BAILEY, *supra* note 198, at § 7,204-230; OLSON & HATCH, *supra* note 266, at §§ 1.07, 1-29-1-37.

314. See *supra* note 313 for those state statutes that are mandatory/self-enacting changes in the due care standard.

Ohio,³¹⁵ Florida,³¹⁶ and Indiana,³¹⁷ for instance, have lowered the standard of care expected of corporate directors.³¹⁸ These statutes generally require a showing of willful misconduct or recklessness for a

315. OHIO REV. CODE ANN. § 1701.59 (Baldwin Supp. 1985). Ohio's due care provisions as amended in the aftermath of the *Trans Union* liability crisis read in pertinent part:

(C) (1) A director shall not be found to have violated his duties under division (B) of this section unless it is proved . . . the director has not acted in good faith, in a manner he reasonably believes to be in or not opposed to the best interests of the corporation, or with the care than an ordinarily prudent person in a like position would use under similar circumstances, in any action brought against a director

(D) A director shall be liable in damages for any action he takes or fails to take as a director only if it is proved . . . that his action or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the corporation or undertaken with reckless disregard for the best interests of the corporation

316. FLA. STAT. ANN. § 607.0831 (West Supp. 1990). Florida's due care liability limitation provisions read in pertinent part:

607.0831. LIABILITY OF DIRECTORS

(1) A director is not personally liable . . . unless:

(a) The director breached or failed to perform his duties as a director; and

(b) The director's breach of, or failure to perform, those duties constitutes:

1. A violation of the criminal law. . . .

2. A transaction from which the director derived an improper personal benefit, either directly or indirectly;

. . . .

4. In a proceeding . . . in the right of a shareholder, conscious disregard for the best interest of the corporation, or willful misconduct; or

5. In a proceeding by or in the right of someone other than the corporation or a shareholder, recklessness or an act or omission which was committed in bad faith or with malicious purpose

317. IND CODE ANN. § 23-1-35-1 (Burns Supp. 1989). Indiana's due care provisions read in pertinent part:

(a) A director shall, based on facts then known to the director, discharge the duties as a director,

(1) In good faith;

(2) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) In a manner the director reasonably believes to be in the best interests of the corporation.

. . . .

(e) A director is not liable for any action taken as a director, or any failure to take any action, unless:

(1) The director has breached or failed to perform the duties of the director's office in compliance with this section; and

(2) The breach or failure to perform constitutes willful misconduct or recklessness.

318. For an excellent discussion of the differences in the state statutes found *supra* notes 313-317, see KNEPPER & BAILEY, *supra* note 198, at § 7.05-7.09, 219-24.

director to incur duty of care liability.³¹⁹ Unlike section 102(b)(7),³²⁰ the statutes lowering the duty of care standard are self-executing and do not require amendments to the corporate charter.³²¹

Another approach to limiting director liability imposes a cap on monetary awards in duty of care lawsuits.³²² Virginia limits director liability to \$100,000.³²³ The Virginia legislature, however, went even further by permitting individual corporations to limit director liability to as little as one dollar with stockholder approval.³²⁴ Many states have also adopted indemnification statutes permitting the corporation to reimburse directors suffering damage losses in fiduciary duty litigation.³²⁵ In sum, the state statutes limiting director and officer liability

319. See OHIO REV. CODE ANN. § 1701.59(D) (Baldwin Supp. 1985); FLA. STAT. ANN. § 607.0831(1)(b)(4)-(5) (West Supp. 1990); IND. CODE ANN. § 23-1-35-1(e) (Burns Supp. 1989).

320. DEL. CODE ANN. tit. 8 § 102(b)(7) (Supp. 1985).

321. The Ohio, Indiana and Florida statutes limiting liability may be "opted out" by corporate amendment or bylaws. For Ohio opt out provisions, see OHIO REV. CODE ANN. § 1701.59(D) (Baldwin Supp. 1985). For Indiana corporations "opting out" of the liability limiting statute, see KNEPPER & BAILEY, *supra* note 198, at § 7.05, 219.

322. VA. CODE ANN. § 13.1-692.1 (1989).

323. *Id.* The Virginia due care provisions read in pertinent part:

A. In any proceeding brought by a shareholder in the right of a corporation or brought by or on behalf of shareholders of the corporation, the damages assessed against an officer or director arising out of a single transaction, occurrence or course of conduct shall not exceed the lesser of:

1. The monetary amount specified in the articles of incorporation or
2. The greater of (i) \$100,000 or (ii) the amount of cash compensation received by the officer or director from the corporation during the twelve months immediately preceding the act or omission for which liability was imposed.

B. The liability of an officer or director shall not be limited . . . if the officer or director engaged in willful misconduct or a knowing violation of the criminal law or of any federal or state securities law,

324. *Id.* at (A)(1).

325. See, e.g., ALA. CODE § 10-2A-21 (1987); CAL. CORP. CODE § 317 (West Supp. 1990); CONN. GEN. STAT. § 33-320(a) (1987); DEL. CODE ANN. tit. 8, § 145 (1988); D.C. CODE ANN. § 29-304(16) (1981); FLA. STAT. ANN. 607.014 (West Supp. 1989); GA. CODE ANN. §§ 14-2-850 to 859 (1980); ILL. REV. STAT. ch. 32, para. 8.75 (Supp. 1989); IND. CODE ANN. §§ 23-1-37-1 to -15 (Burns Supp. 1989); IOWA CODE ANN. § 496A.4A (West Supp. 1989); KAN. STAT. ANN. § 17-6305 (1988); MD. CORPS. & ASS'NS CODE ANN. § 2-418 (Supp. 1989); MASS. GEN. LAW ANN. ch. 156B, § 67 (West Supp. 1989); MICH. CORP. LAWS ANN. §§ 450.1561 to -1571 (Supp. 1989); MINN. STAT. ANN. § 362A.521 (West Supp. 1990); MISS. CODE ANN. §§ 79-4-8.50 to -8.58 (Supp. 1988); MO. REV. STAT. § 351.355 (Vernon Supp. 1990); N.J. REV. STAT. § 14A:3-5 (West Supp. 1987); N.Y. BUS. CORP. LAW §§ 721-726 (McKinney Supp. 1990); OHIO REV. CODE ANN. § 1701.13(E) (Supp. 1988); PA. CONS. STAT. tit. 15, § 1741-1750 (Supp. 1989 and 1989 Special Pamphlet); R.I. GEN. LAWS § 7-1.1-4.1 (1988); TEX. BUS. CORP. ACT ANN. art 2.02-1 (Supp. 1990); VT. STAT. ANN. tit. 11, § 1852(15) (1984); VA. CODE ANN. §§ 13.1-696 to -704 (1989); WASH. REV. CODE ANN. § 23A.08.025 (Supp. 1989); W.VA. CODE § 31-1-9 (1988); WIS. STAT. ANN. §§ 180.042 to .059 (West Supp. 1989). For a comprehensive discussion of Indemnification, see OLSON & HATCH, *supra* note 266, at §§ 4-9.

alleviated fears that corporations would be unable to attract experts in corporate business to directorship positions after *Trans Union*,³²⁶ and fueled a resurgence in the director and officer liability insurance³²⁷ market.

IV. SAVINGS AND LOAN INSTITUTIONS: A CORPORATE FORM IN CRISIS

In the 1980s, one of the United States' major corporate industries, savings and loan institutions, faced economic crisis. Congress responded by restructuring the regulatory apparatus that had governed savings and loans since the Great Depression of the 1930s. Perhaps most significantly, Congress reformulated the corporate fiduciary regime, which had existed since the Berle and Means thesis attempted to resolve the ownership and control problem of the modern corporation.³²⁸ The Financial Institutions, Reform, Recovery and Enforcement Act of 1989 (FIRREA)³²⁹ abrogates the state statutory corporate governance schemes that have limited director and officer liability since the *Trans Union* decision.³³⁰

New issues in corporate governance arise in the context of a federally regulated corporate financial industry. The federal government and Congress, driven by a public enraged by a \$500 billion bill³³¹ and a depressed economy, have sought to find scapegoats in the boardroom of failed savings and loans institutions. Because of a few high-

326. For an overview of the effects of the state statutory liability limitations, see Bradley & Schipani, *supra* note 66; Thomas C. Lee, *Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Directors' Duty of Care*, 136 U. PA. L. REV. 239 (1987); Steven J. Schleicher, *Director Liability Dilemma: Providing Relief for Executive Anxiety*, 56 U. MO. K.C. L. REV. 367 (1988); Stacy D. Blank, *Delaware Amendment Relaxes Director's Liability*, 44 WASH. & LEE L. REV. 111 (1987); James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988); Dale A. Oesterle, *The Effect of Statutes Limiting Directors Due Care Liability on Hostile Takeover Defenses*, 24 WAKE FOREST L. REV. 31 (1989); Norman Veasey et al., *Delaware Supports Directors with Limited Liability, Indemnification and Insurance*, 42 BUS. LAW. 399 (1987).

327. For a comprehensive discussion of director and officer liability insurance, see OLSON & HATCH, *supra* note 266, at §§ 10, 10-2, 10-5.

328. For a discussion of the Berle and Means ownership and control problem, see *supra* part II.A.

329. Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified in scattered sections of 12 & 15 U.S.C.).

330. For a discussion of the *Trans Union* decision and the subsequent state legislation, see *supra* part III.C.

331. Although experts disagree on the eventual cost of the crisis the United States General Accounting Office estimates the cost of thrift crisis "could be as much as \$500 billion over the next 40 years." Testimony of Assistant Comptroller General, The United States General Accounting Office, before the Committee on Banking, Housing and Urban Affairs, United States Senate, Aug. 1, 1990 (on file with author).

profile directors who allegedly breached their duties to their institutions, and because of the widespread failure in the industry, Congress has conducted a legislative witch hunt aimed at many innocent directors.³³² To this day, the federal government grapples with the political and financial problems associated with the savings and loan crisis as the cost of the bailout continues to rise.³³³

The volume of present and potential litigation is expected to exceed 100,000 suits.³³⁴ Some of the nation's largest law firms are devoting more and more of their resources to savings and loan litigation as fees rise to astronomical levels.³³⁵ In the interim, the federal government has added hundreds of lawyers to its payroll to pursue the lengthy and complex litigation arising from the savings and loan crisis.³³⁶ Much of the litigation focuses on shareholders' and regulators' pursuit of claims against the officers and directors of failed savings and loans.³³⁷ The former board members of savings and loans face increasing liability as federal regulators take over insolvent thrifts.³³⁸

As a result, the 1990s may become known as the decade in which financial institutions were unable to effectively recruit qualified outside directors, and ultimately the decade in which the savings and loan industry, after years of deregulatory and reregulatory measures,

332. See Investigation of Lincoln Savings & Loan Association, Hearings Before the House Committee on Banking, Finance and Urban Affairs, 101st Cong., 1st Sess. (1989) [hereinafter Lincoln Hearings] (House of Representatives investigation of the "notorious" Charles Keating of Lincoln Savings and Loan); Silverado Banking, Savings and Loan Association, Hearings Before The House Committee on Banking, Finance and Urban Affairs, 101st Cong., 2nd Sess. (1990) [hereinafter Silverado Hearings] (House of Representatives investigation of President Bush's son Neil Bush's involvement in the Silverado Savings and Loan Scandal); Centrust Bank, State Savings Bank, Hearing Before The House Committee on Banking, Finance and Urban Affairs, 101st Congress, 2nd Sess. (1990) [hereinafter Centrust Hearings] (House of Representative investigation of David Paul's involvement in the demise of Miami's Centrust Savings Bank) (on file with author).

333. See Jonathan R. Macey, *The Politics of Denying an S&L Crisis; The Bush Administration's Refusal to Acknowledge the Size of the S&L Problem only Increases the Damages*, L.A. TIMES, Dec. 10, 1989, at 3.

334. Former FDIC chairman William Seidman predicted that 100,000 lawsuits would result from the S&L crisis. Robert L. Mashek, *Seidman Sees 100,000 Lawsuits From S&L Scandal*, BOSTON GLOBE, Aug. 15, 1990, at 1.

335. Miriam Rozen, *The Bailout Bonanza Continues; More Fees, More Firms, More Headaches*, AM. LAW., Sept. 1990, at 82.

336. See Mashek, *supra* note 334 (FDIC Chairman Seidman reports on the hiring of more FDIC lawyers).

337. A.A. Sommer, Jr., *Review of Director and officer Liability: Indemnification and Insurance*, 47 BUS. LAW. 355 (1991) ("New actions are commenced daily against officers and directors by the FDIC and the RTC . . .").

338. David Tobenkin, *New S&L Regulations Tag Directors for Penalties*, L.A. BUS. J., Jan. 15, 1990, Sec. 1, at 30.

finally capitulated.³³⁹ The great irony is that the outside directors, the corporate monitors, are most dearly needed in the industry. The savings and loan industry faces an ever more difficult, if not entirely futile, road to recovery if these institutions are unable to attract qualified managers. Under the fiduciary regime of FIRREA, directors' and officers' fears of expanding liability and the concurrent crisis in director and officer liability insurance in the mid-1980s will potentially be relived in the 1990s. Whatever the fallout from FIRREA, traditional notions of corporate governance are reevaluated and to a large extent discarded in the new federal statutory and regulatory scheme.

A. *The Savings and Loan: An American Success Story?*

1. BUILDING ASSOCIATIONS AND EARLY THRIFTS

The earliest savings and loan institutions in the United States were formed over 150 years ago.³⁴⁰ Early thrifts known as building associations consisted of shareholders, each of whom invested in the organization.³⁴¹ The building association required shareholders to make contributions to fund individual members' home construction.³⁴² When construction of all homes was completed the building association closed.³⁴³ Building associations gradually evolved into building and loan associations that loaned money to shareholders building their own homes and financed the purchase of existing homes.³⁴⁴

339. Jay Baris, *Thrifts With Help, Have Outlived Usefulness*, AM. BANKER, Nov. 17, 1989, at 4; Peter F. Blackman, *Thrift Officials Face Added Liability After Feds Take Over S&Ls*, L.A. BUS. J., April 9, 1990, Sec. 1, at 1.

340. BRUMBAUGH, *supra* note 10. According to Brumbaugh "[t]he first American thrift institution, the Oxford Provident Building Association, was organized in Frankford, Pennsylvania, on January 3, 1831." *Id.* at 3. STEPHEN PIZZO ET AL., *INSIDE JOB: THE LOOTING OF AMERICAN SAVINGS AND LOANS* (1989). "The First Savings and Loan in the United States—then called a "building and loan" . . . [was] . . . tailored after building and loan societies in England." *Id.* at 9. PAUL Z. PILZER & ROBERT DEITZ, *OTHER PEOPLE'S MONEY: THE INSIDE STORY OF THE S&L MESS* (1989). The early British Building and Loan societies were called "friendly savings societies." Usually local parish churches or philanthropic landed gentrymen supported these early savings and loans to encourage local townspeople to save for old age or illness annuities. *Id.* at 18-19.

341. BRUMBAUGH, *supra* note 10, at 3. PILZER & DEITZ, *supra* note 340, at 26-27.

342. *Id.*

343. BRUMBAUGH, *supra* note 10, at 3.

344. *Id.* PILZER & DEITZ, *supra* note 340, at 27-28. The building and loan societies soon developed attributes of the modern savings banks as members began to make deposits for later use as the basis for home loans. Inevitably, some depositors sought the withdrawal of their accounts prior to maturation and many depositors sought loans quickly. As building and loans became more flexible in their services, the local society evolved into the local savings bank, offering withdrawals or principal and interest and immediate home loans. *Id.*

Prior to the emergence of the first building and loans, both commercial banks and mutual savings banks offered home loans among their financial services.³⁴⁵ As these organizations grew, however, they began to specialize in other financial services, such as commercial loans and demand deposits.³⁴⁶ The specialization in different financial services was reflected on the balance sheets of these institutions.³⁴⁷ Even today, at a time when financial service distinctions begin to blur, the basic differences in the balance sheets of commercial banks, mutual savings banks and savings and loans still exist.³⁴⁸

By 1890, thrift institutions had spread throughout the United States,³⁴⁹ and large, self-perpetuating thrifts began to replace the early building and loan associations with their inherently limited life span.³⁵⁰ With middle-class expansion and the help of home mortgage loans, more and more families found it possible to build and purchase homes and maintain a savings account.³⁵¹ As a result, the number of savings and loan associations increased, and their aggregate assets eventually exceeded those of the mutual savings bank industry.³⁵²

State and, to a limited extent, federal government regulation grew alongside the savings and loan industry.³⁵³ By the early 1900s,

345. BRUMBAUGH, *supra* note 10, at 4.

346. *Id.*

347. *Id.*

348. See *infra* part IV.A.2. The distinction between the early American financial institutions was largely "a function of business decisions and . . . government limitations of balance-sheet activities." *Id.* Historically, financial firms lacked diversification in services. "Financial 'supermarkets' " offering a broad array of both financial and non-financial services are modern innovations that ultimately question the utility of savings and loan institutions. *Id.*

349. *Id.* at 4-6. LEON T. KENDALL, *THE SAVINGS AND LOAN BUSINESS: ITS PURPOSES, FUNCTIONS, AND ECONOMIC JUSTIFICATIONS* 5 (1962). Oklahoma was the final state to offer a home to a thrift institution in 1890. BRUMBAUGH, *supra* note 10, at 4. "Thrift" is used interchangeably with savings and loans throughout this Comment. The name "thrift" evolved with the growth of the first savings and loans because people were encouraged to save and be thrifty, hence "thrift."

350. *Id.* The first "self-liquidating" thrifts required shareholding members to receive mortgage loans. When all thrift members had satisfied their loan obligation, the thrift association expired. Gradually, however, thrifts began to accept shareholders without mortgage loan obligations. With expanded membership, thrifts were no longer hampered by a limited lifespan and the availability of mortgage loan funds grew. Furthermore, national thrifts with branch offices across the country began to replace the local thrift with its limited geographical scope. *Id.* at 4-6. According to Kendall, analysts estimated that between 3,000 and 3,500 thrifts were in existence by 1888, with aggregate assets of \$300 million. KENDALL, *supra* note 349, at 6.

351. BRUMBAUGH, *supra* note 10, at 6; PILZER & DEITZ, *supra* note 340, at 28.

352. With middle-class expansion, more Americans could afford home ownership, which spurred the success of the savings and loans in number of institutions, depositors and assets. Pilzer & Deitz, *supra* note 340, at 28.

353. KENDALL, *supra* note 349, at 5-6. State governments regulated thrifts in the late 1800s and early 1900s by "deposits to state officials," "voluntary state examinations," and

state legislatures began to examine thrifts by monitoring their financial statements and by regulating the grant of thrift charters.³⁵⁴ Federal regulation of thrifts, however, did not become prominent until hundreds of financial institutions failed during the Great Depression.³⁵⁵

2. THE ANATOMY OF A SAVINGS AND LOAN

Other than by name, it is difficult to distinguish savings and loan institutions from other financial firms in today's market of modern financial "supermarkets."³⁵⁶ Financial institutions generally fall into two types: depository financial firms such as savings and loans and banks, and non-depository financial firms such as insurance companies, pension funds, brokerage houses, investment banking concerns and mutual funds. An analysis of a firm's balance sheet distinguishes savings and loans from other financial and non-financial firms.³⁵⁷ A depository financial firm's tangible assets consist primarily of loans, and its liabilities are mostly deposits.³⁵⁸ A non-financial firm's tangible assets are usually plant and equipment and its liabilities consist of debt and equity.³⁵⁹

The distinction between savings and loans and commercial banks, however, is more obscure.³⁶⁰ Historically, commercial bank liabilities were "demand" deposits which depositors could withdraw at any time, while savings and loan liabilities were generally "time" deposits, such as savings accounts, which the depositor could only withdraw after a certain period.³⁶¹ The distinction between "time" and "demand" deposits has faded, and today, the only significant difference between savings and loan institutions and commercial banks is their loan maturity term.³⁶² Commercial banks usually make short-

ultimately by "required state examinations." BRUMBAUGH, *supra* note 10, at 6. State examiners at that time favored single-family home loans and disapproved loans outside this traditional savings and loan lending field. State regulators also attempted to ensure the vitality of individual thrifts by limiting new thrift charters to the needs of the community. Gradually, regulation focused on thrift balance sheets, effectively prohibiting the diversification of thrift financial services. Except for a federal tax exemption, the federal government did not regulate the savings and loan industry until the Great Depression. *Id.*

354. BRUMBAUGH, *supra* note 10, at 6; *see supra* note 348.

355. KENDALL, *supra* note 349, at 6-8.

356. BRUMBAUGH, *supra* note 10, at 4.

357. *Id.* at 2.

358. *Id.*

359. *Id.* In fact, the more frequently financial firms invest directly in real assets, the more closely they resemble non-financial firms. *Id.*

360. *Id.*

361. *Id.*

362. *Id.*

term commercial loans—savings and loans make long-term home loans.³⁶³

Government regulations have maintained the distinction between savings and loans and other financial firms such as commercial banks by prescribing different business activities, capital requirements and borrowing bases for each.³⁶⁴ In fact, until FIRREA, separate regulatory enforcement agencies governed savings and loans and banking institutions.³⁶⁵ The separate regulatory schemes for banks and savings and loans evolved in Depression era legislation from Congress' desire to maintain the separation of banking and commerce in the aftermath and lingering fear of the Depression.³⁶⁶

3. DEPRESSION ERA REGULATION

The Great Depression drastically affected all financial institutions.³⁶⁷ Thrifts that did not accept demand deposits suffered as individual incomes dwindled, prohibiting investment, prompting withdrawals and causing delinquency in loan repayments at the local savings association.³⁶⁸ Because thrifts' assets consisted primarily of home mortgage loans, they had little cash to meet the rash of withdrawals.³⁶⁹ As a result, more than 1,700 thrifts failed between 1930 and 1939.³⁷⁰ With financial institutions in chaos, the United States League of Local Building and Loan Associations, the largest trade association for the nationally important thrift industry, lobbied for

363. *Id.*

364. *Id.* See *infra* part VI.B for a discussion of the separation of banking and commerce.

365. See *infra* part IV.A.3 for a discussion of the Depression era regulations and part IV.C for an overview of FIRREA.

366. See Halpert, *supra* note 185, at 482. The separation of banking and commerce is a pervasive tradition in financial institution regulation, with roots extending "three hundred years under English law." *Id.* (citations omitted). Both the state and federal governments achieved the separation of banking and commerce by imposing "substantial legal impediments to the integration within a firm of both banking and non-banking businesses." *Id.*

367. BRUMBAUGH, *supra* note 10, at 8. Brumbaugh identifies two periods of economic difficulty during which thrift institutions suffered dramatic failure. The first occurred during the Depression of the early 1890s. During this economic crisis, national thrifts disappeared entirely from the savings association business scene and locally based thrifts suffered as well. The most notable effect of this crisis was the creation of the United States League of Local Building and Loan Associations. The "association" of local building and loan associations later became the United States Savings and Loan League. KENDALL, *supra* note 349, at 6.

368. KENDALL, *supra* note 349, at 6-8. Contributing to the demise of the savings and loan industry was the failure of 8,800 commercial banks. Many savings association customers lost deposit accounts in bank failures and were unable to make home loan payments. *Id.* at 6-7. See also BRUMBAUGH, *supra* note 10, at 8-9.

369. BRUMBAUGH, *supra* note 10, at 8.

370. *Id.* "From 1930 to 1933 . . . the size of the thrift industry shrank by about 15 percent. During that period, more than 500 thrifts failed, and another 1,200 or so failed from 1933 to 1939." *Id.* Nearly 9,000 banks failed in 1930 alone. *Id.* at 8-9.

federal government assistance.³⁷¹

The Federal Home Loan Bank Act of 1932 revamped the savings and loan industry under a comprehensive federal regulatory scheme.³⁷² With the passage of the Federal Home Loan Bank Act, President Hoover and Congress created the Federal Home Loan Bank System.³⁷³ Under the Federal Home Loan Bank System, strict federal regulations monitored federally chartered thrifts that were part of the Federal Home Loan Bank System. The Home Owners' Loan Act³⁷⁴ established the Home Owners Loan Corporation to refinance troubled home mortgages. Under this system, the Federal Home Loan Bank Board, which remained intact for the next fifty years, established a regulatory structure for federal savings and loans, specified the type of loans thrifts could make, and lent money through the Federal Home Loan Bank System for the use of potential home-owning borrowers.³⁷⁵

371. PIZZO ET AL., *supra* note 340, at 9. Pizzo, Fricker and Muolo suggest that the prominence of the thrift industry in the nation's economy demanded a federal government bailout. "By then thrifts had become a critical element in the national economic machinery and their troubles could not be easily ignored." *Id.*

372. 47 Stat. 725 ch. 522 (1932) (codified as amended at 12 U.S.C. §§ 1421-1449). In 1913, Congress enacted the Federal Reserve Act which created the Federal Reserve System, placing banks under federal regulatory control. The Federal Reserve System loaned money to banks during periods when banks were unable to attract deposits. Seemingly, this System provided a sense of bank safety. That sense of security proved to be unfounded with the bank failures during the Depression. Importantly, the Federal Reserve System did not offer the same "safety" loans to thrifts.

373. The Federal Home Loan Bank Act created the hierarchical structure and regulatory apparatus that governed the savings and loan industry until the passage of FIRREA in 1989. At the highest regulatory level, the Federal Home Loan Bank Board in Washington governed the twelve regional Federal Home Loan Banks. Each of the regional banks regulated and loaned funds to thrifts within their region. Not all thrifts, however, chose to be federally chartered and some were instead chartered, and therefore regulated, at the state level. *See* 47 Stat. 725 ch. 522 (1932) (codified as amended at 12 U.S.C. §§ 1421-1449). *See also* STRUNK & CASE, *supra* note 14; PIZZO ET AL., *supra* note 340, at 9-10; PILZER & DEITZ, *supra* note 340, at 31-57; BRUMBAUGH, *supra* note 10, at 9-10. The funds lent by the Federal Home Loan Banks "were intended to be lent ultimately to borrowers. In short the main stated purpose of the Federal Home Loan Bank System was to strengthen savings and loan association financially in order to promote home ownership." *Id.* The promotion of affordable housing goals, a laudable, socially responsible goal, was therefore initiated at the executive level. FIRREA, for the first time, mandates the socially responsible goal of affordable housing through a corporate governance scheme that contemplates the dictates of the community as well as of shareholders. *See infra* part VI.C.

374. *See* 48 Stat. 128 ch. 64 (1933) (codified as amended at 12 U.S.C. §§ 1461-1464).

375. *See supra* note 373. Another major purpose of the Federal Home Loan Bank Act was the chartering of Federal Savings and Loans. The Federal Home Loan Bank Board had the authority to grant charters based on the "need and effect on existing institutions, to charter federal savings and loan associations following the best principles of existing local mutual organizations." BRUMBAUGH, *supra* note 10, at 9, quoting MORTON BODFISH & A.D. THEOBALD, SAVINGS AND LOAN PRINCIPLES 54.

The American public, however, was still wary about placing money in financial institutions.³⁷⁶ As a result, surviving savings and loans struggled to maintain equity growth.³⁷⁷ In response, Congress and the Roosevelt administration enacted the National Housing Act of 1934 establishing federal savings deposit insurance.³⁷⁸ The Federal Savings and Loan Association reassured depositors and insured the integrity of thrifts by backing savings deposits with a government-maintained insurance fund.³⁷⁹ The final element of the financial insti-

376. PIZZO ET AL., *supra* note 340, at 10.

377. *Id.* Depositors' wariness of the safety of institutions prevented the successful growth of the local savings and loan industry. To allay depositors' lingering fears and "[t]o encourage them to fund their neighborhood savings and loans," Congress created the deposit insurance system. *Id.*

378. *Id.* See 48 Stat. 1246 ch. 847 (1931) (codified as amended at 12 U.S.C. §§ 1701-1730).

379. Although deposit insurance may have instilled confidence in depositors in the wake of the Depression, many scholars now blame it for the ills of the savings and loans in the 1980s. BRUMBAUGH, *supra* note 10, at 175-78. R. Dan Brumbaugh asserts that the deposit insurance system could be eliminated without dramatic instability to the American financial system. The Federal Reserve acts as a failsafe lender to solvent institutions during "runs" in order to stave off insolvency. For the depositor in solvent institutions, "deposit insurance is redundant." During periods of crisis, shareholders, uninsured creditors and depositors all stand to lose their financial stake in a failing institution. Furthermore, the deposit insuring bodies also stand to lose as they attempt to bail out failing institution deposit accounts. In a financial system without deposit insurance, depositors in solvent institutions, shareholders, and uninsured creditors are no worse off than in a banking system with insurance protection. The insolvent institution that previously insured depositors, however, does stand to lose. Many commentators query whether such a result is necessarily undesirable considering the effects of deposit insurance on the variety of financial institution actors. Under a deposit insurance system, shareholders of financial institutions bear the cost as solvent institutions pay deposit insurance premiums. Furthermore, if the crisis is particularly severe, as was the case with the savings and loan crisis in the mid- to late 1980s, taxpayers ultimately bear the burden of failure. Since solvent institutions may pass on the cost of insurance premiums to their customers, solvent institution depositors also bear part of the burden of loss. Essentially, under a system without deposit insurance, depositors of insolvent institutions would lose their proportionate share but external societal costs would be low. Losses would therefore be redistributed from shareholders, customers and taxpayers to insolvent institution depositors, a result that does "not appear to be too formidable." *Id.* at 175-176 (citations omitted). See also James R. Barth & R. Dan Brumbaugh, Jr., *The Rough Road From FIRREA to Deposit Insurance Reform*, 2 STAN. L. & POL'Y REV. 58 (1990). In a recent work with James R. Barth, Brumbaugh continued his criticism of the present deposit insurance system and argued that "FIRREA's most serious limitation is that it ignores the fundamental cause of the savings and loan problem: federal deposit insurance." *Id.* See also the Testimony of William R. Watson, Risk-Based Deposit Insurance Premiums, before the Senate Committee on Banking, Housing and Urban Affairs, April 19, 1991. Furthermore, the vitality of deposit insurance is in question as federal regulators battle to maintain the solvency of the fund itself. Testimony of L. William Seidman, The Condition of the Bank Insurance Fund and Recapitalization, before the Senate Committee on Banking, Housing, and Urban Affairs, Mar. 21, 1991 (on file with author). In 1991, former Chairman of the Federal Deposit Insurance Corporation L. William Seidman testified that many "pessimistic . . . observers believe that the banking industry and the BIF are hopelessly insolvent and will require billions of taxpayer dollars to fix." *Id.* at 2-3.

tutions regulatory regime came in 1933, when Congress passed, and Franklin Roosevelt signed into law, the Glass-Steagall Banking Act³⁸⁰ and the Securities Act of 1933.³⁸¹

The legislation, particularly the Glass-Steagall Act, in the immediate post-Depression era envisioned the banking industry as conglomerates of power with potentially insidious effects on the American economy.³⁸² The series of banking panics that ultimately led to the Depression-era failures crippled the nation's economy and turned the nation's collective psyche to rage against banks and their managers.³⁸³ To allay these concerns, Congress denied banks and savings and loans the opportunity to engage in non-banking business practices, effectively prohibiting the integration of diverse financial services within banking institutions.³⁸⁴ In fact, savings and loan institutions were even more limited than commercial banks in the services

380. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.).

381. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified in scattered sections of 15 U.S.C.).

382. Banks have been the focus of American suspicions since the earliest days of the United States. "Like the owners of large railroads and armaments manufacturers, bankers have been suspected of pursuing clandestine, antisocial ends and, despite their relatively small numbers, of having wielded enormous political influence." Halpert, *supra* note 185, at 505 (citations omitted). Inevitably, American public suspicions shaped the banking laws and cemented the separation of banking and commerce. *Id.* The fears undoubtedly increased with Depression era bank failures. For an excellent discussion of the Glass-Steagall Act and its genesis, see GEORGE J. BENTSON, *THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING* (1990).

383. The impetus for the Glass-Steagall Banking Act came directly from the hearings in the Senate Committee on Banking and Currency's Stock Exchange Practices concerning National City Bank. See BENTSON, *supra* note 382, at 2 (citing Edwin S. Perkins' *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483, 528 (June 1971)). See EDWARD J. KELLY, *LEGISLATIVE HISTORY OF THE GLASS-STEAGALL ACT* 41-65 (1985), for a discussion of the national fears culminating in the Glass-Steagall Act.

384. See BENTSON, *supra* note 382. Bentson identifies eight factors that led to the federally mandated separation of banking and commerce: (1) Bank "underwriting and holding of corporate securities and . . . revenue bonds" posed a "significant risk of loss to depositors" and the federal deposit insurance fund. (2) The integration of investment banking services into traditional depository institutions lent potential to managerial "conflict of interest" abuses. (3) The American public and Congress were generally averse to the integration of "securities related activities" into banking institutions. (4) "[S]ecurities brokers . . . underwriters and some bankers" sought to prohibit the market competition naturally resulting from banks offering integrated financial services. (5) Federal deposit insurance would necessarily become more costly to protect from the greater risk of loss associated with integrated firms. (6) Banks, effectively "subsidized" by deposit insurance, would unfairly compete because of "access to 'cheap' deposit funds." (7) Fear of an increased concentration of economic power in banking institutions encouraged a limitation on banking activities. (8) Without the separation of banking and commerce, the American banking system would evolve into a close parallel of the unattractive "German universal" banking system. *Id.* at 13-14.

Many of these themes, particularly (1) risk of loss, (2) conflicts of interest, and (3) the federal safety net, were revisited with the systematic deregulation of the savings and loan industry discussed *infra* part IV.B.

they could offer.³⁸⁵ In essence, thrifts were "frozen by both statute and regulation" to a one-product business: long-term home mortgage loans.³⁸⁶ Eventually, the limitation on thrift activities sank the industry while commercial banks, though also limited, retained broad enough powers to survive with adequate diversification.³⁸⁷ The resulting separation of banking and commerce, which prevented banks and savings and loans from engaging in business practices other than "traditional" banking activities, survived the next fifty years.³⁸⁸ Yet, until the adoption of FIRREA in 1989, Congress never legislated the separation in a corporate governance context.³⁸⁹

In the aftermath of the Depression, public sentiment feared integrated firms³⁹⁰ as potentially jeopardizing the stability of the banking

385. Carl Felsenfeld, *The Savings and Loan Crisis*, 59 FORDHAM L. REV. 51, 511 (1991).

386. *Id.* The separation of banking and commerce forced thrifts into a "single-risk" business, relinquishing the advantages associated with diversified investments and "portfolio theory." Furthermore, home mortgages are long-term, fixed-rate loans. With every home mortgage loan, thrift managers were "betting that in the next ten to twenty years it would not have to pay more for its money than it was earning on that asset. If the reverse became true, the S&L ran a real risk of failure." *Id.* (citations omitted).

387. *Id.* Whereas thrifts were dramatically limited by the separation of banking and commerce, commercial banks had greater opportunity to diversify investment practices. The National Bank Act of 1863 granted banks broad authority to choose investment and business practices. As a result, banks until the 1980s avoided long-term home mortgage loans. The commercial banks' concentration on short-term credit "probably saved the banks from the disaster ultimately experienced by the S&Ls." *Id.*

388. In essence, non-traditional banking practices are securities-related activities. See BENTSON, *supra* note 382, at 11. Professor Halpert identifies the "primary legislative vehicles for the development of the separation [of banking from commerce] in this century . . ." Halpert, *supra* note 185, at 482 n.3. As previously discussed, the Banking Act of 1933 (Glass-Steagall) is the ultimate legislative separation of banking and commerce. The Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (codified at 12 U.S.C. §§ 1847-1850 (1982)) furthered the separation of banking and commerce by barring "multi-bank holding companies from engagement in, or ownership of, business not 'closely related to banking.'" Halpert, *supra* note 185, at 482 n.3. The Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760 (codified at 12 U.S.C. §§ 1841-1850, 1971-1978 (1982)) extended the 1956 Act's prohibition of holding company ownership of banks. Halpert, *supra* note 185, at 482 n.3. The Depository Institutions Act, Pub. L. No. 91-607, 84 Stat. 1760 (codified at 12 U.S.C. §§ 216-216d (1982)) (Garn-St. Germain Act), although primarily a deregulatory act, furthered the separation by prohibiting bank involvement in the insurance business. Halpert, *supra* note 185, at 482 n.3. FIRREA which re-regulated the savings and loan industry continues the tradition of the separation of banking and commerce, and for the first time mandates the separation through a depository institution corporate governance scheme. See *infra* part VI.B.

389. See *infra* part VI.B. Savings and Loans were traditionally limited to local home lending as a "community interest The nature of S&L regulation ensured that the associations specialized in local home lending." Fred E. Case, *Deregulation: Invitation to Disaster in the S&L Industry*, 59 FORDHAM L. REV. 593 (1991).

390. Integrated firms are depository institutions that offer financial services beyond the usual loans and deposits.

industry.³⁹¹ Congress sought to prevent the "undue concentration of control of banking activities" because integrated firms faced the temptation of the securities market, with greater risk of insolvency, ultimately undermining depositor confidence.³⁹² By separating banking and commerce, federal legislation denied savings and loans and banks the opportunity to engage in risky investment practices that could threaten insolvency.³⁹³ While the prohibition against integration of other commercial practices into thrift institutions effectively reduced the potential for risky investment practices to restore depositor confidence, another legislative confidence builder would later cause deregulated banking institutions' gravitation towards risky behavior.³⁹⁴

Fixed rate deposit insurance, one of the primary methods employed to restore confidence in an American Public shaken by the Depression, inspired many modern thrift insolvencies.³⁹⁵ With the creation of the deposit insurance system, the federal government

391. See *supra* note 384.

392. Halpert, *supra* note 185, at 494. Although Bentson questions the validity of the "conflict of interest" abuses, "the existence of serious abuses by commercial bank's securities affiliates and directly carried out securities activities appears to be accepted by both proponents and opponents of the Glass-Steagall Act, and by many historians and economists." BENTSON, *supra* note 382, at 44. Bentson systematically analyzes the alleged "conflicts of interest" that led to enactment of the Glass-Steagall Act and concludes that the data supporting these allegations were insufficient. BENTSON, *supra* note 382, at 43-122. Although the respective congressional hearings came after the enactment of FIRREA, the alleged wrongdoing at high-profile savings and loans such as Lincoln, Silverado and Centrust undoubtedly contributed to the public pressure leading to FIRREA's enactment. See Centrust Hearings, Lincoln Hearings, Silverado Hearings, *supra* note 332.

393. While the continued solvency of any corporation serves public policy goals, the solvency of banking institutions became an issue of paramount importance after the Depression-era failures and bank holidays. See *supra* note 377. See also BRUMBAUGH, *supra* note 10, at 8-12 for a discussion of bank failures and the Depression.

394. Fixed-rate deposit insurance encouraged banking institution risktaking during the deregulatory period of the early 1980s. Because of the crisis in the savings and loan industry in the 1980s, many savings and loans approaching failure gravitated to risky investment practices permissible under Reagan-era deregulation. With deregulation, thrift "[h]igh-risk takers soon found, and exploited, a fatal flaw in the deregulatory scheme: The federally insured accounts of the typically local depositor (the traditional S&L customer) could be used to fund the lending and investment projects that the deregulated S&Ls were now free to pursue." Case, *supra* note 389, at 597. Fixed-rate deposit insurance, which bore no relation to risk of investment, encouraged banks with their large liquid asset base to engage in super-optimal risktaking. Furthermore, these institutions were not constrained by depositors who "unlike creditors of other kinds of institutions, have no incentive to constrain management excesses." Halpert, *supra* note 185, at 513. For an overview of the Deposit Insurance System, see Thad Grundy, Jr., *Practical Aspects of the Deposit Insurance System*, 44 BUS. LAW. 169 (1988). See also *supra* note 379.

395. The National Housing Act created the Federal Savings and Loan Insurance Corporation, which insured the deposits of thrifts. Ch. 847, 48 Stat. 1246 (1934) (codified as amended at 12 U.S.C. §§ 1701-1730 (1989)). For the deposit insurance provisions, see *id.* § 402(A) 48 Stat. at 1256.

assumed the responsibility for thrift and bank deposits.³⁹⁶ Significantly, scholars now blame the fixed rate deposit insurance system for excessive risktaking by savings and loans, and ultimately insolvency, during the crisis of the 1980s.³⁹⁷

B. *Deregulation and Crisis in the Savings and Loan Industry*

1. MODERN THRIFTS: FROM BOOM TO CRISIS IN A FICKLE REGULATORY ENVIRONMENT

Banks and savings and loans thrived in the post-war years.³⁹⁸ National prosperity, spurring private home building and ownership as well as family savings, enabled the local thrift to resemble the ideal of Frank Capra's savings and loan in *It's a Wonderful Life*.³⁹⁹ The federal thrift framework functioned well, as savings and loans used insured deposits to make loans to home buyers, who in turn became depositors, perpetuating a business cycle that furthered middle-class home ownership while strengthening thrift institutions.⁴⁰⁰ However, lurking beneath thrift success was the tenuous balance between the risk incentive of deposit insurance and the separation of banking and commerce.⁴⁰¹ As modern economic markets became more sophisti-

396. BRUMBAUGH, *supra* note 10, at 9. However, no apportionment of risk responsibility was delegated to depository institution management in a corporate governance context. FIRREA's "unsafe and unsound" fiduciary standard is the first legislative attempt to achieve the separation of banking and commerce through a corporate governance scheme.

397. See *supra* note 379. Since deposit insurance rates are fixed and unrelated to the riskiness of institutional investment practices "a depository institution has an incentive to undertake more risky investments than it would choose in a world without such deposit insurance." Halpert, *supra* note 185, at 510. The Federal Deposit Insurance Fund inspires risky investment because the premium charged to the institution is constant and independent of the risk of the investment. Therefore, the depository institution derives any and all of the benefit from the risky investment and the insurance fund bears any and all risk. Depository institutions logically should favor riskier investments as loss exposure is borne by the insurance fund and profitable return exclusively accrues to the institution. Compounding the risk-propensity problem is that insured depositors have little incentive to prevent managerial risktaking as their monies are protected by the insurance fund and, in essence, as they have nothing to lose. *Id.* at 510-12. Thrift risktaking was magnified during Reagan-era deregulation, as the separation of banking and commerce reached its lowest level this century. See *infra* part IV.B.2.

398. For a discussion of savings and loan growth in the post-war years up to 1960, see KENDALL, *supra* note 349. "The expansion of the savings and loan business was an outstanding feature of the postwar decade." *Id.* at 8.

399. *IT'S A WONDERFUL LIFE*, (Republic Studios 1947).

400. In the immediate post-war years, demand for housing was great as veterans returned home and took advantage of the Veterans Home Loan Program and the FHA loan program. Thrift institutions prospered in the post-war growth years because the American public became increasingly affluent and interested in long term investment and home ownership. STRUNK & CASE, *supra* note 14, at 20.

401. See *supra* part IV.A.3.

cated and financial services diversified, issues of thrift competitiveness arose, questioning the viability of the separation of banking and commerce.⁴⁰²

The first hints of difficulty in the savings and loan industry came with the inflationary period of the 1970s.⁴⁰³ As inflation drove interest rates higher, federal reserve interest-rate regulations kept thrift interests rates down, encouraging disintermediation.⁴⁰⁴ The Federal Reserve Regulations, known generally as Regulation Q,⁴⁰⁵ prohibited banks from paying interest on checking accounts and placed a ceiling on the interest rate payable to savings and loan depositors.⁴⁰⁶ With rampant inflation, however, Regulation Q only succeeded in driving thrift customers to higher-yield financial instruments.⁴⁰⁷ In addition,

402. Competition in the financial services market intensified as "non-depository" financial firms commanded a larger share of available investment assets because of "inflation, improved techniques for managing cash, innovation in financial instruments, and the deregulation of financial markets." BRUMBAUGH, *supra* note 10, at 14. Furthermore, the seemingly complacent post-war thrift management was ill-suited to meet the competitive challenge as "both interest rate and lending risks" increased "to a degree far beyond those experienced before." STRUNK & CASE, *supra* note 14, at 26. Issues of thrift competition also arose in the area where thrifts specialized: Home mortgages. The Federal National Mortgage Association (Fannie Mae), the Government National Mortgage Association (Ginnie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), "computer applications to mortgage loan servicing" and "the securitization of mortgages" all undermined thrift dominance in the home loan field. *Id.* at 50. At the same time, "[c]ommercial banks and thrift institutions began competing more with other types of financial firms providing interest-earning deposits and checkable-type accounts." BRUMBAUGH, *supra* note 10, at 35 (citations omitted). See also KERRY COOPER & DONALD R. FRASER, *BANKING DEREGULATION AND THE NEW COMPETITION IN THE FINANCIAL SERVICES INDUSTRY* (1984).

403. BRUMBAUGH, *supra* note 10, at 36. The genesis of the disparity between thrift interest rates and inflationary market interest rates "was the regulation of interest rates imposed on banks during the Great Depression and on thrifts in 1966" *Id.* Interest rate regulation ensured that in a market dominated by banks and thrifts, a "monopoly-like" profitability guaranteed the success of both banks and thrifts, "with thrifts given a . . . 25-basis-point spread above bank rates to attract savings deposits" *Id.* Unfortunately, thrifts in the modern market were forced to compete against a variety of other financial service institutions offering market sensitive instruments. See *supra* note 402.

404. Disintermediation is the flight of thrift depositors to other market sensitive or higher interest paying instruments. BRUMBAUGH, *supra* note 10, at 15. Savings depositors left the conservative security of the thrifts for new market-sensitive financial instruments. These new instruments, which included negotiable orders of withdrawal and money market accounts, disadvantaged savings and loan and other financial institutions that could not compete because of Regulation Q. *Id.* See *infra* note 406.

405. Regulation Q was enacted in 1966 and limited the interest rate thrifts could pay on deposits. See Act of Sept. 12, 1966, Pub. L. No. 89-597, 80 Stat. 823 (1966). Commercial banks were limited by Regulation Q since 1933.

406. Regulation Q became the bedrock for the insured depository institution industry. Banks thrived in a non-competitive interest rate environment while thrifts were guaranteed an opportunity to pay higher interest rates than commercial banks, which assured continuing depositor interest. STRUNK & CASE, *supra* note 14, at 39.

407. See *supra* note 404.

technology spurred creative investment portfolios for worldwide financial instruments, offering depositors the opportunity to invest in a variety of portfolio options.⁴⁰⁸ The competitive failings of savings and loans prompted a series of deregulatory actions and thrift investment decisions that weakened the industry's financial condition in the volatile markets of the 1980s.⁴⁰⁹

In an attempt to help savings and loans regain competitiveness, Congress and the Reagan administration began to deregulate the thrift industry, erasing to a large extent the traditional separation of banking and commerce.⁴¹⁰ The first move toward the diversification of thrift services came in 1978, when regulators permitted thrifts, as well as banks, to offer six-month money market accounts and relaxed interest rate restrictions.⁴¹¹ Money market accounts offering higher yields than savings accounts increased savings and loan competitiveness, but thrift earnings decreased as thrift operating costs increased.⁴¹² Operating costs surged because inflationary interest

408. In the 1970s, technological "change and financial-service innovation developed with unprecedented speed and rapidly eroded the differences among firms hitherto providing distinct financial services." BRUMBAUGH, *supra* note 10, at 35.

409. See generally STRUNK & CASE, *supra* note 14 (arguing that the savings and loan crisis occurred as a derivative of the deregulatory moves of Congress, the President and regulatory agencies). See also Joseph J. Norton, *The 1982 Banking Act and the Deregulation Scheme*, 38 BUS. LAW. 1627 (1983) (outlining the deregulation of the savings and loan industry).

410. See Norton, *supra* note 409, at 1627. "Deregulation" was effected from an "intraindustry" perspective. Initially "statutory and regulatory barriers" were removed, interjecting competitiveness between commercial banks and thrifts. Unencumbered by federal prohibition, the thrift institutions "liberalized" both the asset and liability side of the balance sheet. *Id.* Thrift regulatory limitations were seen as a relic of primitive financial markets. "Market discipline" as opposed to federal regulation became the theme of deregulation. Case, *supra* note 389, at 596 (citing D.P. Riordian, *Deregulation and the Future of the Thrift Industry* 7, Sept. 8, 1980, presented at 63d Annual Convention, Arkansas Savings and Loan League, Sept. 8, 1980 (16-2,9, 17-3,4)). See also Robert S. Plotkin, *What Meaning Does Glass-Steagall Have for Today's Financial World*, 95 BANKING L.J. 404 (1978).

411. BRUMBAUGH, *supra* note 10, at 40. Significantly, money market accounts comprised 20% of all thrift deposits by 1979. *Id.* See also John A. Adams, *Money Market Mutual Funds: Has Glass-Steagall Been Cracked?*, 99 BANKING L.J. 4 (1982). In 1978, the deregulation process began modestly when compared to the legislation enacted in the following years. The Financial Institutions Regulatory and Interest Control Act of 1978, ("FIRA") Pub. L. No. 95-630, 92 Stat. 3641 (1978), first liberalized the loan and investment practices of savings and loans. Norton, *supra* note 409, at 1628. Significantly, FIRA showed the first signs of expanded managerial liability and questioned managerial service on financial institution boards. See Lynn Nicholas, *FIRA: Emerging Patterns of Director Liability*, 103 BANKING L.J. 151 (1986); Alan E. Grunewald & Bruce P. Golden, *Bank Director Liability Post-FIRA: How to Avoid It*, 98 BANKING L.J. (1981); Raymond Guenter, *The Lance Legacy—Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978*, 96 BANKING L.J. (1979).

412. BRUMBAUGH, *supra* note 10, at 40. Deregulatory changes counteracted disintermediation, but troubles continued because rising interest rates drove thrift interest expenses up. Nonetheless, disintermediation was perceived as the most dangerous threat

rates increased short-term deposit costs faster than repayment of long-term mortgages.⁴¹³ Because the majority of thrift assets remained in long-term mortgages, thrifts did not have the cash flow to meet their short-term deposit and money market liabilities.⁴¹⁴

Interest rates continued to rise unabated during the late 1970s⁴¹⁵ and the thrift industry faced growing losses with little hope from the existing regulatory scheme.⁴¹⁶ Finally, in 1980, Congress dismantled much of the regulatory apparatus separating banking and commerce in the savings and loan industry with the Depository Institutions Deregulation and Monetary Control Act ("Monetary Control Act").⁴¹⁷ With enactment of the Monetary Control Act, Congress

because deposit withdrawals could have forced the firesale of thrift home mortgage assets. Because rising interest rates drove mortgage values down, the forced sale of mortgages "could have been disastrous" for the thrift industry. *Id.* at 40-41.

413. As inflation soared, "[s]mall savers rushed to the thrifts to move their cash from low-interest passbook accounts into high-interest money market accounts at an astounding pace." PILZER & DEITZ, *supra* note 340, at 65. Time depositors rapidly fled to money market accounts. "[F]rom January 1, 1979, to June 30, 1980, the level of ordinary passbook time deposits at banks and thrifts fell by 24 percent, from \$907 billion to \$690 billion." *Id.* at 66.

414. This cash flow shortage was the essence of the thrift problem, leading to deregulatory changes. Because of the new money market accounts, thrifts were forced to "pay" high interest rates while they were locked into "earning" lower interest rates on long term mortgage loans. In order to compete "thrifts were having to pay 10 to 20 percent interest on short term-money certificates." PILZER & DEITZ, *supra* note 340, at 65. Yet, thrifts still had to invest money market "high-cost funds in residential mortgage loans" at a lower interest rate. *Id.* Thrifts, therefore, faced a dual problem: "high interest costs and disintermediation." *Id.* (citing TIME MAGAZINE, June 8, 1981, at 58).

415. In 1979, the Federal Home Loan Bank Board attempted to curtail the interest rate problem. The most effective changes, however, came too late to alleviate the problem of low interest earned on pre-existing mortgage loans. Newly permitted variable mortgage interest rates were more sensitive to "the real cost of funds" on newly originated mortgage loans, but the majority of preexisting mortgages were locked into non-profitable rates. *Id.* at 67. Ultimately, monetary policies contributed to inflation and heralded the deregulatory Reagan era. President Carter's Federal Reserve Chairman Paul Volcker's response to rising inflation all but assured financial difficulty at thrifts as interest rates soared. Volcker's "Saturday-Night Special" announced the federal government's change in inflation policy from an effort to hold down interest rates to a concentration on controlling the money supply. The result was an "inflationary and interest rate firestorm" that proved disastrous to the thrift industry. PILZER & DEITZ, *supra* note 340, at 68 (quoting FREDERICK E. BALDERSTON, THRIFTS IN CRISIS: STRUCTURAL TRANSFORMATION OF THE SAVINGS AND LOAN INDUSTRY 4 (1985)).

416. Deregulation to many seemed the only solution to the growing thrift problems and out-of-control interest rates. With the Federal Reserve "declining" to restrain interest rates, "[t]he squeeze on the nation's S&L's quickly became intolerable" *Id.* Regulatory reform was the inevitable choice as "some officials acknowledged that consumers had already made deregulation a *de facto* reality." *Id.*

Consumers were sophisticated and invested in unregulated institutions that offered higher interest rates than thrifts. The easy, though in the long run disastrous, answer to this problem was congressional deregulation and effective removal of the separation of banking and commerce.

417. Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified as amended in scattered sections of 12 U.S.C.). Under the Act, thrifts finally could offer interest-bearing accounts at competitive

and the Reagan administration sought to enhance the competitiveness of the thrift industry by removing the interest rate ceiling on deposits. Still, the Act failed to address the inability of thrifts to rapidly earn revenue from asset-side long-term loans.⁴¹⁸

In 1982, Congress and the Reagan administration finally took steps to address the thrift industry's asset-side problems.⁴¹⁹ The Garn-St. Germain Depository Institutions Act ("Garn-St. Germain Act") permitted thrifts to offer commercial real estate loans, additional consumer loans and, perhaps most notably, allowed thrift investment in commercial paper and corporate debt securities.⁴²⁰ The Garn-St. Germain Act also allowed thrifts to offer demand deposit accounts, and a full range of money market accounts.⁴²¹ Under this Act, Congress and the Reagan administration completed the emasculation of the regulatory scheme and effectively joined banking and commerce.⁴²² Unfortunately, the Garn-St. Germain Act laid the

interest rates. Significantly the Monetary Control Act also increased FSLIC deposit insurance from \$40,000 to \$100,000. See Ronald L. Weaver & Andrew M. O'Malley, *The Depository Institutions Deregulation and Monetary Control Act of 1980: An Overview*, 98 BANKING L.J. 100 (1981); COOPER & FRASER, *supra* note 402, at 105-126.

418. BRUMBAUGH, *supra* note 10, at 41-43. The Monetary Control Act's shortcomings were obvious. "You didn't need to be a genius to understand that if you were borrowing money at 16 percent and lending it out at 8 percent, you wouldn't remain in business for very long." PILZER & DEITZ, *supra* note 340, at 69-70.

Thrift difficulties on the asset side of the balance continued despite Bank Board measures permitting thrifts to offer market sensitive Adjustable Rate mortgages in 1981. In perhaps the Federal Regulators' most significant measure, the Board changed Regulatory Accounting Principles ("RAP") pushing thrifts to amortize the loss on sales of assets at a market value below book value. This change in RAP was in direct conflict to Generally Accepted Accounting Principles ("GAAP") and had profound consequences for the entire industry. BRUMBAUGH, *supra* note 10, at 44. See *infra* notes 431-437 and accompanying text.

419. Just prior to congressional legislation in 1982, the Federal Home Loan Bank Board took further measures to help thrifts attract deposits. In taking these measures, the Board aided thrifts' battle against disintermediation but simultaneously exacerbated the asset-side problem. The Board allowed thrifts to entertain a greater percentage of brokered deposits, which in reality was a stop gap measure to disintermediation and invariably increased the cost of thrift funds. PILZER & DEITZ, *supra* note 340, at 72.

420. Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C.). For an overview of the completed deregulatory scheme with a focus on the Garn-St. Germain Act, see Joseph Jude Norton, *The 1982 Banking Act and the Deregulation Scheme*, 38 BUS. LAW. 1627 (1983); see also COOPER & FRASER, *supra* note 402, at 127-141.

421. See *infra* note 422.

422. The "Garn-St. Germain" Act completed the deregulatory scheme by broadening thrift powers in order to attract asset-side revenues. See Norton, *supra* note 409. Now, under deregulation, thrifts could attract a variety of revenue sources through a wide array of loan agreements. The loan making capacity of federal savings and loans under Garn-St. Germain is summarized as follows:

- (1) loans on the security of its transaction accounts; (2) loans on the security of liens (not necessarily first liens, with real property loans secured by nonresidential real property being subject to a forty percent aggregate loan

foundation for the decimation of the thrift industry as managers, no longer constrained by the separation of banking and commerce, were able to engage in super-optimal risktaking, gambling on the resurrection of the industry with the backing of deposit insurance.⁴²³

Further deregulation occurred when the Federal Home Loan Bank Board ("Bank Board") encouraged managerial divergence from the traditional separation of banking and commerce⁴²⁴ and modified thrift ownership regulations.⁴²⁵ To encourage investment in the industry, the Bank Board changed the traditional notion of mutual depositor-owned thrifts by permitting single shareholder ownership, thereby attracting a more sophisticated and speculative breed of thrift management.⁴²⁶ The Bank Board eased capitalization requirements by authorizing non-cash assets to capitalize savings and loans, further

limitation); (3) loans for home improvement and loans for manufactured homes; (4) certain federally insured loans to finance the purchase of real estate; (5) loans to financial institutions subject to federal examination or supervision, or to federally registered brokers or dealers, secured by loans, obligations, or investments that the S&L has statutory power to invest in directly; (6) secured or unsecured consumer loans (subject to a thirty percent aggregate limitation); (7) educational loans (subject to a five percent aggregation limitation); (8) nonconforming real estate loans for primarily residential or farm purposes (subject to a five percent aggregate limitation); (9) loans to business development credit corporations (limited in aggregate to the lesser of one percent of the S&L's assets or \$250,000, and subject to other requirements); (10) unsecured construction loans (subject to a five percent aggregate limitation); (11) loans secured by mortgages as to which the S&L has the benefit of federal insurance; and (12) loans for commercial, corporate, business, or agricultural purposes (subject to a five percent aggregate limitation that increases to ten percent on January 1, 1984).

Id. at 1641-42 (citations omitted).

423. PILZER & DEITZ, *supra* note 340, at 73-74. BRUMBAUGH, *supra* note 10, at 63.

424. PILZER & DEITZ, *supra* note 340, at 74. The Bank Board diligently and enthusiastically urged thrifts to engage in deregulatory operations in a supervisory climate that was no more strenuous than under the previous "separated" thrift industry. In fact, the Board urged thrift management to engage in the very practices for which the Resolution Trust Corporation now seeks to hold thrift management liable. *Id.* See discussion *infra* part V.

425. PIZZO ET AL., *supra* note 340, at 12-13. Traditionally, thrift chartering was based on the needs of the community and the competitive market. Now, the Bank Board sought to attract "innovative, visionary entrepreneurs to be the saviors of the thrift industry. What the industry got was a rush of brash, new owners with no other stockholders to buffer the S&L's well-being from the controlling owner's ambition, bad judgment, or greed." *Id.* at 12.

426. *Id.* See also STRUNK & CASE, *supra* note 14, at 94. The traditional requirements for acquiring a thrift charter was a minimum of 400 stockholders, and no single stockholder was permitted to own more than 25% of the outstanding stock. The removal of these requirements permitted a variety of "businessmen" to enter the industry all at the behest of the Bank Board, which encouraged thrifts to "operate like other businesses—not as organizations designed primarily to serve local communities." PIZZO ET AL., *supra* note 340, at 12. There was a problem, however: "Not only were new charters available, but entrepreneurs desirous of exploiting short-term profit opportunities could easily buy an existing institution for a relatively small investment." *Id.*

facilitating the acquisition of thrifts by many non-traditional "entrepreneurial" investors.⁴²⁷ Spurring the diversity of thrift loanmaking, regulators permitted savings and loans to finance one hundred percent of a borrower's transaction with no down payment.⁴²⁸ In another move to encourage thrift competitiveness, which contributed to the unification of banking and commerce, the Bank Board permitted thrifts to expand the geographic extent of their real estate loans throughout the county.⁴²⁹ These Bank Board regulatory changes encouraged the new growth of single shareholder-owned savings and loans with complex ownership and control problems, turning the once conservative thrifts into free-wheeling investment houses with a risktaking mandate from Congress and federal regulators.⁴³⁰

As the complexion of the industry changed, thrift accounting practices changed as well. Owners, with the approval of federal regulators, began to manipulate the thrift balance sheet to create capital.⁴³¹ The Bank Board aided in the balance sheet manipulation by changing Regulatory Accounting Principles ("RAP") in response to the declining net worth of thrifts caused by the sale of assets at a market value below book value.⁴³² These changes permitted thrifts, which previously were required to take an immediate loss on the sale of assets below book value, to amortize the loss in a "goodwill" asset account.⁴³³ As a result, many thrifts "looked" more solvent under RAP than under the business standard Generally Accepted Account-

427. *Id.* at 12-13.

428. Traditionally, thrifts required a down payment for home loan borrowers. Now, under the new regulations authorized by the Gart-St. Germain Act, a variety of borrowers could receive loans from thrifts without the pay-back incentive of a down payment. *Id.*

429. By loaning beyond their immediate geographic scope, the focus of the "George Bailey" thrift changed from a locally contend "community" business to a regional or national loaning machine. Invariably, managerial hands-on oversight of many loans was reduced. The inability of managers to monitor the new diverse thrift loans properly undoubtedly contributed to the increased number of "bad" thrift loans under deregulation. *Id.* at 13.

430. See discussion *infra* part IV.B.2.

431. The savings and loan associations that emerged from deregulation changed the traditional balance-sheet look of thrifts. Assets became diversified, reflecting investment in corporate securities and commercial real estate. Liabilities also changed, reflecting short term demand deposits and other short term accounts. As a result, the savings and loan associations were less easily distinguishable from commercial banks and other non-depository financial institutions by their balance sheets. BRUMBAUGH, *supra* note 10, at 2. For a discussion of the differences between traditional thrifts and banks prior to the unification of banking and commerce, see *supra* part IV.A.2.

432. The accounting changes the Bank Board implemented in 1981 were designed to encourage thrifts to restructure their fixed-rate home loan portfolios in order to begin the phase-in of market sensitive adjustable-rate mortgages. The Board's rationale was that without the incentive of amortization of losses, thrifts would be forced to sell assets at a market value well below book value. *Id.* at 41-43.

433. *Id.* The Bank Board's change in RAP was particularly noteworthy in that under

ing Principles ("GAAP").⁴³⁴ By employing dubious accounting principles, thrifts that the Bank Board would have declared insolvent were permitted to continue operations, only to delay and exacerbate the resolution of these "GAAP insolvent" thrifts.⁴³⁵ The Bank Board's regulatory forbearance from closing "insolvent" thrifts by manipulating accounting principles only served as an anesthetic to the eventual painful recognition of the deterioration in the thrift industry.⁴³⁶ Under the revamped regulatory scheme governing thrifts, the balance between risk-encouraging deposit insurance and the separation of banking and commerce was shattered. Instead, under deregulation, the unification of banking and commerce and the reaffirmation of the deposit insurance system encouraged a risktaking course in the industry that in large measure caused the \$500 billion thrift crisis.⁴³⁷

The Monetary Control Act, the Garn-St. Germain Act, and the Bank Board's change in regulations enabled formerly conservative thrifts to attract entrepreneurial management and \$100,000 insured accounts, which they invested in diversified portfolios with great profit potential but great financial risk. Predictably, many thrifts gambled on high-risk investments to stave off insolvency and federal takeover, only to delay the ultimate failure.⁴³⁸ Initially, deregulation

GAAP the Financial Accounting Standards Board would not permit the amortization of thrift "Goodwill" asset accounts. BRUMBAUGH, *supra* note 10, at 44.

434. The treatment of Goodwill under RAP provided a huge, but cosmetic improvement to thrift solvency. "The total difference between RAP and GAAP net worth reached \$9 billion by 1984." BRUMBAUGH, *supra* note 10, at 44. Goodwill as an intangible asset comprised over forty percent of the thrift industry's net worth by 1986. PIZZO ET AL., *supra* note 340, at 13. Although RAP's treatment of qualifying mutual and income-capital certificates, qualifying subordinated debentures and the appraised value of thrift branches contributed to the net worth disparity, the Bank Board's treatment of Goodwill was largely responsible for the inflated RAP net worth value. BRUMBAUGH, *supra* note 10, at 44.

435. RAP accounting principles, which effectively disguised institution insolvency, furthered regulatory forbearance. "[O]nly 251 institutions were insolvent according to RAP at the end of 1986, whereas 468 institutions were insolvent according to GAAP." *Id.* As a result, RAP accounting dramatically reduced the number of "insolvent" institutions and therefore the number of regulatory closures. *Id.* For a general discussion of the Bank Board's methods of closing an institution, see BRUMBAUGH, *supra* note 10, at 49-53. For the exacerbation of thrift solvency problems by Board closure lag time, see STRUNK & CASE, *supra* note 14, at 111.

436. See discussion *infra* part IV.B.2.

437. See discussion *infra* part IV.B.2.

438. Many thrifts, facing depressed real estate markets, loaded their portfolios with an unprecedented level (at least in banking institutions) of high-risk ventures. The failure in the high-yield securities market increased the severity of the savings and loan crisis as thrift failure became rampant throughout the industry. Many failed thrifts gambled on the ability of these investments to save them from insolvency and takeover, while the Federal Deposit Insurance Fund bore the majority of the risk and ultimately the actual loss. In fact, much of the present thrift director and officer liability litigation focuses on the accumulation of junk bonds in thrift portfolios, despite the underlying deregulatory scheme that actually encouraged these

and the effects of an improved real estate market,⁴³⁹ along with Michael Milken and the junk bond market,⁴⁴⁰ buoyed the thrift industry.⁴⁴¹ Ultimately, however, the real estate market soured,⁴⁴² the market for junk bonds crashed,⁴⁴³ Milken went to jail,⁴⁴⁴ and the decimated savings and loan industry was left with a portfolio of worthless assets.⁴⁴⁵

2. DEREGULATION, FORBEARANCE, AND FAILURE

Between 1979 and 1983, the Bank Board, Congress, and President Reagan dismantled much of the thrift regulatory framework in an attempt to place the thrift industry in a competitive market position. Initially, spurred by new accounting principles, success in the junk bond market, and a sudden dip in interest rates, the savings and loan industry progressed toward recovery.⁴⁴⁶ In fact, the thrift industry "appeared to grow by \$300 billion" in 1983 and 1984.⁴⁴⁷ However, the "new" thrift industry—changing from the traditional, conservative institution to a money lending and investment firm—soon revealed financial weakness.⁴⁴⁸ The recession and collapse in the real estate market,⁴⁴⁹ questionable and sometimes illicit thrift investment practices,⁴⁵⁰ and the inadequacy and forbearance of federal reg-

investments. See STRUNK & CASE, *supra* note 14, at 54-79. Joseph A. Grudfest, *Lobbying into Limbo: The Political Ecology of the Savings and Loan Crisis*, 2 STAN. L. POL'Y REV. 25 (1990); Thomas R. Romer & Barry R. Weingast, *Congress: The Genesis of the Thrift Crisis*, 2 STAN. L. & POL'Y REV. 37 (1990).

439. See STRUNK & CASE, *supra* note 14, at 98-100 (describing thrift successes in the booming real estate market between 1982 and 1985).

440. See WALDMAN, *supra* note 3, at 38-44 (describing increased thrift involvement in the bond market, particularly with Michael Milken and Drexel Burnham & Lambert).

441. "And for a while it looked like deregulation was working." PIZZO ET AL., *supra* note 340, at 13.

442. See STRUNK & CASE, *supra* note 14, at 100-107 (discussing the depressed real estate market, particularly in the Southwest, in the mid-1980s).

443. See WALDMAN, *supra* note 3, at 41 (commenting on the crash of the junk bond market).

444. *Id.* (commenting on the criminal charges faced by Michael Milken); but see *Milken Keeps \$125 Million After Settling 150 Lawsuits*, MIAMI HERALD, Feb. 28, 1992, at 1C (describing Milken's wrongdoing that left him with a \$125 million fortune).

445. See *Federal Deposit Ins. Corp. v. Milken*, Complaint 91 Civ. No. 0433 (S.D.N.Y. 1991) (on file with author) (describing more than 200 thrift institutions alleging fraud against Drexel Burnham & Lambert and Michael Milken for junk-bond purchases).

446. BRUMBAUGH, *supra* note 10, at 56. Despite the immediate successes, the signs of crisis were omnipresent as "the regulatory damage-control mechanism was thoroughly strained. The FSLIC fund was inundated by record failures and was performing triage on record numbers of insolvent but open institutions." *Id.*

447. *Id.*

448. BRUMBAUGH, *supra* note 10, at 56; PIZZO ET AL., *supra* note 340, at 13-14.

449. See Felsenfeld, *supra* note 385, at 532.

450. *Id.* at 534.

ulators monitoring the new free-wheeling savings and loan industry ultimately led to the failure of thrift institutions across the country.⁴⁵¹

Between 1980 and 1988, approximately 1045 federally insured savings and loans failed.⁴⁵² The breadth of failure in the thrift industry was even more pronounced because of the number of GAAP-defined insolvent institutions.⁴⁵³ Significantly, while 387 thrifts were resolved between 1984 and 1988, a yearly average of 866 institutions operated in the "red" during the same period.⁴⁵⁴ The disparity between the number of insolvent thrifts and the number of FSLIC closures has since widened because federal regulators with a policy of forbearance have not kept pace with the number of insolvent thrifts.⁴⁵⁵ The inability of FSLIC regulators to accurately and timely determine a thrift's insolvency, the limited number of FSLIC employees, and the relatively small number of healthy thrifts have all contributed to the large number of insolvent institutions still operating.⁴⁵⁶

451. BRUMBAUGH, *supra* note 10, at 56. The FSLIC regulatory staff was both undermanned and inexperienced. *Id.*; Felsenfeld, *supra* note 385, at 536-38.

452. "Failed" in this context is defined by a change in operations status forced by the intervention of Federal Regulatory bodies. (FSLIC and/or FDIC) See F. Jean Wells, *Banks and Thrifts: Restructuring and Solvency 1990*, at 11 (Sept. 12, 1990) (on file with author). Brumbaugh's statistics find that 669 savings and loans failed between 1979 and 1986, with a peak of 252 failures in 1982. BRUMBAUGH, *supra* note 10, at 40. Between 1980 and 1988, the FSLIC resolved approximately 500 failed thrifts. In 1980 alone, the FSLIC resolved 205 failed thrifts. Wells, *supra* at 11. As of June 31, 1991, the Resolution Trust Corporation had taken over 623 institutions and was operating 193 failed thrifts. From the enactment of FIRREA to June 1991, the RTC resolved 430 institutions. Barbara Miles & Thomas Woodward, *The Savings and Loan Cleanup: Background and Progress* 4-5 (Sept. 6, 1991) (on file with author). Regulators resolve failed institutions by one of three methods: In a "purchase and assumption" agreement a solvent and stable institution "purchases" an insolvent institution, acquiring its assets intact. In a "payout" transaction, the federal regulators pay off insured depositors and retain institution assets for later sale. In the final method, an insured deposit transfer, federal regulators close a failed institution and transfer its deposits to a healthy institution. Inevitably, the federal regulators choose the most cost-effective method. *Id.* at 5. For a list of thrifts in RTC conservatorship, see Resolved Conservatorship Report (FOIA Format) (1991) (on file with author).

453. See *supra* notes 431-437 and accompanying text.

454. E. KANE, *THE S&L INSURANCE MESS: HOW DID IT HAPPEN?* 80 (1989). See also BRUMBAUGH, *supra* note 10, at 44. The total decline of thrift institutions in the 1980s was dramatic, from a total of 4,002 institutions in 1980 to 3,220 institutions in 1986. *Id.* at 39.

455. BRUMBAUGH, *supra* note 10, at 49. Regulatory forbearance was motivated by several factors: Accounting principles, fears of a housing decline, a misunderstanding of the depth of the industry's problems, bad publicity and emotional concerns, and an inadequately capitalized deposit insurance fund. All factors also contributed to regulatory forbearance in the closure of weak institutions. G. Thomas Woodward, *Origins and Development of the Savings and Loan Situation*, 7-8 (Nov. 5, 1990) (on file with author).

456. See *supra* note 455. The FSLIC's ability to close a thrift immediately upon insolvency is limited by the regulatory oversight mechanism. Because regulatory examinations are infrequent and irregular, because institutions file financial reports only quarterly, and because of the masking qualities of RAP accounting, federal regulators face difficulty in determining precisely when an institution's net worth becomes zero. As a result, there often is considerable

Furthermore, failure in the industry inevitably drove the FSLIC insurance fund toward insolvency and questioned the continuing viability of the federal deposit insurance system.⁴⁵⁷ The financially troubled FSLIC had difficulty efficiently closing and resolving the growing number of insolvent thrifts, a difficulty ultimately hampering the bailout of the entire industry.⁴⁵⁸

3. RE-REGULATION AND CLEAN-UP BEFORE FIRREA

After five years of deregulation⁴⁵⁹ and the demise of hundreds of institutions, critics of the lax regulatory apparatus called for greater oversight of thrift institutions, especially in the area of risktaking.⁴⁶⁰ Until then, Congress and the federal regulators had taken almost no action to handle the growing insolvencies in the savings and loan industry.⁴⁶¹ In 1985, as insolvencies amassed and savings and loans diversified to riskier assets to stave off failure, the Bank Board began to regulate excessive risk transactions in an effort to decrease the risk of loss borne by the FSLIC.⁴⁶² Bank Board regulations limited the investments of a federally insured thrift to amounts not exceeding the greater of ten percent of its assets or twice its net-worth.⁴⁶³ The regulations also imposed greater net worth requirements on growing

lag time between insolvency and closure. BRUMBAUGH, *supra* note 10, at 49-51. The limited staff available to the FSLIC throughout much of the crisis also exacerbated the FSLIC's inability to close insolvent thrifts. Only 34 FSLIC employees worked on 297 institutions in 1980. Although the number of employees grew to 159 by 1985; the number of financially troubled institutions grew to 655. Significantly, over the same period, the number of thrift field examiners declined. *Id.* at 57. Failure was so pervasive in the industry that even healthy thrifts were either wary to merge with troubled institutions or did not have the resources to complete a successful merger. Since the most efficient means for the FSLIC to dispose of insolvent institutions was by merger, the FSLIC was further hampered in resolving failed institutions. *Id.* at 51-53. All of these factors contributed to further delay resolution of "failed" thrifts, resolution already slowed by regulatory forbearance.

457. BRUMBAUGH, *supra* note 10, at 51. The FDIC (which insures both banks and thrift deposits under FIRREA) faces continuing operating losses and "[m]ost observers of the banking industry and the insurance fund agree that both face challenges not encountered since the inception of federal deposit insurance in 1934." Testimony of L. William Seidman, Hearing on The Condition of the Bank Insurance Fund and Recapitalization before the Senate Committee on Banking, Housing and Urban Affairs, at 2 (Mar. 21, 1991) (on file with author). See also General Accounting Office Report to Congress Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund (Sept. 1990) (discussing the solvency of the insurance fund with projections through 1995).

458. See *supra* notes 456-457.

459. See *supra* notes 417-418 and accompanying text for a discussion of the Monetary Control Act of 1978, which began the deregulatory trend.

460. BRUMBAUGH, *supra* note 10, at 75.

461. The Bank Board did, however, raise the capital requirements in 1983 for new thrift institutions seeking charters. BRUMBAUGH, *supra* note 10, at 73.

462. *Id.* at 74.

463. *Id.* These regulations were the first regulatory attempt to separate banking and

thrifts and prohibited accounting techniques that lowered thrift net-worth requirements.⁴⁶⁴ These Bank Board regulations were the first step toward reestablishing the historic separation between banking and commerce established during the Depression years.⁴⁶⁵

In 1986, the Bank Board further stiffened thrift regulations.⁴⁶⁶ New regulations created higher incremental capital requirements for risky investments such as land loans, direct investments, non-residential construction loans, and letters of credit.⁴⁶⁷ To encourage a conservative thrift strategy, the Bank Board lowered the capital requirements for institutions lowering their interest exposure.⁴⁶⁸ Further contributing to its risk adverse posture, the Bank Board adopted additional direct investment regulations in late 1986 through 1987.⁴⁶⁹ Though these additional regulations further curtailed excessive risktaking, they were too late to curb the mounting thrift crisis, and they failed to assist already insolvent institutions, straining an already taxed FSLIC regulatory apparatus.⁴⁷⁰

With the insurance fund reeling, the Bank Board and United States Treasury officials developed a recapitalization plan to provide the FSLIC with additional funds to dispose of assets of closed and insolvent institutions.⁴⁷¹ In 1987, Congress and the Reagan administration (in a reversal of its earlier deregulatory stance) adopted a plan

commerce since the unification beginning with the Monetary Control Act in 1978 and culminating with the Garn-St. Germain Act of 1982. See *supra* part IV.B.2.

464. *Id.* For a discussion of the problems inherent in accounting practices, see, e.g., FEDERAL TRADE COMMISSION, FEDERAL TRADE COMMISSION ECONOMIC REPORT ON CORPORATE MERGERS 120, 127-29 (1969) (stating that "if accounting is a tool designed to facilitate a rational assessment of business success or failure, its techniques should give a timely and accurate representation. . ."); Ross, *The Wonderful World of Accounting*, in EMPIRICAL RESEARCH IN ACCOUNTING: SELECTED STUDIES 108 (1970) (questioning the empirical validity of accounting data); cf. Homer Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1188 (1970) (commenting on the "wildly unorganized accounting of the 1920s").

465. These regulations show that the Bank Board recognized the danger implicit in unifying banking, commerce, and deposit insurance.

466. BRUMBAUGH, *supra* note 10, at 76.

467. *Id.* The Bank Board raised the minimum net worth requirements for existing thrifts from a low of four percent to six percent RAP net worth. *Id.*

468. *Id.*

469. *Id.* As Brumbaugh notes, the Bank Board's decision to reduce thrift risktaking by raising capital requirements was "unassailable." *Id.* at 79.

470. *Id.* Net worth and other regulatory restrictions, although generally appropriate for the industry, did little to resurrect already insolvent, but still breathing institutions. Unfortunately, the federal regulatory scheme largely ignored the increased numbers of operating insolvent institutions since the early 1980s. "It is astounding that from the time this problem was perceived in late 1982 and early 1983 no coherent strategy to resolve it has been devised by the Bank Board, the executive branch, or Congress." *Id.*

471. *Id.* at 80. The Bank Board plan was to create a corporation out of capital taken from each of the twelve regional Federal Home Loan Banks. The corporation would "sell debt"

similar to the one the Bank Board had formulated to recapitalize the FSLIC.⁴⁷² The Competitive Equality Banking Act ("Competitive Equality Act"), authorized formation of the FSLIC Financing Corporation to raise \$10.8 billion to bail out insolvent thrifts.⁴⁷³ While aiding *insolvent* thrifts, the Competitive Equality Act hurt the condition of *solvent* thrifts by placing a premium on deposit insurance to raise recapitalization funds for the bail out.⁴⁷⁴ Worse still, the Competitive Equality Act fell short of the projected cost and ultimately, the actual cost of closing and resolving failed thrifts.⁴⁷⁵

In 1988, the Bank Board, under M. Danny Wall, developed its controversial "Southwest Plan."⁴⁷⁶ Under the "Southwest Plan," the Bank Board sold "sick" thrifts to healthy financial institutions, giving subsidies and tax breaks to encourage the deals.⁴⁷⁷ The Bank Board sold eighty-seven thrifts at bargain prices in fifteen separate transactions.⁴⁷⁸ Unfortunately, the "fire sale" cost the federal government dearly. Instead of raising money for the FSLIC and for recapitalizing closed thrifts,⁴⁷⁹ the Southwest Plan cost taxpayers \$8.5 billion alone on the tax breaks to thrift buyers.⁴⁸⁰ Not surprisingly, the Bush Administration soon terminated the Bank Board's authority to conduct Southwest Plan transactions and inspired a Congressional overhaul of the savings and loan regulatory scheme in 1989.⁴⁸¹

C. *The Financial Institutions Reform, Recovery, and Enforcement Act of 1989*

Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") in response to the esca-

repayable by placing capital in zero-coupon bonds. Any interest on the debt was to be paid from deposit insurance premiums. The plan hoped to raise \$5 billion per year. *Id.*

472. *Id.* See *infra* note 473.

473. Pub. L. No. 100-86, 101 Stat. 552 (1987) (codified as amended in scattered sections of 12 U.S.C.). See also BRUMBAUGH, *supra* note 10, at 80-81.

474. *Id.* See also Stephen K. Huber, *The Competitive Equality Banking Act of 1987: An Analysis and Critical Commentary*, 105 BANKING L.J. 284 (1988).

475. BRUMBAUGH, *supra* note 10, at 80-81.

476. *Id.* See also PILZER & DEITZ, *supra* note 340, at 203-232.

477. See *supra* note 476.

478. WALDMAN, *supra* note 3, at 85.

479. *Id.* at 84.

480. *Id.* The total cost of the "Southwest Plan" is estimated at \$66.9 billion over ten years. The "Southwest Plan" was a virtual "catalogue of flaws." PILZER & DEITZ, *supra* note 340, at 205-06. "[T]he Southwest Plan represented bad business judgment and faulty economic reasoning, since it sought to delay rather than resolve a critical problem." *Id.* Public outrage at M. Danny Wall's secretive thrift sale certainly inspired later congressional reaction to the thrift crisis in the passage of FIRREA. *Id.*

481. WALDMAN, *supra* note 3, at 87 (discussing the "Southwest Plan's" impact on the White House and its "spark plug" role in the enactment of FIRREA).

lating savings and loan crisis.⁴⁸² FIRREA revamped the regulatory apparatus that governed thrift institutions since the Depression and reversed the deregulatory trend of the late 1970s and early 1980s.⁴⁸³ Its breadth is enormous,⁴⁸⁴ contemplating both the funding and resolution of insolvent institutions and the continuing viability of the thrift industry.⁴⁸⁵

FIRREA did away with the Bank Board (and its infamous Southwest Plan),⁴⁸⁶ and divided the Board's responsibilities among three regulatory bodies: the Office of Thrift Supervision ("OTS"),⁴⁸⁷ the Federal Deposit Insurance Corporation ("FDIC"),⁴⁸⁸ and the Federal Home Financing Board ("Finance Board").⁴⁸⁹ The OTS became the primary regulator of federally-insured, federal and state chartered thrifts.⁴⁹⁰ The FDIC assumed the Bank Board's deposit insurance function.⁴⁹¹ The Finance Board replaced the Bank Board

482. Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified in scattered sections of 12 U.S.C. and 15 U.S.C.). For a comprehensive discussion of FIRREA, see David B. Gail & Joseph J. Norton, *A Decade's Journey from "Deregulation" to "Supervisory Regulation": The Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 BUS. LAW. 1103 (1990). Although FIRREA primarily addresses problems in the thrift industry and its governing regulatory framework, it also changes banking regulations; M. Maureen Murphy, *FIRREA: The Financial Institutions Reform, Recovery, and Enforcement Act of 1989: A Summary*, Aug. 28, 1989 (on file with author).

483. See *supra* part IV.B.2.

484. FIRREA's 1000-page length in itself is an appropriate commentary on its comprehensive coverage. Because of the Act's length, Congress had to enact a joint resolution to expedite its passage. See Gail & Norton, *supra* note 482, at 1106 n.14 (citing H.R.J. Res. 390, 101st Cong., 1st Sess., 135 Cong. Rec. H5315 (daily ed. Aug. 4, 1989)). Public pressure for a response to the thrift crisis spurred the Bush administration and Congress to enact this voluminous legislation. As Gail and Norton explain, the savings and loan crisis "was clearly the administration's number one domestic priority following President Bush's inauguration in January and the pressure on Congress to act swiftly was immense." Gail & Norton, *supra* note 482, at 1106 (citing S. Rep. No. 19, 101st Cong., 1st Sess., pt. 1, at 967 (1989)).

485. See *infra* notes 486-516 and accompanying text.

486. FIRREA § 401(a)(2), 103 Stat. 183, 354 (codified at 12 U.S.C. § 1437 note (West Supp. 1992)) (closing the Federal Home Loan Bank Board); *id.* § 401(a)(1) (dissolving the Federal Savings and Loan Insurance Corporation).

487. *Id.* § 301, 103 Stat. at 278 (codified at 12 U.S.C. § 1462a(a) (West Supp. 1992)) (establishing the OTS).

488. *Id.* § 401(A), 103 Stat. at 354 (codified at 12 U.S.C. § 1437 (West Supp. 1992)) (transferring the Bank Board's role of insuring deposits of thrifts through the FSLIC to the FDIC).

489. *Id.* § 702(A), 103 Stat. at 413 (codified at 12 U.S.C. § 1422a(b)(1) (West Supp. 1992)) (transferring the Bank Board's oversight role of the Federal Home Loan Banks to the Federal Housing Finance Board).

490. *Id.* § 301, 103 Stat. at 280 (codified at 12 U.S.C. § 1463(a) (West Supp. 1992)) (empowering the OTS with supervisory and regulatory authority over federal and state thrifts).

491. *Id.* § 401(A), 103 Stat. at 354 (codified at 12 U.S.C. § 1437 (West Supp. 1992)). Within the FDIC, the Bank Insurance Fund insures bank deposit accounts and the Savings Associations Insurance Fund insures the savings accounts of thrift institutions. *Id.* § 211(3), 103 Stat. at 369 (codified at 12 U.S.C. § 1441a(b)(3)(A) (West Supp. 1992)).

as the monitor of the Federal Home Loan Bank System.⁴⁹²

In addition to the OTS, the FDIC, and the Financing Board, FIRREA created the Resolution Trust Corporation⁴⁹³ ("RTC") and the Resolution Funding Corporation⁴⁹⁴ ("REFCORP") as temporary regulatory agencies. The RTC's function is to resolve failed thrifts in receivership or conservatorship previously insured by the now defunct Federal Savings and Loan Insurance Corporation.⁴⁹⁵ The RTC Oversight Board monitors the RTC's resolution of closed thrifts.⁴⁹⁶ Congress created REFCORP to finance, partially through the sale of bonds, the resolution of insolvent financial institutions.⁴⁹⁷

FIRREA sought to resurrect the savings and loan industry by separating banking and commerce, ending regulatory forbearance, and financing the resurrection of the savings and loan insurance fund.⁴⁹⁸ Congress hoped to achieve these goals by limiting the risk taking tendencies of deregulated institutions and by stricter monitoring of thrift business practices.⁴⁹⁹ Through FIRREA, Congress attempted to rebuild the deposit insurance reserve and to return to a "safe and stable system" of housing finance institutions.⁵⁰⁰ It did so by tightening capital, accounting, and other supervisory standards, and by placing stringent restrictions on high-risk investments.⁵⁰¹ To facilitate implementation of FIRREA's mandates, Congress vested federal regulators with more expansive criminal and civil enforcement powers.⁵⁰²

FIRREA raises capital standards of savings and loans in three areas. Its goal is to prevent unnecessary waste of federal deposit insurance funds by placing a greater risk burden on thrift owner-

492. *Id.* § 702(A), 103 Stat. at 413 (codified at 12 U.S.C. § 1422(A)(b)(1) (West Supp. 1992)).

493. *Id.* § 501(a), 103 Stat. at 363 (codified at 12 U.S.C. § 1441a(b)(1) (West Supp. 1992)) (establishing the RTC).

494. *Id.* § 511(A), 103 Stat. at 394 (codified at 12 U.S.C. § 1441b(A) (West Supp. 1992)).

495. *Id.* § 501(a), 103 Stat. at 363 (codified at 12 U.S.C. § 1441a (West Supp. 1992)). This section gives the RTC receivership and conservatorship authority for thrifts between January 1, 1989 and August 9, 1992, and empowers the RTC to dispose of all assets of the Federal Asset Disposition Association by February 4, 1990).

496. *Id.* § 501(A), 103 Stat. at 369 (codified at 12 U.S.C. § 1441a(b)(3) (West Supp. 1992)).

497. *Id.* § 511, 103 Stat. at 394 (codified at 12 U.S.C. § 1441(b)(e) & (f) (West Supp. 1992)).

498. *Id.* § 101, Stat. 183, 187 (codified at 12 U.S.C. § 1811 note (West Supp. 1992)).

499. For a discussion of the risktaking incentives of deposit insurance and of the unification of banking and commerce, see *infra* part VI.B.

500. FIRREA § 101(1) & (2), 103 Stat. 187 (codified at 12 U.S.C. § 1811 note (West Supp. 1992)).

501. *Id.* § 101(3), 103 Stat. 187 (codified at 12 U.S.C. § 1811 note (West Supp. 1992)).

502. *Id.* § 101(9), 103 Stat. 187 (codified at 12 U.S.C. § 1811 note (West Supp. 1992)) (stating another of FIRREA's purposes: "To strengthen the enforcement powers of federal regulators of depository institutions.").

ship.⁵⁰³ First, FIRREA requires thrifts to maintain a certain leverage limit—a minimum of a three percent capital to asset ratio.⁵⁰⁴ Second, it limits thrifts' use of intangible assets such as goodwill in thrift capital bases.⁵⁰⁵ Third, it requires thrifts to maintain certain amounts of capital and assets based on their risk characteristics.⁵⁰⁶ Under this capital standard, to invest in risky assets, a thrift must maintain higher relative capital on those assets compared with other more stable assets.⁵⁰⁷ Although FIRREA sets minimum capital standards, the OTS may require individual institutions to exceed the minimum standard capital based on the level of risk as determined on a case by case basis.⁵⁰⁸

With FIRREA, Congress and the Bush administration enacted specific provisions designed to curtail industry-wide failure and to secure the vitality of the thrift industry.⁵⁰⁹ Furthering this purpose, FIRREA enacts other measures to strengthen the savings and loan industry by placing limits on certain transactions.⁵¹⁰ FIRREA limits thrifts to certain dollar amounts on loans to one borrower⁵¹¹ on non-residential real property loans,⁵¹² and on unrated or below-investment-grade high yield securities,⁵¹³ and curtails the ability of thrifts to

503. H.R. REP. NO. 222, 101st Cong., 1st Sess. 408, *reprinted in* 1989 U.S.C.C.A.N. 432 (1989) [hereinafter Conference Report]. See FIRREA § 301, 103 Stat. at 303 (codified at 12 U.S.C. 1464(t)(1)(A)) (West Supp. 1992)).

504. FIRREA § 301, 103 Stat. 304 (codified at 12 U.S.C. § 1464(t)(2)(A)) (West Supp. 1992)).

505. *Id.* § 301, 103 Stat. 304 (codified at 12 U.S.C. § 1464(t)(2)(B)) (West Supp. 1992)). To compensate for the presence of "Goodwill" on many thrifts' balance sheets, FIRREA permits the phase-in of core capital requirements for eligible thrifts for qualifying supervisory goodwill. *Id.* § 301, 103 Stat. at 310 (codified at 12 U.S.C. § 1464(t)(9)(B)) (West Supp. 1992)).

506. *Id.* § 301, 103 Stat. 304 (codified at 12 U.S.C. § 1464(t)(2)(C)) (West Supp. 1992)).

507. *Id.*

508. Authorized by *id.* § 301, 103 Stat. at 303 (codified at 12 U.S.C. § 1464(s)(2)) (West Supp. 1992)) and formulated by 54 Fed. Reg. 4108, 4109 (1989) (codified at 12 C.F.R. § 3.100)).

509. See F. Jean Wells, *Savings Institutions and Their Regulatory Environment Under P.L. 101-73*, 7-9 (March 7, 1990) (on file with author).

510. FIRREA § 301, 103 Stat. at 282 (codified at 12 U.S.C. § 1464(u)(i)) (West Supp. 1992)). Limitations are usually 15% of a thrift's unimpaired capital and uninterrupted surplus. *Id.* This provision of FIRREA overturns the prior thrift practice which permitted real estate loans in value up to 100% of the thrifts' net worth.

511. *Id.* § 301, 103 Stat. at 310 (codified at 12 U.S.C. § 1464(u)(1)) (West Supp. 1992)).

512. *Id.* § 301, 103 Stat. at 286 (codified at 12 U.S.C. § 1464(C)(2)(B)(i)) (West Supp. 1992)). This provision reduces the amount of thrift loan funds in nonresidential real property to 400% of capital. *Id.*

513. Specifically, the Act prohibits investment in any security that has not received an investment grade rating from a nationally recognized statistical rating organization. FIRREA § 222, 103 Stat. at 270 (codified at 12 U.S.C. § 1833(d)(1)) (West Supp. 1992)) (prohibiting investment); § 222, 103 Stat. at 270 (codified at 12 U.S.C. § 1631(d)(4)(A)) (West Supp. 1992)) (defining investment grade security).

accept brokered deposits.⁵¹⁴ Federal regulators under FIRREA also employ a "qualified thrift lender" test, mandating that all savings and loan institutions retain at least seventy percent of their assets in "qualified investments," particularly housing finance.⁵¹⁵ Significantly, FIRREA holds state-chartered federally insured thrifts to the same standards as federally-chartered institutions.⁵¹⁶

1. REREGULATION TO LIMIT MANAGERIAL RISK-TAKING: BEARING THE BURDEN OF THE CRISIS

FIRREA completes the regulatory, deregulatory, re-regulatory cycle that has provided the backdrop for the thrift industry since the Depression-era legislation. Furthermore, re-regulation and the dramatic restructuring of the thrift industry under FIRREA occurred within eight years of a Congress and President bent on deregulating and broadening thrift business practices.⁵¹⁷ With deregulation, Congress and the President responded to the criticism of the separation of banking and commerce, which inhibited potentially competitive thrift business practices.⁵¹⁸ Unfortunately, the logical complement of unifying banking and commerce—amending the deposit insurance system to eliminate or reduce risk incentives⁵¹⁹—was omitted from the deregulatory scheme. Instead, the super-risktaking effects of unifying banking and commerce in concert with deposit insurance drove many

514. The brokered deposit limitation essentially requires thrifts to maintain FIRREA's capital requirements in order to receive brokered deposits. Those institutions not in compliance must receive FDIC approval to be eligible to receive brokered deposits. FIRREA § 301, 103 Stat. at 308 (codified at 12 U.S.C. § 1464(t)(6)(a)(iv) (West Supp. 1992)).

515. The Qualified Thrift Lender Test originated in the Competitive Equality Banking Act of 1987 ("CEBA"), Pub. L. No. 100-86, 101 Stat. 552 (1987). Under CEBA's Qualified Thrift Lender Test, the Bank Board required thrifts to maintain at least sixty percent of their tangible assets invested in qualified thrift investments on an average basis in three out of four quarters and two out of every three years. 12 U.S.C.A. § 1730a(o)(1) (1989). FIRREA retained CEBA's test until July 1, 1991, FIRREA § 301, 103 Stat. at 331-32 (codified at 12 U.S.C. § 1467a(m) (West Supp. 1992)) at which time FIRREA increased the required thrift investments to 70% of portfolio assets on a constant basis, *id.* § 303(A), 103 Stat. at 343-44 (codified at 12 U.S.C. § 1467(A) (West Supp. 1992)), and narrowed qualified thrifts' investments to an emphasis on housing finance. *Id.* § 303(A), 103 Stat. at 347 (codified at 12 U.S.C. § 1467(A) (West Supp. 1992)).

516. FIRREA § 222, 103 Stat. at 269 (codified at 12 U.S.C. § 1831(c) (West Supp. 1992)) (prohibiting state thrifts from engaging in activities that federal regulators prohibit national thrifts from participating in). Also, the FDIC has the authority to prohibit state thrifts from engaging in activity which threatens loss to the deposit insurance fund. *Id.* § 221(4), 103 Stat. at 268 (codified at 12 U.S.C. § 1828(m)(3) (West Supp. 1992)).

517. See *supra* part IV.B.2.

518. See, e.g., Roberta S. Karmel, *Glass-Steagall: Some Critical Reflections*, 97 BANKING L.J. 631 (1980) (arguing that the separation of banking and commerce operates inefficiently but is nevertheless significant in a revamped form).

519. See *supra* note 379.

thrifts to failure.⁵²⁰

Now, under FIRREA, Congress and the President (recognizing the dramatic risk incentives) took steps to reestablish the separation of banking and commerce in order to reinvent the thrift industry as a conservative, but still profitable, housing finance industry.⁵²¹ However, in FIRREA's re-regulation of the thrift industry, Congress and President Bush profoundly affected traditional notions of corporate governance in insured depository institutions. Under FIRREA, thrift management faces unprecedented liability in a fiduciary regime dramatically removed from the traditional Berle and Means corporate governance model, yet sympathetic to Berle and Means' ideal of a new corporate economic order based on the dictates of community.⁵²²

Inevitably, the news media's portrayal of thrift "bad boys" such as Charles Keating, Neil Bush, and David Paul created public resentment of all thrift industry management analogous to the outrage over "conflicts of interest" that spurred enactment of the Glass-Steagall Act in 1933.⁵²³ Congressional investigations into the massive financial failures at Keating's Lincoln Savings and Loan,⁵²⁴ Bush's Silverado Savings and Loan,⁵²⁵ and Paul's Centrust Savings Bank⁵²⁶ captivated and polarized the American public. Guided by reports of rampant fraud and questionable business practices, Congress sought a political scapegoat, and found one in thrift management.⁵²⁷ The question thus becomes: What is the cost of "punishing" thrift management?

FIRREA reinforced the wall between banking and commerce by imposing personal liability on corporate managers for excessive commercial risktaking.⁵²⁸ As a result, FIRREA profoundly disrupts traditional notions of corporate governance and places the burden of the savings and loan crisis on the shoulders of largely undeserving thrift management.

520. See discussion *supra* notes 395-397 and accompanying text.

521. See *supra* notes 486-516 and accompanying text, for a discussion of FIRREA's stated purposes of providing an effective system of housing finance.

522. See *supra* part II.A.3.

523. For a discussion of Depression fears and "conflicts of interests," see *supra* part IV.A.3.

524. See Lincoln Hearings, *supra* note 332.

525. See Silverado Hearings, *supra* note 332.

526. See Centrust Hearings, *supra* note 332.

527. See *supra* note 332; David A. Rosenbaum, *How Capital Ignored Alarms on Savings*, N.Y. TIMES, June 6, 1990, at A1, D4.

528. For a discussion of FIRREA and the separation of banking and commerce, see *infra* part VI.B.

2. THE FIDUCIARY REGIME UNDER FIRREA: *TRANS UNION* REVISITED

FIRREA creates a new federal fiduciary regime for insured depository institution management. FIRREA's fiduciary regime rejects the statutory and common law developed in the wake of *Trans Union*,⁵²⁹ which sought to limit the overextension of director and officer liability.⁵³⁰ In fact, FIRREA's fiduciary regime is strikingly similar to the standard articulated by the *Trans Union* court and thus begs the question whether fears of *Trans Union* liability will dissuade competent and qualified directors from service in thrift institution management. With the enactment of FIRREA, it appears that savings and loans will be guided by a new federal fiduciary regime that exacerbates ownership and control problems in corporate financial institutions.⁵³¹

a. The Gross Negligence Standard

Under FIRREA, directors and officers of financial institutions are held to a single standard of liability: gross negligence. Section 1821(k) of FIRREA states:⁵³²

A director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action . . . for gross negligence, including a similar conduct or conduct that demonstrates a greater disregard of duty of care (than gross negli-

529. 488 A.2d 858 (Del. 1988). See *supra* part III.C.1.

530. See *supra* part III.C.2.

531. See BARRY S. ZISMAN, *BANKS AND THRIFTS GOVERNMENT ENFORCEMENT AND RECEIVERSHIP* 1991 § 5.04(1) at 5-46, for a general discussion of FIRREA's fiduciary standard.

532. Pub. L. No. 101-73 § 212(K) (codified at 12 U.S.C. 1821(k) (West Supp. 1992)). Section § 1821(k) read:

(k) Liability of directors and officers. A director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action by, on behalf of, or at the request or direction of the Corporation [FDIC], which action is prosecuted wholly or partially for the benefit of the Corporation—

- (1) acting as conservator or receiver of such institution,
- (2) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed by such receiver or conservator, or
- (3) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed in whole or in part by an insured depository institution or its affiliate in connection with assistance provided under S. 1823 of this title,

for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined under applicable State law. Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law.

gence), including intentional tortious conduct, as such terms are defined and determined under applicable state law.⁵³³

Significantly, Congress used the same gross negligence language found in *Trans Union* and presumably intended a gross negligence standard similar to *Trans Union* to apply to thrift management in Delaware.⁵³⁴ Furthermore, FIRREA preempts state limitations on managerial liability,⁵³⁵ including all state defenses in the form of director and officer

533. *Id.*

534. KNEPPER & BAILEY, *supra* note 198, Cumulative Supp. at 59. The general application of Delaware "gross negligence" fiduciary law is arguably the basis for FIRREA's statutory standard: "[T]he term gross negligence [in FIRREA] suggests that such liability will follow the pattern made by the Delaware courts where gross negligence has been the criterion for directorial personal liability." *Id.*

535. *Id.* "The statute would presumably preempt any contrary state law, including any defenses to liability available under state law, such as the business judgment rule, the reliance defense, etc., to the extent that those defenses apply to gross negligence." *Id.*

The legislative history of section 1821(k) reveals a Congressional intent to preempt state liability-limiting statutes in the context of insured depository institutions. Even though Congress knew of the hazards of expanded liability, it still, somewhat surprisingly, preempted the state statutory regimes with the obvious, though anomalous, result of dissuading managerial service in the boardroom of insured depository institutions. Senator Sanford gives a somewhat confused comment on the section 1821(k) provisions, a comment that is contrary to plain reading of the Act:

Mr. President, I would like to thank the distinguished managers of the bill, Senator Riegle and Senator Garn, for including in the managers' amendment modifications to the bill regarding directors['] and officers['] liability . . . provisions relating to State laws affecting the liability of officers and directors of financial institutions.

I believe that these changes are essential if we are to attract qualified officers and directors to serve in our financial institutions. The bill as drafted would have preempted numerous State laws which provide limited indemnification for directors and officers. These State laws were enacted largely in response to problems faced by corporations in attracting good officers and directors. Problems also occurred in obtaining directors and officers insurance due to potential law suits against these directors and officers personally based on even simple negligence claims. Nothing in these State laws would preclude the bringing of such suits against the corporation itself, but these laws limit the personal liability of the officers and directors in certain circumstances.

The amendment which the managers have accepted modifies the bill to preempt State law only in a very limited capacity. The amendment would permit the FDIC to bring an action or direct others to bring an action against the directors and officers of a financial institution if the director or officer acted with gross negligence or committed an intentional tort.

While I fundamentally believe that issues of corporate governance and the standard of care to which corporate officers and directors should be held are matters of state law, not Federal law, the preemption of State law permitted by this bill is limited solely to those institutions that have Federal deposit insurance and to those cases in which the directors or officers have committed intentional torts or acts of gross negligence. As such, the establishment of a Federal standard of care is based on the overriding Federal interest in protecting the soundness of the Federal Deposit Insurance Corporation fund and is very limited in scope. It is not a wholesale preemption of longstanding principles of corporate

liability protection statutes.⁵³⁶ State legislatures enacted these statutes to limit potential officer and director liability after *Trans Union* and the director and officer liability insurance crisis of the mid-1980s.⁵³⁷ Because FIRREA preempts these state statutes, federal regulators are free to second-guess management's business judgment when they allege "unsafe and unsound" business practices violative of the gross negligence standard.⁵³⁸ Although FIRREA's standard creates uni-

governance, nor does it represent a major step in the direction of establishing Federal tort standards or Federal standards of care of corporate officers and directors.

135 Cong. Rec. S. 4276.

Senator Sanford provides the simplistic analysis of the preemption provisions that fails to consider the potential flight from insured depository institution board service under a fiduciary regime strikingly similar to the *Trans Union* liability crisis.

There is a dispute, however, as to the extent of the section 1821(k) preemption. See *Federal Deposit Ins. Co. v. McSweeney*, 1991 W.L. 173336 at 8 (S.D. Cal.) (holding that section 1821(k) preempts only those state laws not rising to the levels greater than gross negligence); but see *FDIC v. Canfield*, 763 F. Supp. 533 (C.D. Utah 1991) (holding that section 1821(k) preempts all state law). The *Canfield* decision was, however, reversed on appeal, *FDIC v. Canfield*, 967 F.2d 44 (10th Cir. 1992). While the majority of case law seems in agreement that 1821(k) preserves state causes of action for breaches of duty of care standards stricter than gross negligence, see, e.g. *FSLIC v. Shelton*, 789 F. Supp. 1360 (M.D. La. 1992); *FDIC v. Williams*, 779 F. Supp. 63 (N.D. Texas 1991); *FDIC v. Miller*, 781 F. Supp. 1271 (N.D. Ill. 1991); *FDIC v. Isham*, 777 F. Supp. 828 (D. Col. 1991); *FDIC v. Blade*, 777 F. Supp. 919 (W.D. Okl. 1991); *FDIC v. Fay*, 779 F. Supp. 66 (S.D. Texas 1991), the issue seems ripe for Supreme Court review. In fact, the defendant directors in *Canfield* have petitioned the Supreme Court for review and are awaiting word as to whether or not the Supreme Court will take jurisdiction. For an excellent overview of the Supreme Court briefs in *Canfield*, see Tracy Collins, (*Standard of Care*); *FDIC v. Canfield, Supreme Court is Asked to Review Simple Negligence Ruling*, *Failed Bank and Thrift Reporter* at 16,014 (Sep. 23, 1992).

536. See *supra* note 535.

537. For a discussion of the state statutory liability regime, see *supra* part III.C.2.

538. Congress did not define an "unsafe and unsound" practice in FIRREA. The usual meaning of the phrase comes from the then-chairperson of the Federal Home Loan Bank Board, John Horne:

Generally speaking, an 'unsafe or unsound practice' embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.

Zisman, *supra* note 531, at 2-6 (citing 112 Cong. Rec. 26474). Zisman gives illustrations of the "unsafe and unsound" standard in *First National Bank of Bellaire v. Comptroller of the Currency*, 697 F.2d 674, 685 (5th Cir. 1983) and *First National Bank of Eden v. Office of the Comptroller of the Currency*, 568 F.2d 610, 611 n.2 (8th Cir. 1978).

The RTC is using the "unsafe and unsound" standard to second-guess the business practices of failed institution management. The theory, presumably, is that any "unsafe and unsound" practice is gross negligence. In one pending litigation, the RTC sued the former directors and officers of a failed thrift for breaches of fiduciary duty. The RTC's description of the "nature of the action" is indicative of the strategy of second-guessing thrift managers' business judgment:

[T]he Office of Thrift Supervision ("OTS") and the Office of the Comptroller of the State of Florida ("Florida Comptroller") (collectively "the regulators")

formity amongst the states, its emasculation of the business judgment rule, of reliance, and of other defenses, raises questions about Congress' memory of history. With the stated goals of returning the thrift industry to viability, Congress achieved an undesirable result: *Trans Union*-type liability facing already disheartened thrift management. Under FIRREA, the uncertain ability to attract qualified management threatens the effective implementation of FIRREA's regulatory scheme aimed at revitalizing a dying industry.

Federal regulators can assert that any non-traditional thrift practice is an "unsafe and unsound" business practice for which management may be found grossly negligent and thus personally liable.⁵³⁹ Surprisingly, thrift management may also be found grossly negligent for business practices during the 1980s because of the possible retroactive application of FIRREA.⁵⁴⁰ Therefore, not only is the business judgment rule no longer a viable defense, but managerial decision-making may be affirmatively reevaluated with 20-20 hindsight, as thrift regulators apply the "unsafe and unsound [business] practice" standard.⁵⁴¹

declared Centrust to be operating in an unsafe and unsound condition and placed Centrust in conservatorship.

The rapid rise and fall of Centrust is a result of the acts of waste and mismanagement committed by the former Centrust directors and officers who are the named defendants in this Complaint. Each of these officers and directors owed fiduciary duties of care and loyalty to Centrust. The directors and officers breached these fiduciary duties by authorizing or permitting the depletion of Centrust's assets through extravagant and inappropriate expenditures. . . . The defendants also breached their fiduciary duties by authorizing or permitting a highly speculative investment strategy that concentrated much of Centrust's portfolio in high risk, unrated junk bonds. In breach of their duties, the defendants ignored Centrust's deteriorating financial condition from its ordinary banking operations and the warnings and directives of the regulators that Centrust's expenditures and investment strategy were inappropriate for a federally insured savings and loan.

Complaint, Resolution Trust Corp. v. David L. Paul et al., Case No. 90-1477-CIV-Atkins, at 2-3 [hereinafter "Centrust Complaint"] (on file with author). In the Centrust litigation, the RTC seeks to second-guess Centrust's investment strategy, a strategy that was permitted and even encouraged under 1980s deregulation. See *infra* notes 539-543 and accompanying text.

539. See *supra* note 538.

540. For an overview of the case law discussing the retroactive application of FIRREA, see Charles L. O'Brien & Lisa M. Cavage, *FIRREA: Retroactive Application, Due Process Issues, Right-Duty Analysis and the Statute of Limitations*, 108 BANKING L.J. 308 (1991). Federal courts or administrative agencies must apply the law in effect at the time of decision, unless doing so would result in manifest injustice or there is statutory discretion or legislative history to the contrary. Although there is a tradition to the presumption of retroactive application of civil statutes, see *Bradley v. Richmond School Board*, 416 U.S. 696 (1974), where the Supreme Court seems to have retreated from this position. See *Kaiser Aluminum Corp. v. Bonjorno*, 110 S. Ct. Rep. 1570 (1990).

541. For an example of the RTC's application of 20-20 hindsight, see Centrust Complaint, *supra* note 538, at 2-3.

Effectively, the reevaluation of business decisions under FIRREA is a stiffer review than even under *Trans Union*.⁵⁴² Whereas in *Trans Union* the court reevaluated management's procedural steps leading to the business judgment, under FIRREA the business judgment itself is the subject of scrutiny.⁵⁴³ In any event, the eradication of the business judgment safe harbor exposes insured depository institutions' management to far greater potential liability than other corporate management.

b. Civil Enforcement Provisions

In addition to gross negligence liability under FIRREA, managers of insured depository institutions also face civil money penalties for breaches of fiduciary duty under FIRREA.⁵⁴⁴ In Title IX of FIRREA, Congress created a three-tier civil penalty regime to police directors' and officers' duties to FDIC-insured depository institutions.⁵⁴⁵ As a result, the gross negligence corporate governance

542. The review of gross negligence under *Trans Union* did not reevaluate managerial business decisions for the decision itself but rather the procedural steps managers took in arriving at the decision. See *supra* part III.C.1.

543. The RTC has sought to hold directors liable for "questionable" investments—junk bonds, for example—even though the prior corporate governance law allowed and protected these investments under the business judgment rule. See, e.g., *Centrust Complaint*, *supra* note 538, at 2-3.

544. Pub. L. No. 101-73 Title IX (codified at scattered sections of 12 U.S.C.). See Gail & Norton, *supra* note 482, at 1188-1200 and Zisman, *supra* note 531, at § 9.04, for a discussion of the civil money penalty enforcement provisions of FIRREA. The civil enforcement provisions apply to a wide variety of depository institution actors beside those in managerial positions. The civil enforcement provisions apply to "institution affiliated parties," defined as

(1) any director, officer, employee, or controlling stockholder (other than a bank holding company) of, or agent for, an insured depository institution;

...

(3) any shareholder (other than a bank holding company), consultant, joint venture partner, and any other person as determined by the appropriate Federal banking agency (by regulation or case-by-case) who participates in the conduct of the affairs of an insured depository institution; and

...

who knowingly or recklessly participates in—

(A) any violation of law or regulation;

(B) any breach of fiduciary duty; or

(C) any unsafe or unsound practice, which is caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution.

Id. § 901(a), 103 Stat. at 446 (codified at 12 U.S.C. § 1786 (West Supp. 1992)).

545. FIRREA creates a general civil money penalty section applicable to all insured depository institutions. FIRREA § 907(a), 103 Stat. at 462 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)). For Federal Court review of FDIC penalty assessment see *Dazzio v. FDIC*, 970 F.2d 71 (5th Cir. 1992) (agency assessment constituted abuse of discretion); *Akin v. Ots*, 950 F.2d 1180 (5th Cir. 1992) (cease and desist order penalty assessment held valid); *Stanley v. Bd. of Governors of the Federal Reserve*, 940 F.2d 207 (7th Cir. 1991) (cease and

regime is supplemented by a regulatory/administrative corporate governance apparatus that compels further managerial accountability through the threat of enormous potential liability.

The First Tier of civil penalties under FIRREA concerns the obligations of insured depository institutions and their affiliated parties to the governing regulatory agencies.⁵⁴⁶ Punishable breaches of duty occur when the institution or its affiliates violate any law or regulation, regulatory final order, or temporary order issued to mandate compliance with FIRREA's enforcement provisions.⁵⁴⁷ Other violations under the First Tier include the breach of any condition or agreement drawn between the insured institution and the governing regulatory agency.⁵⁴⁸ The penalty imposed upon the insured institution and its affiliated parties for First Tier violations is a maximum of \$5,000 per day during the breaching period.⁵⁴⁹

The Second Tier of civil penalties under FIRREA's civil enforcement provisions specifically addresses fiduciary duties to the financial institution.⁵⁵⁰ By this provision, any affiliated party who "recklessly

desist order penalty assessment held valid); *Ambery v. FDIC*, 934 F.2d 681 (5th Cir. 1991) (assessment of civil penalties held to be abuse of discretion where FDIC asserted that directors were precluded from contesting assessment); *Abercrombie v. Clarke*, 920 F.2d 1351 (7th Cir. 1990) (upholding agency authority to assess civil penalties for violations prior to notice of cease and desist).

546. FIRREA § 907(a)(2)(A), 103 Stat. at 462 (codified at 12 U.S.C. § 1818(i)(2)(A)) (West Supp. 1992). The First Tier provision reads in pertinent part:

(A) First tier.—Any insured depository institution which, and any institution-affiliated party who—

- (i) violates any law or regulation;
- (ii) violates any final order or temporary order . . . ;
- (iii) violates any condition imposed in writing by the appropriate Federal banking agency in connection with the grant of any application or other request by such depository institution and such agency, shall forfeit and pay a civil penalty of not more than \$5,000 for each day during which such violation continues.

Id.

547. *Id.* § 907(a)(2)(A)(i) & (ii), 103 Stat. at 462 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)).

548. *Id.* § 907 (a)(2)(A)(iii) & (iv), 103 Stat. at 462 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)).

549. *Id.* § 907(a)(2)(A), 103 Stat. at 462 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)).

550. *Id.* § 907(a)(2)(B), 103 Stat. at 463 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)). The Second Tier provision reads as follows:

(B) Second Tier.—Notwithstanding subparagraph (A), any insured depository institution, which, and any institution-affiliated party who—

- (i)(I) commits any violation described in any clause of subparagraph (A);
- (II) recklessly engages in an unsafe or unsound practice in conducting the affairs of such insured depository institution; or
- (III) breaches any fiduciary duty;
- (ii) which violation, practice, or breach—

engages in an unsafe or unsound practice" in the administering of the business affairs of an insured depository institution breaches her duty.⁵⁵¹ Any breach of fiduciary duty that follows a pattern of breach and results in loss to the institution also violates the Second Tier provisions.⁵⁵² Second Tier violations call for a maximum penalty of \$25,000 per day during the period of the violation.⁵⁵³

The Third Tier imposes the stiffest penalties for breaches of duty.⁵⁵⁴ A Third Tier violation occurs when any affiliated party knowingly commits a First Tier violation, "engages in any unsafe or unsound practice" while "conducting the affairs" of the depository institution, or "breaches any fiduciary duty."⁵⁵⁵ If, while committing these violations, the party knowingly harms the institution or benefits an affiliated party to the detriment of the institution,⁵⁵⁶ the breaching party is subject to a civil money penalty of up to \$1,000,000 per day

- (I) is part of a pattern of misconduct;
- (II) causes or is likely to cause more than a minimal loss to such depository institution; or
- (III) results in pecuniary gain or other benefit to such party, shall forfeit and pay a civil penalty of not more than \$25,000 for each day during which such violation, practice, or breach continues.

Id.

551. *Id.* § 907(a)(2)(B)(i)(II), 103 Stat. at 463 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)).

552. *Id.* § 907(a)(2)(B)(i)(III), 103 Stat. at 463 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)).

553. *Id.* § 907(a)(2)(B), 103 Stat. at 463 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)).

554. *Id.* § 907(a), 103 Stat. at 463 (codified at 12 U.S.C. § 1818(I)(2) (West Supp. 1992)). The Third Tier provisions read as follows:

(C)

Third Tier.—Notwithstanding subparagraphs (A) and (B), any insured depository institution which, and any institution-affiliated party who—

(i) knowingly—

(I) commits any violation described in any clause of subparagraph (A);

(II) engages in any unsafe or unsound practices in conducting the affairs of such depository institution; or

(III) breaches any fiduciary duty; and

(ii) knowingly or recklessly causes a substantial loss to such depository institution or a substantial pecuniary gain or other benefit to such party by reason of such violation, practice, or breach,

shall forfeit and pay a civil penalty in an amount not to exceed the applicable maximum amount determined under subparagraph (D) for each day during which such violation, practice, or breach continues.

Id.

555. *Id.* § 907(a)(2)(c)(i)(I)(II) & (III), 103 Stat. at 463 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)).

556. *Id.* § 907(a)(2)(c)(ii), 103 Stat. at 463 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)).

during the course of the violation.⁵⁵⁷

The regulatory agency's assessment of a penalty is also to take mitigating factors into account in determining the amount of the levied penalty.⁵⁵⁸ The agency must consider the appropriateness of the penalty in relation to the financial resources and good faith of the breaching affiliated party.⁵⁵⁹ It must also weigh the severity of the violation, the history of previous violations, and other equitable considerations.⁵⁶⁰ Although a breaching party can seek judicial review of the agency assessment of a civil penalty, the amount of the penalty is not subject to review.⁵⁶¹

Further subjecting thrift managers to greater potential liability are certain provisions in FIRREA that give federal regulators the right as conservators or receivers of insolvent institutions to repudiate director and officer indemnity contracts with the depository institution.⁵⁶² FIRREA also expands liability exposure by extending the statute of limitations period to six years, beginning upon the termination of service of parties affiliated to the depository institutions.⁵⁶³ In the case of failed institutions, where the FDIC becomes a creditor, the RTC may consolidate and assert any and all causes of action derivative of the institution.⁵⁶⁴

557. See *id.* § 907(a)(2)(D), 103 Stat. at 463 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)), for the applicable penalty scale.

558. *Id.* § 907(a)(2)(G), 103 Stat. at 464 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)). The mitigation factors section reads as follows:

(G) MITIGATING FACTORS.—In determining the amount of any penalty imposed under subparagraph (A), (B), or (C), the appropriate agency shall take into account the appropriateness of the penalty with respect to—

- (i) the size of the financial resources and good faith of the insured depository institution or other person charged;
- (ii) the gravity of the violation;
- (iii) the history of previous violations; and
- (iv) such other matters as justice may require.

Id.

559. *Id.* § 907(a)(2)(G)(i), 103 Stat. at 464 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)).

560. *Id.* § 907(a)(2)(G)(ii)(iii) & (iv), 103 Stat. at 464 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)).

561. *Id.* § 907(a)(2)(I), 103 Stat. 464 (codified at 12 U.S.C. § 1818(i)(2) (West Supp. 1992)).

The civil liability provisions took effect on August 9, 1989. However, the \$5,000 and \$25,000 per day civil penalties apply to conduct before this date if the breaching party was not subject to notice of an administrative proceeding on these matters or the if the breach occurred after completion of the last regulatory examination of the institution. *Id.* § 907(l)(1) & (2) (codified at 12 U.S.C. § 93 note (West Supp. 1992)).

562. *Id.* § 212(e), 103 Stat. at 234 (codified at 12 U.S.C. § 1821(e) (West Supp. 1992)).

563. *Id.* § 905(a)(3), 103 Stat. at 459 (codified at 12 U.S.C. § 1818(i) (West Supp. 1992)).

564. For an example of a case where the RTC consolidated several shareholder derivative actions, see *Centrust Complaint*, *supra* note 538.

Furthermore, FIRREA subjects management to this stringent standard of care without state statutory limitation of liability in any civil action that is even "partially" for the benefit of the FDIC.⁵⁶⁵ The Act thus preempts statutory limitations on director and officer liability in almost every case, because derivative litigation will nearly always benefit the FDIC.⁵⁶⁶ The net result of these procedural provisions is to expand FIRREA liability in any litigation in which the FDIC or RTC plays a role.

Although FIRREA gives regulators the right to repudiate management indemnity contracts, the OTS has provided for indemnification contracts by regulation.⁵⁶⁷ OTS regulations permit indemnification contracts between depository institutions and directors and officers in cases where the indemnified party prevails in a judgment.⁵⁶⁸ The OTS also permits indemnity where a judgment has been rendered against the indemnified party, if a majority of disinterested directors approve the indemnification contract on the belief that the indemnified party acted in good faith and in the best interest of the financial institution.⁵⁶⁹

Because the FDIC is empowered to repudiate any indemnification contract, it would seem unlikely that an indemnity contract would survive the scrutiny of the FDIC in an action brought by the FDIC.⁵⁷⁰ Furthermore, the OTS can reject an indemnity contract if it deems the incurred expense unreasonable.⁵⁷¹ Therefore, in the vast majority of cases, directors and officers face enormous potential liability under FIRREA, which is not balanced by either the protection of state statutory or federal regulatory indemnification.

FIRREA turns the clock back to 1985. It establishes a *Trans Union*-type gross negligence standard and civil enforcement provisions that effectively achieve a corporate governance separation of banking and commerce in the limited, but important, context of insured depository institutions.⁵⁷² In an attempt to cure the pervasive ills of the thrift industry, Congress implemented a mandatory federal

565. FIRREA § 212(k), 103 Stat. at 243 (codified at 12 U.S.C. § 1821(k) (West Supp. 1992)). See *supra* note 532.

566. In nearly every suit, the RTC is a receiver or conservator of a failed institution and/or the FDIC is a creditor for the federal assistance given to resolve the institution.

567. 12 C.F.R. 545.121 (1992).

568. *Id.* at (c)(1).

569. *Id.* at (c)(2).

570. FIRREA § 212(e), 103 Stat. at 234 (codified at 12 U.S.C. § 1821(e) (West Supp. 1992)).

571. 12 C.F.R. 545.121(b)(2) (1992).

572. For a discussion of the FIRREA corporate governance regime separating banking and commerce, see *infra* part VI.B.

fiduciary standard and civil enforcement provisions that hold management accountable not just to shareholders, but also to other corporate actors, based on the public policy goals of constraining thrift "commercial" operations.⁵⁷³ Congress, assuredly driven by the cost of the bail-out and by the public outcry over the savings and loan crisis, enacted mandatory accountability rules despite admitted concerns that many potential candidates would decline seats on financial institution boards.⁵⁷⁴

V. FIRREA AND THE LIABILITY OF CORPORATE GOVERNORS: IN JUDGMENT OF BAD BUSINESS?

The corporate governance statutory regime prior to FIRREA sought to reduce director and officer liability after *Trans Union* and to respond to the fear that qualified individuals would decline service on corporate boards.⁵⁷⁵ FIRREA abrogates the protection afforded by these statutes in the limited context of insured depository institutions.⁵⁷⁶ In doing so, it effectively emasculates the business judgment rule as the safe harbor of corporate management.⁵⁷⁷ Now, under FIRREA, directors and officers of insured depository institutions are potentially liable for "knowingly or recklessly engaging in unsafe or unsound [business] practices."⁵⁷⁸ Because the RTC has defined "unsafe and unsound [business] practices" to include the diverse thrift practices both prevalent and permissible in the deregulated 1980s, fiduciary liability is predicated upon the judgment of bad business.⁵⁷⁹ Directors and officers "breach their fiduciary duty by authorizing or permitting a highly speculative investment strategy . . . inappropriate

573. For a discussion of the significance of FIRREA's mandatory federal corporate governance regime, which recognizes community goals, see *infra* part VI.E.

574. See *supra* note 535.

575. For a discussion of the expanded liability under *Trans Union* and the liability crisis, see *supra* part III.C.

576. See *supra* part III.C.2.

577. The paucity of judicial decisions on FIRREA's gross negligence standard limits any hypothesis as to a judicial interpretation reading a business judgment rule into the statute. However, the express preemption of state liability limitation statutes and congressional failure of inclusion of a business judgment provision strongly suggest that courts may strictly interpret the section 1821(k) standard without the business judgment defense. Certainly, a court's failure to find business judgment protection in FIRREA's fiduciary standard would come as far less of a surprise than the Delaware's Supreme Court opinion in *Trans Union*.

578. While the unsafe and unsound practices language is found in FIRREA's civil enforcement provisions section, the RTC has applied similar language in lawsuits based upon breach of fiduciary duty. See *Centrust Complaint*, *supra* note 538, at 3. Furthermore as a prerequisite to fiduciary litigation, institutions are closed for "operating in an unsafe and unsound condition." *Id.* at 2. Inevitably, the unsafe and unsound practices that form the basis for a bank's closure also form the allegations of subsequent fiduciary litigation. *Id.*

579. See, e.g., *Centrust Complaint*, *supra* note 538, at 2-3.

for a federally insured savings and loan.”⁵⁸⁰ Despite the teachings of years of corporate law, FIRREA’s statutory language licenses federal regulators and other derivative claimants to second-guess the business judgment of insured depository institution management.

The gross negligence and civil enforcement provisions took effect on August 9, 1989, the enactment date of FIRREA. Yet, the RTC still seeks to judge directors and officers for business decisions made in the 1980s.⁵⁸¹ Because of the presumptive retroactive application of civil statutes, FIRREA’s strict mandates may apply to the variety of deregulated practices that were the last gasps of now-insolvent institutions.⁵⁸² Conveniently, the RTC has forgotten that its regulatory predecessors permitted and even encouraged the very same practices for which the RTC now seeks to hold management liable.⁵⁸³ Furthermore, many thrifts have been unable to unload their high-risk investments because of the collapse of the junk-bond market.⁵⁸⁴ Management faces the unenviable choice between divesting their portfolios of prohibited loans and investments at an immediate loss, and suffering liability under FIRREA’s gross negligence and civil enforcement provisions.⁵⁸⁵ Thus, the RTC could subject directors and officers to astronomical liability and/or fines in its pursuit of claims against officers and directors for permissible and logical investments made when regulatory concern was thrift competitiveness in a high

580. *Id.*

581. Despite the dubious validity of the presumption of retroactive application of civil statutes, the RTC continues to allege managerial liability for permissible high-risk investments made prior to the enactment of FIRREA. See *Centrust Complaint*, *supra* note 538, at 2-3. See *supra* note 540, for case law and literature questioning the retroactive presumption as applied to civil statutes.

582. *Id.*

583. For a discussion of the congressional and agency deregulatory policies that encouraged the expansion of thrift practices, see *supra* part IV.B.2.

584. For an excellent gauge on the vast number of high yield securities that remain in savings and loan portfolios, see RTC Inventory of High Yield Securities, Apr. 17, 1991 (on file with author), which lists the aggregate inventory of high yield securities held by the RTC in conservatorship or receivership. Recently, however, junk bonds have rebounded from their collapse in the late 1980s. Allen R. Myerson, *As Defaults Drop, Junk Bonds Make a Comeback*, N.Y. TIMES, Sept. 23, 1992, at A1. New life in the junk bond market questions the regulatory business judgment requiring divestiture of junk bond portfolios at the bottom of the market while the RTC zealously pursues claims against former thrift management for breaches of fiduciary duty. Seemingly, thrift management and federal regulators both misplayed the junk bond market; however, potential liability unjustly accrues only to savings and loan management.

585. FIRREA does provide for a moratorium on the divestiture of junk bonds until July 1, 1994. FIRREA, § 222, 103 Stat. at 286 (codified at 12 U.S.C. § 1464(c)(1)(Q) (West Supp. 1992)). For a discussion of divestiture procedures, see Paul T. Clark et al., *Regulation of Savings Associations Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 BUS. LAW. 1013, at 1083-1087 (1990).

interest-rate market.⁵⁸⁶

The directors and officers of failed thrifts now face lawsuits for alleged breaches of their fiduciary duties in authorizing these deregulatory-era investments.⁵⁸⁷ Certainly, under the liability of FIRREA, the RTC can allege an "unsafe and unsound [business] practice" on nearly every thrift investment that did not conform to traditional, conservative business practices. In effect, without the limitation of the business judgment rule, the RTC may declare any unfortunate business decisions unsound in hindsight. The RTC could characterize all assets or liabilities on thrifts' balance sheets other than the safest home mortgage loans and savings accounts as "unsafe or unsound business practices."

Presumably, only those business practices permitted under FIRREA are safe and sound.⁵⁸⁸ The unfortunate reward to thrift management for operating within the strictures and under the approval of the permissive regulatory framework of the mid-1980s is nearly unlimited liability.⁵⁸⁹ Managers of insured depository institutions will now have to conform their activities to a far higher standard than other corporate directors. Without the business judgment rule, the RTC can review any director and officer transaction under a "heads, I win, tails, you lose" standard. Under this standard, armed with FIRREA hindsight, the RTC may classify even activities permitted under FIRREA as reckless, unsafe or unsound if they end up as "bad business" in a future regulatory environment.

While limited to insured depository institutions, FIRREA's significance may transcend insured depository institutions and ultimately serve as the forerunner to a new general corporate fiduciary regime. Given the history of financial institution cases that shaped existing corporate law, FIRREA's fiduciary regime and its impact on the business judgment rule will likely serve as a model for general corporate fiduciary law.⁵⁹⁰ And, on a larger scale, perhaps the expanded liability under FIRREA portends a reevaluation of the traditional understanding of the separation of ownership and control,

586. See *supra* part IV.B.2.

587. See, e.g., *Centrust Complaint*, *supra* note 538.

588. For a discussion of the business practices permissible under FIRREA, see Gail & Norton, *supra* note 482; Clark et al., *supra* note 585.

589. In the *Centrust* litigation, the RTC seeks approximately \$250 million in damages from former officers and directors. *Centrust Complaint*, *supra* note 538.

590. See CARY & EISENBERG, *supra* note 198, at 516 (observing that "[m]any of the early cases in which directors were held liable for negligence concerned . . . bank directors") (emphasis added).

and questions the present understanding of the corporate form of business organization.

VI. REGULATED DEPOSIT INSTITUTIONS AND THE CORPORATE FORM OF BUSINESS ORGANIZATION

FIRREA's fiduciary regime "re-separates" banking and commerce,⁵⁹¹ dramatically revamps the common law and statutory corporate fiduciary regime,⁵⁹² and curiously fits into the corporate governance scholarship debate.⁵⁹³ In a single fell-swoop, Congress repudiated the statutory fiduciary regimes enacted in the wake of the Delaware Supreme Court's decision in *Trans Union*.⁵⁹⁴ In their place, Congress imposed a minimum federal standard of gross negligence and strict civil enforcement provisions.⁵⁹⁵ Spurred by the ill-fated deregulatory unification of banking and commerce, Congress and President Bush rushed to enact a scheme of corporate governance that "re-separates" banking and commerce.⁵⁹⁶ Remarkably, FIRREA's scheme of corporate governance recognizes the fiduciary rights not just of shareholders but of creditors as well, particularly rights in relation to the government as deposit insurer.⁵⁹⁷ Also significant is FIRREA's amalgamation of principles articulated by both coercionist and contractarian scholars and its inclusion of community goals, mirroring the approach urged by corporate social responsibility scholars.⁵⁹⁸ Though noted for its comprehensive reform of the savings and loan industry as a whole, FIRREA creates major changes in the boardrooms of thrift institutions, the fiduciary rights of creditors, and the scholarship debate on corporate governance. Setting the stage for FIRREA's dramatic departure from traditional corporate governance are the inherent flaws of the savings and loan industry which led to crisis and which question the ultimate viability of the thrift industry.

A. *The Basis for Failure*

The given causes of the thrift crisis are as numerous as those willing to offer an opinion. While surely a variety of factors contributed to the demise of the thrift industry that triggered the enactment

591. See *infra* section B.

592. See *infra* section C.

593. See *infra* section E.

594. See *supra* part IV.C.2.

595. See *supra* part IV.C.2.

596. See *infra* section B.

597. See *infra* section D.

598. See *infra* section E.

of FIRREA, certain core problems led to the actual thrift crisis.⁵⁹⁹ The synergy of untimely economic effects, a tenuous and unworkable relationship between the unification of banking and commerce and deposit insurance, and regulatory and congressional forbearance doomed the savings and loan industry. These factors provide the necessary backdrop for an understanding of FIRREA's overhaul of traditional corporate governance.

The roots of the savings and loans crisis lie in the evolution of modern financial markets and inflation. In the late 1970s, rising interest rates and the growth of market sensitive financial instruments exposed thrift non-competitiveness as disintermediation drove depositors away from passbook savings accounts.⁶⁰⁰ Concurrently, the initially deregulated thrifts offering negotiable orders of withdrawal and money market accounts could not meet their short-term liabilities because asset-side entries were tied up in long-term home mortgages.⁶⁰¹ The final deregulation of thrifts removed asset-side limitations and permitted thrifts to invest in diverse commercial real estate and high-risk securities.⁶⁰² The ensuing recession and the collapse of the real estate market dealt the ultimate blow to a shaky thrift industry, which had initially shown improvement in the deregulatory environment.⁶⁰³ In fact, each of the Congressional regulatory enactments, including FIRREA, has been a knee-jerk response to adverse financial markets that undermined the savings and loans as a profitable industry.⁶⁰⁴

At the heart of the savings and loan problem is the separation of banking and commerce and the dominance of Depression-era thinking.⁶⁰⁵ Because of the fears of uncontrolled economic power compounded by Depression despair, Congress separated depository institutions from other financial service firms.⁶⁰⁶ Balancing the risk aversion of separating banking and commerce, risk-inducing federal

599. See *supra* part IV.B.1. For a general discussion of the roots of the savings and loan crisis which is also significant for its intended congressional audience, see G. THOMAS WOODWARD, ORIGINS AND DEVELOPMENT OF THE SAVINGS AND LOAN SITUATION (Nov. 5, 1990) (on file with author).

600. See BRUMBAUGH, *supra* note 10, at 31-57; WOODWARD, *supra* note 599, at 3.

601. See *supra* note 600.

602. See *supra* note 422.

603. See *supra* note 446 and accompanying text. But in reality, congressional deregulation of the industry "whatever else it might accomplish—had come too late to save the industry." WOODWARD, *supra* note 599, at 5.

604. See *supra* note 603.

605. See STRUNK & CASE, *supra* note 14, at 26 (discussing the effect of lingering Depression fears on the regulation of the thrift industry); BENTSON, *supra* note 382 (discussing the rationale for the separation of banking and commerce); see *supra* part IV.A.3.

606. See *supra* part IV.A.3.

deposit insurance reserves guaranteed depositor confidence and encouraged home loans.⁶⁰⁷ However, thrift competitiveness slackened as the separation of banking and commerce thwarted thrift business opportunities in evolving financial markets.⁶⁰⁸ To counteract the dying thrift business, Congress, the President, and federal regulators systematically deregulated the industry to revive lost thrift competitiveness, with the result of effectively uniting banking and commerce.⁶⁰⁹ Unfortunately, however, deposit insurance remained, encouraging continued thrift risktaking.⁶¹⁰ Thrifts, motivated by a risktaking mandate, diversified their portfolios with commercial real estate and unrated high-risk securities, only to suffer losses when the markets for these investments deteriorated. The result: the combined effect of risk-inducing unification of banking and commerce and of risk-inducing deposit insurance in the volatile economic market of the 1980s spelled doom for hundreds of thrifts and cost taxpayers billions of dollars.

Compounding the effects of the unification of banking and commerce with deposit insurance was congressional and presidential failure to modernize thrift regulatory oversight concurrently with thrifts' expanded commercial powers.⁶¹¹ Regulatory forbearance only delayed the closure of failed institutions and exacerbated the problems of healthy institutions. As thrift institution management with a federal risktaking mandate gambled for thrift solvency, regulatory oversight was either inadequate or purposefully restrained.⁶¹² In the relaxed regulatory environment with diversified thrift practices, the opportunity for excessive risktaking and fraud contributed to the demise of thrift institutions and inspired scandalous news reports disparaging the reputation of all thrift management.

The combined effects of unifying banking, commerce and deposit insurance and of inadequate regulatory supervision provided the foundation for inflationary interest rates and the eventual recession to expose the weakness of the entire industry.⁶¹³ FIRREA's overhaul of

607. See *supra* part IV.A.3.

608. Thrift weakness became particularly pronounced when rising interest rates caused disintermediation while thrifts were limited to the interests payable on deposits. See *supra* notes 600-604 and accompanying text.

609. See *supra* part IV.B.2.

610. In fact, deposit insurance increased from \$40,000 to \$100,000 on each account in the Monetary Control Act. See *supra* part IV.B.2.

611. See WOODWARD, *supra* note 599, at 7-9.

612. *Id.*

613. See *id.* at 10-11, for a concise summary of the variety of combined effects that contributed to the demise of the industry. See also STRUNK & CASE, *supra* note 14, at 14-16, for an overview of the causes of the savings and loan crisis.

the savings and loan regulatory structure directs reform at the perverse effects of the unification of banking and commerce, deposit insurance and regulatory forbearance.⁶¹⁴ In doing so FIRREA makes control of corporate governance the priority of thrift reform.

B. FIRREA and Risktaking: Fiduciary Duties Separating Banking and Commerce

The unification of banking and commerce and the effects of fixed-rate deposit insurance drove many thrifts to a super-optimal risktaking posture in the wake of deregulation.⁶¹⁵ Untimely market effects drove many of these institutions to insolvency and federal takeover.⁶¹⁶ Congress and the Bush Administration, inspired by the perceived failure of the deregulatory experiment, enacted FIRREA as a means of controlling risk by limiting certain thrift practices in commercial activities.⁶¹⁷ In effect, FIRREA "re-separates" banking and commerce. Yet, portfolio control and other restrictions were seemingly not enough for a Congress and Presidency facing a political maelstrom over the scandal in the thrift industry. Assuredly driven by political pressure and newsroom scandal, Congress and the Bush administration took the unprecedented step of using a scheme of corporate governance to further separate banking and commerce.

In the legislative environment still seemingly dominated by Depression-era fears, Congress and the President enacted FIRREA, which left the risk-inducing deposit insurance system intact but reasserted the Depression-era balance with a risk-reducing limitation of

614. For a discussion of FIRREA's reforms, see *supra* part IV.C.

615. For a discussion of the risktaking effects of deposit insurance and of risktaking and the separation of banking and commerce, see Halpert, *supra* note 185, at 509-17. For a comprehensive overview of the separation of banking and commerce, see BENTSON, *supra* note 382.

616. See STRUNK & CASE, *supra* note 14, at 98-105, for an account of the recessionary economic effects of the mid-1980s.

617. While thrifts under FIRREA are not regulated to the prohibitive extent they were under the Glass-Steagall Act, FIRREA does enact a variety of portfolio restrictions designed to inhibit risktaking. For an overview of those provisions, see Gail & Norton, *supra* note 482. For an excellent discussion on control of risk, see Alex M. Azar II, *FIRREA: Controlling Savings and Loans Association Credit Risk Through Capital Standards and Asset Restrictions*, 100 YALE L.J. 149 (1990). Three types of risk are associated with Savings and Loans: credit risk, interest rate risk and liquidity risk. Credit risk concerns a borrower's potential default on a loan. Interest rate risk is the measure of the spread between interest rates paid on deposits and interest rates returned on mortgage loans. Liquidity risk is a measure of the possibility of disintermediation or other flight of depositors from thrift institution accounts. *Id.* at 151-52. Credit risk is the primary focus of this comment as "[a]n S&L can invest in higher earning, yet riskier assets and still pay the same interest rate to depositors and the same premiums to the FDIC." *Id.* at 156. FIRREA's fiduciary regime limits credit risk by threatening personal liability for poor business decisions that deviate from traditional thrift "investment" practices.

thrift activities. FIRREA's gross negligence and civil penalty provisions prevent all but the most conservative of business strategies. Management, threatened with hindsight evaluation of their business decisions under FIRREA's "unsafe and unsound practices" standard, must necessarily be risk-averse. In effect, management is obligated to observe the separation of banking and commerce by the threat of enormous personal liability. Whereas the traditional separation of banking and commerce placed limitations on specific thrift activities, FIRREA's corporate governance "separation" conceives of a core corporate relationship based on risk aversion. This relationship explicitly recognizes the risk of loss borne by the deposit insurance fund as institutions gamble to thwart insolvency and federal takeover.⁶¹⁸

While FIRREA includes other measures to prevent managerial misuse or abuse of an institution's assets, its fiduciary provisions create a trust relationship between depository institution management and the federal government as insurer.⁶¹⁹ The trust relationship vests the federal regulators with enforceable rights against management for breaches of fiduciary duty in the exercise of due care and loyalty to the institution. Insured depository institution managers now owe a duty of due care and loyalty to the federal deposit insurers, akin to the duty traditionally owed to shareholders, yet conceptually different in FIRREA's concept of a corporate financial institution structure dramatically removed from the Berle and Means thesis.⁶²⁰

FIRREA's strict corporate governance regime, distinct from traditional corporate law, inserts a regulatory trust relationship into the pervasive tension between managers and shareholders. The Berle and Means separation of ownership and control problem is exacerbated as the goals of the federal government as insurer and stockholding ownership materially diverge.⁶²¹ Unfortunately, the difficulty that thrift management faces in resurrecting the industry is now compounded by distinct liability to both shareholders and the Federal Government. FIRREA's incorporation of the separation of banking and commerce into the structural tension in corporate law questions

618. See Coffee, *supra* note 190, for a discussion of the risk propensity of savings and loans approaching insolvency.

619. FIRREA's fiduciary trust relationship harkens back to the "corporate powers as powers in trust" debate between Berle and E. Merrick Podd. See *supra* part II.A.3.

620. The separation of ownership and control thesis is discussed *supra* part II.A.

621. The government as insurer becomes risk averse particularly as institutions approach insolvency, while shareholders with nothing to lose and everything to gain favor risk as institutions approach insolvency. For a discussion of this relationship, see Coffee, *supra* note 190.

the viability of the thrift industry in a corporate form, as management attempts to serve the disparate goals of two unforgiving masters, both threatening enormous liability.

C. *Life in the Boardroom After FIRREA*⁶²²

The regulatory framework created under FIRREA will have a similar effect on the corporate governance of insured depository institutions as *Trans Union* did on the general corporate governance regime.⁶²³ FIRREA will cause directors and officers of banks and thrifts to rethink their commitment to service at these institutions. Many of the most qualified leaders,⁶²⁴ fearing tremendous personal liability, will resign or refuse to serve on savings and loan and bank boards. The projected difficulty in attracting the most qualified persons to serve in a fiduciary capacity arises at a time when the need for effective corporate governance in the savings and loan and banking industries is the greatest. Only the most qualified boards could help the savings and loan industry emerge from a decade of insolvency and prevent the banking industry from suffering a similarly bleak fate in the 1990s.

Perhaps Congress and President Bush believe that in the stringent regulatory environment of FIRREA there will be no need for the entrepreneurial management that operated the savings and loans in the deregulated 1980s. Since federal regulation strictly monitors the governance of financial institutions, less qualified and/or cautious individuals, serving as "foremen," would facilitate the rebirth of the savings and loan industry by pursuing the legislatively mandated conservative corporate strategy.⁶²⁵ In FIRREA's regulatory model, managers as "foremen" would take guidance from the regulatory apparatus, which prohibits all but the most traditional aspects of thrift and banking business based upon the strictures of public policy rather than shareholder wealth maximization.⁶²⁶

However, given the enormous potential liability of FIRREA's fiduciary provision, Congress' belief that the resurrection of the sav-

622. See Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1 (1985), for the effects of *Trans Union* on corporate managerial liability.

623. *Id.* See *supra* part II.C.

624. For a discussion of the skills needed by thrift management under FIRREA, see David de Wilde, *Fitting Talent to Thrift Industry Needs*, AM. BANKER, Nov. 2, 1989, at 1.

625. Corporate "foremen" is an allusion to, and perhaps a realization of Berle and Means' "neutral technocratic" management, allocating decisions based on the dictates of community through public policy. BERLE & MEANS, *supra* note 17. See *supra* part III.C.

626. See *infra* part VI.E.

ings and loans can be accomplished through cautious, non-risktaking management is questionable. After all, what right-minded, cautious, non-risktaking person would seek a management position with an insured depository institution facing the potentially enormous personal liability of FIRREA? Whatever effect FIRREA has on the savings and loan industry, the federal fiduciary regime for financial institution directors and officers has become entirely distinct from the fiduciary regime of general corporate law.

Whether FIRREA relies on corporate governance in the 1990s the same debate and liability crises *Trans Union* did in the 1980s remains to be seen. The President and Congress, under enormous political pressure from the mounting savings and loan crisis, seem to have ignored the evolution of the state statutory corporate governance regime.⁶²⁷ FIRREA, in its attempt to resurrect the devastated thrift industry, has enacted a liability regime with provisions similar to those in the *Trans Union* decision that shook the corporate world. The effect of *Trans Union* on corporations was clear. Many of the most qualified individuals refused to serve on the boards of corporations for fear of potentially great liability. Ironically, FIRREA's purpose is to promote "a safe and stable system of affordable housing finance."⁶²⁸ Yet, FIRREA, by subjecting directors and officers to greater liability standards, implicitly suggests that qualified directors and officers do not play any significant role in achieving the stated purpose of FIRREA.

By effectively removing directors and officers from the creation and administration of a viable thrift industry, Congress assumes that the regulatory framework alone will establish a successful depository institution industry. But, as the history of federal thrift regulation suggests, legislation and agency regulation have been inadequate to establish a stable savings and loan industry.⁶²⁹ Knee-jerk regulating has been ineffective in responding to dynamic market forces. With the ever-changing market, the savings and loans industry needs effective autonomous managers to navigate back to health. A sluggish regulatory framework cannot properly monitor an industry thus exposed to the vagaries of market forces, as demonstrated by the ill-timed regulatory, deregulatory, re-regulatory see-saw between 1978 and 1989.

But did not the regulatory agencies also bear the responsibility of

627. *But see* the rather incongruous Senate debate, *supra* note 535.

628. FIRREA, § 101(1), 103 Stat. at 187 (codified at 12 U.S.C. § 1811 note (West Supp. 1992)).

629. For an overview of the ineffective regulatory history of the thrift industry, see *supra* part VI.A.

the thrift industry collapse? By deregulating the industry, President Reagan and Congress made the same high-risk investment decision for which FIRREA now seeks to impose liability upon directors and officers. Economic forces, the unwieldy balance between deposit insurance and the unification of banking and commerce, regulatory forbearance, and boardroom decisions systematically caused the collapse of the savings and loan industry. As directors and officers bear the brunt of litigation and liability, the political consequences suffered by politicians and regulators seem mild in comparison. After all, the majority of officers and directors acted in good faith and in compliance with Congressional and regulatory provisions. The result: institutional failure. The causes of the thrift fiasco go far deeper than the boardroom and the offices of management. While some high-profile industry magnates committed serious breaches, under FIRREA, Congress and President Bush designated the managers of failed thrifts as the major cause of the savings and loan collapse. Succumbing to political pressures, FIRREA's drafters naively sought to recoup bailout costs from the pocketbooks of deposed management, despite the obvious adverse effects of expanded liability.

As a fiduciary measure, FIRREA is an effort by the federal government to resolve the corporate governance conflict in insured depository institutions. In its efforts, however, Congress has supplanted director and officer management with a regulatory "foreman" management. Yet, by effectively placing much managerial responsibility within regulatory agencies, Congress has not resolved the potentially conflicting interests between absentee owners and management. Now, absentee shareholder-owners face a management regime even less responsive and accommodating than that of traditional directors and officers. Under FIRREA, regulatory management's primary goals are to preserve the sanctity of the deposit insurance fund, while shareholders' primary aim still is the maximization of their ownership wealth regardless of the risk to insurance reserves.⁶³⁰ Shareholder-owners, with goals of maximizing wealth, do not share the same exclusive regulatory goal of maintaining a safe system of affordable housing finance.⁶³¹ With shareholder-owners and regulatory management "separated" to an even greater extent than the separation of ownership and control in general corporate law, the future of savings and loans and banks as viable corporate financial forms is dim.

630. See *supra* part VI.D, for a discussion of conflicting shareholder and creditor goals.

631. FIRREA, § 101(1), 103 Stat. at 187 (codified at 12 U.S.C. § 1811 note (West Supp. 1992)).

D. *Fiduciary Rights of Creditors and Shareholders*

Perhaps the most remarkable aspect of FIRREA's corporate governance regime is its implicit recognition of a fiduciary relationship between corporate management and the Federal Government as insurer along with other potential creditors.⁶³² Both the gross negligence standard and the civil enforcement provisions of FIRREA permit second-guessing of corporate management business decisions. In effect, officers and directors of financial institutions are now constrained by the retrospective "unsafe and unsound" business practice standard. This standard reinforces director and officer adversity to strategic corporate risktaking, which, although generally protecting shareholders from the diminution of their equity investment, primarily affects the fiduciary preservation of creditor claims on corporate assets as financial institutions approach insolvency.⁶³³

The business judgment rule as applied to financial institution officers and directors prior to the enactment of FIRREA served the goals of both management and ownership.⁶³⁴ It protected directors and officers because courts would not find them liable even for bad business decisions, despite application of a 20-20 hindsight standard. Shareholders, with goals of wealth-maximization, are served by a management willing to lead the corporation into an innovative, albeit sometimes risky direction. While there is always risk to the corporate enterprise, shareholders may protect themselves against risky ventures by choosing to invest in a certain type of corporation, conserva-

632. Twenty-eight states do however codify "other constituency" statutes which *permit* but do not *require* corporate management to consider non-shareholder constituencies in corporate decision making. See ARIZ. REV. STAT. ANN. § 10-1202 (Supp. 1990); CONN. GEN. STAT. § 33-313(e) (1991); FLA. STAT. § 607.0830(3) (1989); GA. CODE ANN. § 14-2-202(b)(5) (1989); HAW. REV. STAT. § 415-35(b) (Supp. 1990); IDAHO CODE § 30-1702 (Supp. 1991); ILL. REV. STAT. ch. 32, para. 8.85 (1989); IND. CODE §§ 23-1-35-1(d), (f) and (g) (Supp. 1990); IOWA CODE § 491.101B (1991); KY. REV. STAT. ANN. § 271B.12-210(4) (Baldwin 1989); LA. REV. STAT. ANN. § 12:92(G)(2) (West Supp. 1991); ME. REV. STAT. ANN. tit. 13-A, § 716 (West Supp. 1990); MASS. GEN. L. ch. 156B, § 65 (Supp. 1991); MINN. STAT. § 302A.251(5) (1990); MISS. CODE ANN. § 79-4-8.30(d) (Supp. 1990); MO. REV. STAT. § 351.347.1(4) (Supp. 1990); NEB. REV. STAT. § 21-2035(1)(c) (Supp. 1990); N.J. STAT. ANN. §§ 14A:6-1(2), 14A:6-14(4) (West Supp. 1991); N.M. STAT. ANN. § 53-11-35(D) (Supp. 1991); N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1991); OHIO REV. CODE ANN. §§ 1701.13(F)(7), 1701.59(E) (Anderson Supp. 1990); OR. REV. STAT. § 60.357(5) (1989); 15 PA. CONS. STAT. § 1715 and 1716 (1990); R.I. GEN. LAWS § 7-5.2-8 (Supp. 1990); S.D. CODIFIED LAWS ANN. § 47-33-4 (1991); TENN. CODE ANN. § 48-35-204 (1988); WIS. STAT. § 180.0827 (1989-90); WYO. STAT. §§ 17-16-830, 17-18-201 to 17-18-203 (enacted 1989). For a comprehensive review of these statutes, see *Symposium: Corporate Malaise—Stakeholder Statutes*, 21 STETSON L. REV. No. 1 (1991); see also *infra* part VII.

633. See Coffee, *supra* note 190 for a discussion of risktaking by financial institutions approaching insolvency.

634. See *supra* part III.B.

tive or risktaking, most suitable for their potential expected return. Without the business judgment rule, the threat of retrospective criticism by courts would constrain management's decisionmaking and preclude any non-conservative strategy, to the detriment of shareholder investors seeking greater returns on their investment. In fact, the distinction between shareholder and creditor, both as investors in the corporation, becomes blurred in a risk-prohibitive corporate management environment. In FIRREA's risk-prohibitive environment, the investment return ratio of the shareholder is to a large extent subsumed to the investment/return ratio of the corporate creditor. Management, constrained in decisionmaking, limits the shareholders' return on their equity investment to nearly a fixed rate, similar to the expected return of creditors.

The "unsafe and unsound business practice" standard may, however, benefit some shareholders of financial institutions. Given the rampant failure in the industry due in large part to permissive regulations, a risk-prohibitive regulatory environment may prevent failure, at least in the short term, thereby preserving shareholder wealth. Yet, with financial institutions floundering, the "unsafe and unsound" standard primarily benefits financial institution creditors.

As corporate institutions approach insolvency, they are more likely to take investment risks.⁶³⁵ Creditors at this time are more likely to suffer the loss of their originally conservative, fixed-rate investment because risky investments diminish corporate assets. At the same time, shareholders have the most to gain from a last ditch effort to utilize the remaining assets to bail out the institution prior to insolvency and takeover. The "unsafe and unsound" standard preserves the assets of institutions approaching insolvency—a period during which risktaking would favor stockholders. As a result, the "unsafe and unsound" standard primarily favors creditors.⁶³⁶ Therefore, FIRREA's fiduciary regime implicitly recognizes a duty owed by officers and directors to corporate creditors, to conduct business in a "safe and sound" business manner to preserve institution assets.⁶³⁷

As a potential creditor, the deposit insurance reserve benefits from the preservation of assets under the "unsafe and unsound" standard. The ongoing efforts to replenish the progressively depleted deposit insurance fund is well served by a fiduciary regime that preserves the assets of failing institutions. These assets, when liquidated,

635. See Halpert, *supra* note 185, at 512-13.

636. In the unlikely event that corporate assets remain after distribution to creditors, shareholders may recoup some of their losses.

637. For further discussion of the fiduciary rights of creditors, see *infra* part VII.

may keep the federal deposit insurance fund afloat. Any measure that preserves corporate assets prior to failure serves the interests of government and general creditors alike. However, these same measures, designed to preserve institutional assets, may also contribute to institutional failures,⁶³⁸ with the contradictory result of taxing the insurance reserves.

The issue that remains to be settled is the price Congress and the regulators are to willing to pay in their misguided efforts to replenish the insurance fund. By prohibiting risktaking by institutions approaching insolvency, Congress effectively sounded a death-knell for many institutions. The result is that institutions nearing insolvency are not likely to recover. Healthy institutions must compete in a regulatory environment that encourages creditor claims, yet discourages shareholder equity investment. Therefore, the prospects for a rejuvenated savings and loan industry are grim, especially in light of the competition of other financial institutions that offer higher rates of investment return without the history of failure.

E. *FIRREA and the Corporate Governance Scholarship*

FIRREA takes a revisionist approach to the corporate governance scholarship, drawing upon principles from the traditional "coercionist" model, the modern "contractarian" model and the "corporate social responsibility" model.⁶³⁹ FIRREA creates a federal minimum fiduciary duty standard, mirroring the coercionists' mandatory corporate law approach. However, FIRREA's implicit acknowledgement of management's fiduciary duty to creditors suggests a "nexus of contracts" approach to financial institutions, an approach associated with the contractarian school. Most remarkably, however, FIRREA recognizes a corporate governance regime that is responsive to community goals based on public policy. FIRREA's oscillation between the competing views of corporate governance theory is testimony to congressional uncertainty as to the application of corporate governance principles in an industry rife with failure. The difficulty of pursuing the disparate goals of attracting qualified leaders to the boards of financial institutions and of ensuring a healthy, profitable savings and loan industry resulted in a federal enactment that succumbs to the temptation of compromise without appreciating the effects on financial institution management.

As demonstrated, the enactment of the fiduciary regime under

638. The result of the creditor fiduciary standard is to declare still solvent institutions effectively insolvent, preserving creditor claims.

639. See *supra* part II.A.

FIRREA creates a federal uniform fiduciary standard for financial institutions. Congress and President Bush sought, and were successful in achieving, the policy goal of conformity amongst the states. The fiduciary regime under FIRREA is also a minimum fiduciary obligation that permits states to independently enact stiffer fiduciary regulations. FIRREA is a mandatory corporate law that protects shareholders from abuse by officers and directors. It holds directors and officers liable where many state laws prior to the enactment of FIRREA would have permitted them to escape liability. As such, FIRREA is the perfect realization of "coercionist" philosophy: mandatory federal standards driven by the traditional notions of management separated from ownership. Other aspects of FIRREA, however, do not fit as neatly into the coercionist model. In fact, FIRREA assumes a corporate structure far removed from that of the Berle and Means thesis.

FIRREA departs from the coercionist model by recognizing the fiduciary rights of creditors.⁶⁴⁰ In so doing, FIRREA presumes the existence of other corporate actors contractually related to the firm with ownership rights similar to those traditionally held only by shareholders. FIRREA thus adopts the "nexus of contract" approach associated with the contractarian model of corporate governance. Contractarians, however, advocate enabling laws that permit corporate actors to negotiate their own corporate relationships. Although FIRREA establishes a duty owed to creditors and assumes a corporate structure not limited to traditional shareholders and management, it does not enact a federal enabling regime. Instead, FIRREA implements a mandatory federal minimum fiduciary regime.

FIRREA mixes and matches corporate governance theories to combat the savings and loan crisis. By acknowledging the ownership rights of corporate actors other than traditional shareholder owners, Congress and the President implicitly recognized the complexity of the relationships in the corporate financial form. In economic terms, depositor creditors often have as much of an investment in the firm as shareholders.⁶⁴¹ Furthermore, because of the liquidity of depositors' "investment" and the sanctity of a deposit account, deposit creditors interact in a unique relationship with financial institutions. Because of the abuse of that relationship during the early days of the thrift crisis, Congress and President Bush enacted mandatory corporate fiduciary provisions protecting deposit creditors and serving the community goals of maintaining a viable thrift industry.

640. See *supra* part VI.D.

641. See *supra* part II.B.

FIRREA's mandatory application is easily rationalized by the inability of market forces to dictate optimal contractual obligations that would have provided greater protection to thrift investors. But, with the dramatic fallout caused by the savings and loan crisis, Congress replaced the market regulation of corporate actors in financial institutions with an inflexible and strict mandatory fiduciary regime. Yet, the FIRREA fiduciary regime implements an inefficient and unworkable corporate risktaking prohibition that questions the competitive role of the thrift industry in modern financial markets.

Regardless of the ultimate workability of the fiduciary regime established by FIRREA, Congress takes a revisionist approach to corporate governance theory by adopting the contractual model of corporations while implementing coercionist standards. Although FIRREA dramatically restructured the savings and loan regulatory environment, it is also notable for its social responsiveness. By bailing out the savings and loan industry, Congress demonstrated its social commitment to traditional conservative savings depositors and home lenders. FIRREA's recognition of the rights of the government as insurer, of depositors, and of other creditors, is responsive to public policy goals serving a community of actors rather than solely serving shareholder profit goals.⁶⁴² Although a strong savings and loan industry benefits multiple actors in the financial institution, Congress designed the new-regulated thrift industry as a primary safeguard of depositor and homeowner stakes. Government-sponsored depository insurance protects depositors, promoting confidence in institution safety. Homeowners also benefit from the preservation of savings and

642. One former Federal Home Loan Bank Board chairman claims the new savings and loan (and bank) industry will be guided by strong community goals. M. Danny Wall describes the motivations behind the "classification of most of the nation's banks and thrifts as community institutions." M. Danny Wall, *The Future of the Thrift Industry*, 2 STAN. L. & POL'Y REV. 25, 134 (1990).

First, the populist nature of Congress is sensitive to consumers' increasing affinity for supporting institutions that regard consumer service as a primary business, rather than as a sideline. Community development, affordable housing, and services for the elderly predominate congressional debate over the regulation of financial services. An amalgam of appropriately labeled community-oriented institutions can have an intangible, yet invaluable, effect of creating an atmosphere in which these consumer services thrive, set distinctly apart from money center institutions.

Second, such an alignment may lessen the possibility of an increase in the taxpayers' share of the net cost of the thrift industry rescue, estimated at \$166 billion. . . .

Third, there is a perception in the banking industry, particularly among smaller national banks, that consumer and community-oriented institutions should be regulated differently than multinational or industrial lenders.

Id.

loan institutions as the traditional source of low-interest home mortgage loans. Taxpayers are additional indirect beneficiaries of the regulatory regime. By preserving the assets of failing institutions, deposit insurance reserves run less of a risk of depletion, saving taxpayers from bearing further bailout expenses. Combined, the motivations behind FIRREA constitute a recognition of community goals based on public policy.

FIRREA's motivations are not necessarily extraordinary for community responsiveness, because many business regulation statutes provide for socially conscious business.⁶⁴³ However, FIRREA is the first federal corporate governance scheme to pursue corporate social responsiveness.⁶⁴⁴ FIRREA is novel in its recognition of the multiplicity of corporate actors and its focus on the government as insurer, and on depositors, homeowners, and taxpayers. No longer is the goal of shareholder profit maximization the sole aim of corporate management. Now, corporate managers, in their new role as foremen, respond to individual claims on the financial institution based on public policy. The "neutral technocracy" in corporate management—predicted by Berle and Means—may finally become reality in the context of insured depository institutions.⁶⁴⁵

In its effort to cure the ills of the savings and loan industry, Congress discarded the basic concept of corporate structure that had evolved since the Berle and Means thesis.⁶⁴⁶ Instead, Congress attempted to realize communitarian goals as envisioned in Berle and Means' ideal of community obligation. But while other corporate

643. The Community Reinvestment Act of 1977 (CRA), Title VIII of the Housing and Community Development Act of 1977, Pub. L. 95-128 (codified at 12 U.S.C. § 2901-2909) (1991) directly contemplates a financial institution regulatory framework sensitive to community goals. The CRA regulated the financial institution licensing process to serve the "convenience and needs of the community." *Id.* Under the CRA, federal regulatory agencies monitor institutional records of meeting the credit needs of the communities the institutions serve. The agencies' evaluation of an institutions' effectiveness in this area may be persuasive in a regulatory "licensing" decision, such as decisions on charter, branch, relocation and merger. *Id.* For an overview of the CRA, see Warren L. Dennis, *The Community Reinvestment Act of 1977: Defining 'Convenience and Needs of the Community,'* 95 BANKING L.J. 693 (1978); Peter F. Healey, *A Banker's Guide to the Community Reinvestment Act*, 96 BANKING L.J. 705 (1979).

644. The distinction here is between individual and institutional social responsiveness. Business regulation statutes like the CRA attempt to enforce a *corporation's* responsiveness to community. No statute prior to FIRREA has mandated *individual* managerial contemplation of community, enforced with a threat of civil liability. FIRREA is therefore the first statute that expects and requires corporate management to depart from their traditional goal of shareholder wealth maximization to serve community goals in their individual managerial capacities.

645. See *supra* part II.A.

646. See *supra* part II.A.

institutions are unconstrained in their pursuit of traditional shareholder profit maximization goals, FIRREA constrains savings and loan institutions by requiring directors and officers to balance shareholder profit maximization goals with community obligation in a strict regulatory environment threatening enormous personal liability.⁶⁴⁷ The neutral technocracy furthering community obligation is a last-ditch effort to resurrect the failed savings and loan industry with a visionary approach to corporate structure. Nevertheless, the competitiveness of insured depository institutions is in question, because other financial institution management is not obligated to consider the community in their single-minded pursuit of shareholder profit maximization goals.⁶⁴⁸

VII. CONCLUSION

The sweeping reform of the thrift industry implemented under FIRREA indicts financial institution management for their role in causing the thrift crisis. In their zeal, however, the drafters of FIRREA's fiduciary regime overlooked the corporate liability crisis of the early and mid-1980s and its effect on corporate governance. Perhaps the drafters perceived the liability crisis as overblown. If so, the statutory enactments after *Trans Union* are nothing but a "race to the bottom," an end run of corporate plunder at the hands of liability-proof officers and directors. Assuredly, the thrift crisis brought back a vivid memory of the Great Depression, when bank failures pushed the United States into the greatest economic disaster in history. Whatever the psychological motivation, the magnitude of the savings and loan crisis prompted Congress to reconceptualize the corporate structure of financial institutions with a focus on community rather than shareholder profit maximization.

In defense of FIRREA's drafters, reconciling the goals of attracting qualified persons to the boardrooms of financial institutions while holding previous and existing boardmembers liable as scapegoats of the thrift crisis is a difficult if not impossible task. Still, the enactment of FIRREA is a knee-jerk reaction in the hot political climate of the thrift crisis, a reaction that fails to consider the long-term viability of corporate governance in a savings and loan industry on an arduous road to recovery. The question thus becomes whether there is a solution that would respond to the realities of both national politics and corporate governance. Any theory denying the liability of corporate leadership assumes that the cause, or at least a contributing

647. *But see infra* discussion part VII.

648. *See infra* discussion part VII.

cause, of the thrift crisis runs much deeper than the boardroom, and ultimately leads to the steps of the Capitol and the White House. Unless blame is deflected from the boardroom, no alternatives to the fiduciary regime of FIRREA will ever be successful.

Several possible amendments to FIRREA could make insured depository institutions more attractive to talented corporate leaders. First, the codification of the business judgment rule would ensure that the "unsafe and unsound" business practice standard would not allow judicial second-guessing of good faith business decisions. The present liability standards under FIRREA essentially preclude all risktaking. Congress may desire to return the savings and loan industry to the conservative industry it once was, but it is unrealistic to assume that thrifts will survive in modern competitive markets without some risktaking ability. Although the potential would still exist for boardroom liability, a business judgment amendment to FIRREA would attract qualified leaders to the boardroom, leaders who would not be constrained by fear of tremendous personal liability. The expertise of these leaders would possibly guide savings and loans to success in the comprehensive regulatory environment of FIRREA.

Second, FIRREA could distinguish between inside and outside directors and officers.⁶⁴⁹ Inside directors, who are personally involved in the everyday business of the institution, could be held to a higher standard of liability.⁶⁵⁰ Outside directors, who monitor the corporate business, could be held to a lower standard, encouraging greater participation of these directors in financial institution corporate governance. FIRREA could further distinguish fiduciary standards based on service on various committees, such that directors and officers would owe a higher degree of care for claims arising out of information presented to their committee.⁶⁵¹ However, varying standards of liability may seem unwieldy and may dissuade managerial involvement in the corporation, much to the detriment of their monitoring role. If applied retroactively, this model could hold many of the "villains" of the savings and loan crisis liable while exonerating the many innocent directors whose action or inaction could not have forestalled the failure of their institutions.⁶⁵²

649. For an overview of the role of inside/outside directors, see *supra* part III.A.

650. Inside directors rewarded by an employment relationship are less likely to be deferred by liability than outside directors who receive little pecuniary gain in the managerial service.

651. Liability based on particular committee service may have the undesired effect of discouraging committee service, to the detriment of the corporation.

652. Certainly, in the case of "villains" like Charles Keating, Neil Bush, and David Paul, their inside status could lead to greater liability. See Lincoln, Silverado, and Centrust Hearings, *supra* note 332.

Third, FIRREA's fiduciary regime could be amended to serve the goal of limiting director liability and of preserving corporate assets. Fiduciary standards could vary with the solvency of the institution: graduated standards of liability would permit corporate risktaking during periods of institutional strength and prohibit risktaking by institutions approaching insolvency.⁶⁵³ Such standards, depending on a thrift's balance sheet, would promote the vitality of institutions, while institutions approaching failure would be constrained from risking corporate assets eventually destined to reimburse the deposit insurance fund. One difficulty with this approach is that it could have the effect of declaring nearly insolvent institutions legally insolvent.⁶⁵⁴ Furthermore, the weakened condition of the thrift industry might make the graduated standard impractical.

However, a graduated standard might be viable after codification of the business judgment rule and after an opportunity for thrift recovery in the new regulatory environment. The graduated fiduciary method may serve the goals of both attracting personnel to the boardroom and of preserving the assets of failing institutions. Furthermore, an insider/outsider distinction could be appended to this regime to ensure the liability of those high-profile fiduciaries who contributed to the downfall of their institutions. One effect of this entire regime would be the uncertainty of a changing fiduciary standard and the persistent uncertainty and fear of personal liability. A workable graduated standard regime, however, may reduce the conflict between shareholder and creditor by designating optimal duties owed to each.

As both the FIRREA fiduciary regime and the alternate fiduciary principles articulated above indicate, a corporate governance model that completely redresses the ills of the thrift crisis is a virtually unattainable goal. Unfortunately, Congress has focused on punishing thrift management rather than creating a fiduciary regime that revitalizes a failing industry. By cutting the governing head off the savings and loan hydra, FIRREA potentially worsens the prospects of an industry revival.

Perhaps the foregoing analysis falls victim to the same misreading of the Berle and Means thesis given by corporate fiduciary law.⁶⁵⁵

653. A graduated standard of liability is similar to the "springing" fiduciary standard in the *Credit Lyonnais* decision, discussed *infra* this part. See also Coffee, *supra* note 190.

654. See *supra* part VI.B.

655. Corporate fiduciary law misreads the Berle and Means thesis by assuming that shareholders should be subject to protection from potentially self-interested management in control of shareholder wealth. The Berle and Means thesis, however, is not sympathetic to slothful shareholders, but instead envisions an advanced corporate economy driven by community goals. BERLE & MEANS, *supra* note 17, at 312. See *supra* part II.A.

While corporate law gives much weight to Berle and Means' "separation of ownership from control,"⁶⁵⁶ their "convincing system of community obligation" has only recently received the attention of the corporate social responsibility theorists and, historically, has received *no* recognition in corporate fiduciary statutory or common law. FIRREA's incorporation of community into the corporate governance equation suggests, at least as far as financial institutions are concerned, the realization of Berle and Means' prophecy.

In fact, FIRREA may be at the forefront of a dramatic revolution in corporate law, a break with the single-minded capitalist sanctity of ownership wealth maximization. The growth of "other constituency" statutes in more than half the states of the union,⁶⁵⁷ and Delaware's recent court decisions in *Paramount Communications v. Time, Inc.*⁶⁵⁸ and *Credit Lyonnais Bank N.V. v. Pathe Communications*⁶⁵⁹ mark a trend in corporate governance law considering communities of interest removed from shareholder owners. The "other constituency" statutes, *Time Inc.*, and *Credit Lyonnais* all demand a corporate system of community obligation and all question the traditional corporate "capitalist" economy, valuing shareholder wealth above all other interests.

Twenty-eight states have enacted "other constituency" statutes.⁶⁶⁰ These statutes permit managers to consider a wide variety of interests including those of employees, customers, creditors and others in arriving at business decisions affecting the entire corporate enterprise. While each of these statutes merely *permits* management to consider non-shareholder constituencies, their evolution indicates a growing sensitivity to the variety of actors in the corporate community and in society at large. The language of each statute is similar in its contemplation of community goals and instructive of the evolution of a corporate governance scheme driven by public policy:

a director may consider such factors as the director deems relevant, including the long-term prospects and interests of the corporation and its shareholders, and the social, economic, legal, or other effects of any action on the employees, suppliers, customers of the corporation or its subsidiaries, the communities and society in which the corporation or its subsidiaries operate, and the econ-

656. BERLE & MEANS, *supra* note 17, at 300-01. See *supra* part II.A.

657. See *supra* note 632, for a list of the other constituency statutes.

658. 571 A.2d 1140 (Del. 1989).

659. Civ. 12150, 1990 Del. Ch. Lexis 215 (Dec. 30, 1991).

660. See *supra* note 632. For an excellent overview of these statutes, see *Symposium: Corporate Malaise—Stakeholder statutes: Cause or Cure?*, 21 STETSON L. REV. 3 n.1 (1991).

omy of the states and the nation.⁶⁶¹

While no judicial interpretation of these statutes has yet read a fiduciary right of other constituencies, the state statutory recognition of "other constituencies" lends support to the evolution of "a convincing system of community obligation."⁶⁶²

In *Time Inc.*,⁶⁶³ Justice Horsey of the Delaware Supreme Court broadened corporate fiduciary law, at least in the takeover context, to include constituencies other than traditional shareholder ownership. In discussing the long-term corporate versus short term shareholder profit maximization interests, Justice Horsey deviated from the traditional shareholder profitmaking maxim, and instead stated that management is obliged to operate in the *corporation's* best interests.⁶⁶⁴ Furthermore, Justice Horsey claimed that fiduciary rights do not exclusively accrue to shareholders but rather to the *corporation*.⁶⁶⁵ "The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for the achievement of corporate goals. That duty may not be delegated to the stockholders."⁶⁶⁶ Justice Horsey describes corporate goals by quoting from Justice Moore's opinion in *Unocal Corp. v. Mesa Petroleum*.⁶⁶⁷ "We have said that directors may consider, when evaluating the threat posed by a takeover bid, the ' . . . impact on 'constituencies' other than shareholders . . . '"⁶⁶⁸ The language of *Time Inc.* suggests that the corporation and its community of other constituencies is the primary focus of managerial decision-making.⁶⁶⁹ By demanding managerial commitment to the larger interests of the corporation itself rather than to shareholders, *Time Inc.* is part of an evolving trend towards the Berle and Means system of community obligation.

While both *Time Inc.* and the development of "other constituency" statutes form a trend toward community obligation, the most remarkable testimony to the Berle and Means prophecy is the recent Delaware Court of Chancery decision in *Credit Lyonnais*.⁶⁷⁰ In

661. FLA. STAT. ANN. § 607.0830(3) (West Supp. 1992).

662. BERLE & MEANS, *supra* note 17, at 312.

663. 571 A.2d 1140 (Del. 1989). For an excellent discussion of *Time's* recognition of corporate community interests, see Norwitz, *supra* note 190.

664. Justice Horsey stated: "The question of long-term versus short-term values is largely irrelevant because directors, generally, are obliged to charter a course for a *corporation* which is in *its* best interests without regard to a fixed investment horizon." 571 A.2d at 1150 (emphasis added).

665. *Id.* at 1154.

666. *Id.*

667. 493 A.2d 946, 955 (Del. 1985).

668. 471 A.2d at 1153 (quoting *Unocal*, 493 A.2d at 955).

669. See Norwitz, *supra* note 190, at 386.

670. Civ. 12150, 1991 Del. ch. Lexis 215 (Dec. 30, 1991).

Credit Lyonnais, Chancellor Allen shocked corporate law experts by recognizing managerial fiduciary duties owed to creditors and other corporate constituencies.⁶⁷¹ While prior case law found fiduciary rights of creditors *after* an institution's insolvency,⁶⁷² *Credit Lyonnais* holds that management owes fiduciary duties to creditors *prior* to insolvency.⁶⁷³

At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residual risk bearers, but owes its duty to the corporate enterprise . . . [management] had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.⁶⁷⁴

Most importantly, however, the Delaware courts' repeated references to "the community of interests that the corporation represents"⁶⁷⁵ is testimony to a new concept of the corporate economy. Now management, instead of pursuing single-minded shareholder profit goals, has a duty to

recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances will arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.⁶⁷⁶

Chancellor Allen's opinion is immediately significant for its recognition of pre-insolvency duties to creditors, but the opinion's long-term effect may contribute to a revamped corporate scheme where management operates for a wide range of corporate *community* interests.

Do "other constituency" statutes, *Time Inc.*, *Credit Lyonnais* and FIRREA's fiduciary regime fulfill the sixty-year-old Berle and Means prophecy? Is corporate law experiencing a revolution leading to a "convincing system of community obligation"⁶⁷⁷ that inevitably transcends the boardroom and forces a reevaluation of the corporate capitalist economy? The development of community obligation may be an aberrant reactionary trend to the frenzied days of the 1980s. But in the grander scheme, the fulfillment of the Berle and Means

671. *Id.* Slip Op. at 83.

672. See cases cited *supra* note 190.

673. Slip Op. at 83.

674. *Id.*

675. *Id.* at 84 n.55.

676. *Id.*

677. BERLE & MEANS, *supra* note 17, at 312.

prophecy may be a *secure* deviation from the psychology of pure corporate shareholder capitalism that has dominated the corporate world since Adam Smith. And perhaps, given the history of failure in the savings and loan industry, only the sixty-year-old foresight of a "convincing system of community obligation"⁶⁷⁸ may resurrect a dying form of corporate financial institution. The savings and loan industry now answers to "the paramount interests of community" as the "passive [shareholder] property right yields before the largest interests of society."⁶⁷⁹ Emerging from the carnage of the thrift industry debacle is a corporate form of a financial institution that speaks to *community-oriented capitalism* that may force a reevaluation of all core corporate law.

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678. *Id.*

679. *Id.*