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# "IMPORTANCE OF LEGAL ASPECT OF CORPORATE GOVERNANCE IN CASE OF FINANCIAL CRISIS"

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## ABSTRACT

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

## INTRODUCTION

Corporate governance has become a key topic in international practice and economic and legal theory. The definitions of corporate governance vary. Corporate governance is certainly not just corporate law. The short-form definition used by the Cadbury Commission in 1992 is to the point

and internationally agreed upon: Corporate governance refers to 'the system by which companies are directed and controlled'. Direction and control can come from inside or outside. Internal corporate governance refers to government and control by the organs of the corporations, the board in the one-tier system or the management and supervisory boards in the two-tier system. Accordingly, it is hardly astonishing that much of the corporate governance literature deals with the board. External corporate governance can be understood as the disciplinary effects exercised in particular by the takeover market on the directors but also, to a certain degree, effects exercised by the markets for directors, products and services. External corporate governance is weaker for financial institutions than for corporations in general since there is no well-developed market for corporate control as regards financial institutions. Until recently, takeovers did not have a significant corporate control effect for banks, at least not in Europe. Yet under the pressure of globalization, shrinking returns, digitalization and in particular fierce competition from non-bank institutions, this may change soon.[1]

Other Varieties of Corporate Governance for Other Enterprises and Sectors (Non-listed, State-owned, Non-profit, Insolvency, Banking and Insurance)

Corporate governance was first developed as a concept and field of research for private listed corporations. This was due to the self-regulatory efforts of stock exchanges and other private institutions that either had certain requirements for admission or set up recommendations on good corporate governance, usually with corporate governance codes, sometimes with the help of the comply or explain-principle set up by legislators. The idea of developing corporate governance standards spread quickly to other sectors, such as to non-listed companies (among them in particular family companies, state-owned enterprises (SOEs) with public corporate governance codes, non-profit organizations and foundations), insolvent companies and companies in serious financial crisis; the notion of corporate governance was also extended to banks, insurance companies and other financial institutions such as rating agencies. While corporate governance principles for listed corporations have been and are still a major source of inspirations for corporate governance in these other sectors, there is very little cross-fertilization as regards the corporate governance efforts in these other sectors. Therefore, this article basically compares the governance of financial institutions—with banks taken as an example—with general corporate governance, and it will make the point that the corporate governance of banks is different in many

[1] Benjamin W. Heineman, Jr., Shareholders: Part of the Solution or Part of the Problem?, THE ATLANTIC, Oct. 28, 2009, available at http://www.theatlantic.com/politics/archive/2009/10/shareholders-partof-the-solution-or-part-of-the-problem/29188/

respects.

**'Banks are Special': Particular Economic Features of Banks and Other Financial Institutions**

The Basel Committee on Banking Supervision, the world's leading authority on banking regulation and banking supervision, begins its 2015 Guidelines on Corporate Governance Principles for Banks with the words:[2] 'Effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole.' The corporate governance of banks and other financial institutions has gained much attention after the financial crisis. From 270 economic and legal submissions from 2012 to 2016 in the ECGI Working Paper Series of the European Corporate Governance Institute (ECGI), roughly half address corporate governance questions, and more than a quarter of these look at the regulation and corporate governance of banks (in the broad sense). The financial crisis certainly contributed to this, yet whether the financial crisis can really be attributed mainly to financial institutions' shortcomings in corporate governance, as some authors assert, is doubtful.

In theory, practice and supervision, it is a truism that banks are special as compared to non-banking institutions. This is the very basis for the targeted regulation and supervision of banking as a regulated industry. The unique aspects of banks include the very low capitalization of banks as compared to non-banking entities (particularly when short and long financial maturity periods are matched); the complexity and non-transparency of banks' business activities and structures; the fundamental need for trust and the associated danger of bank runs; and in particular the macroeconomic function of banks as manifested in their central importance for the economy, which in turn gives rise to their being subject to far-reaching legislation and state regulation.[Footnote17] Their uniqueness is reflected in frequently recurring banking crises and the structural flaw whereby banks are seen as 'too big to fail' and 'too interconnected to fail', such that state rescue is needed whenever a bail-in is either not an option or proves ineffective. One cannot dispute that these unique characteristics are of course of particular importance for systemically important banks (SIFIs). But they are not limited to such entities. Instead these attributes are of more general relevance, even if they are naturally more consequential and visible

[2] Norton, supra note 41, at 1313; MUlbert, supra note 37 at 14. Adjusting the capital requirements for the riskiness of the bank's assets should decrease this incentive (id)-albeit, this increases the complexity problem with capital requirements

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in the case of SIFIs.

It is hardly astonishing that these special characteristics of banks demand, in turn, a special variety of corporate governance. Yet what is surprising is that particular attention to this has traditionally been absent and that economic research as to the special governance of banks has commenced relatively late[3]. One of the earliest contributions to the field dates from the 1980s. Several factors seem to have contributed to this delay in research. Empirical studies, found mostly in US academic literature, usually focused on the principal-agent dilemma and were oriented on the conflict between directors and shareholders, this corresponding to the US shareholder structure (mostly dispersed shareholdings and relatively few major block-holdings). Consequently, given this focus and in accord with the available data, the natural object of inquiry tended to be publicly-traded companies. Even where banks were the topic of inquiry, earlier studies focused on principal-agent theory as framed by studies in non-banking contexts. By contrast, empirical studies looking specifically at corporate governance in the banking context—and demonstrating the unique characteristics which ensue—are only a more recent development. In the context of this present paper, only a few important findings can be discussed.

Fahlenbrach and Stulz report that worse results were achieved by bank CEO's whose actions were primarily motivated by shareholder interests. Similar findings were reached by Beltratti and Stulz as regards bank boards. Banks with shareholder-friendly boards had significantly poorer results. According to other studies, the composition and characteristics of bank boards had significant effects, and boards with relatively higher shareholder representation undertook more and greater risks. Apparently bank boards charted a course more aligned with the preferences of shareholders, who—if sufficiently diversified in their holdings—embrace risk more readily than, for instance, a bank's creditors. Beltratti und Stulz thus doubt the hypothesis that bad corporate governance was a significant cause of the financial crisis. Banks with independent boards were run more poorly. Banks that were controlled by shareholders saw higher profits before the crisis as compared to banks that were controlled by directors. Enterprises in which institutional investors held stocks correspondingly fared worse. In general, studies showed that the shareholder structure of a bank correlated strongly to the bank's insolvency, particularly where low-level management was significantly involved in the decision-making process.[4]

[3] ALFRED M. POLLARD & JOSEPH P. DALY, BANKING LAW IN THE UNITED STATES § 11.02 (3rd ed. 2009).

[4] William W. Bratton & Michael Wachter, The Case Against Shareholder Empowerment, 158 U. Pa. L. Rev. 653, 704-709 (2010)

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These and further empirical studies suggest that it is erroneous to conclude that traditional—even if empirically established—approaches to the corporate governance of corporations can be seamlessly applied to the corporate governance of banks; in fact, exactly the opposite may be true. This is the case, for example, as regards director independence, which according to recent studies can carry negative effects also in the case of non-financial corporations, whereas expertise and experience are of much greater value[5], at least when obvious conflicts of interest are avoided. Still, it bears emphasis that sound judgment is called for when evaluating empirical findings. Often, findings warranting a differentiated assessment are held up against one another despite their embodying nuanced differences that may reflect a dissimilar time horizon in the studies, an inadequate account of the interdependence of certain factors and, above all, country- and path-dependent differences resulting from legal regulation and cultural circumstances.

**Governance of Banks and Financial Institutions in Supervisory Law and Practice**

**The Basel Committee on Banking Supervision: The Guidelines, Corporate Governance Principles for Banks, 2015**

The Basel Committee has issued the authoritative Guidelines on Corporate governance principles for banks, released in a revised version in July 2015. The Guidelines, while underlining the jurisdictional differences and the necessity of proportionality and differences in governance approaches, set out 13 major principles in respect of banks' corporate governance. They concern (1) The overall responsibilities of boards, (2) Board qualification and composition, (3) The structure and practices of boards, (4) Senior management, (5) Governance and group structures, (6) Risk management functions, (7) Risk identification, monitoring and control, (8) Risk communication, (9) Compliance, (10) Internal audits, (11) Compensation, (12) Disclosure and transparency and (13) The role of supervisors.[6] This list sounds familiar to someone who is

[5] Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 COLUM. L. REV. 1416 (1989). But see Melvin A. Eisenberg, The Structure of Corporation Law, 89 COLUM. L. REV. 1461, 1480 (1989) (arguing that mandatory rules should govem some aspects of public corporations, such as fiduciary duties).

[6] Richard A. Posner, Capitalism in Crisis, WALL ST. J., May 7, 2009, at A 17, available at http://online.wsj.com/article/SBl24165301306893763.html. One might also ask whether the self-interest of the financial institution's creditors will lead creditors to prevent the institution from taking excessive risk. Writers sometimes blame deposit insurance for creating moral hazard by removing the insured depositors' incentive to monitor banks against dangerous risk-taking. E.g., Jonathan R. Macey & Maureen O'Hara, The Corporate Governance of Banks, 9 FRBNY EcON. POL'Y REv. 91, 98 (2003) available at http://www.newyorkfed. org/research/epr/03v09nl/0304mace.html. The problem, of course, is that the threat of a bank run by illinformed depositors, who might be reacting as much to the danger of the run as they are to poor investments of the bank, seems a crude tool to discourage excessive risk-taking that the depositors will be the last people to discover. E.g., Peter 0. Milbert, Corporate Governance of Banks 10, 13 (ECGI - Law Working Paper No.130, 2009),

accustomed to dealing with corporate law and corporate governance, though already at first glance Principle 4 on senior management and Principle 13 on the role of supervisors are special for bank governance. As in corporate governance of non-banking entities, the board is at the center of the attention. But the demands on its composition, qualification, responsibilities and practices are much higher than for non-bank corporations. The risks a bank runs are of course very special. Accordingly the requirements concerning the bank board's governing and controlling functions are spelt out in considerable detail and are much more demanding. So are the disclosure and transparency requirements. It is interesting to see that a special principle is devoted to the governance of group structures, groups of companies being subject to special legal treatment in only some countries (like Germany), while in others they are not recognized as a special area in corporate law and governance. The Guidelines do not have the character of legally binding norms, but they spell out in detail what rules banks should observe.

Principles and Guidelines of Other Supervisory Institutions (European Banking Authority 2016/17, the Financial Stability Board 2017 and Similar National Supervisory Agencies In and Outside of the European Union)

The crisis resulted in many other international institutions adopting recommendations, supervisory measures and regulations in the area of corporate governance as regards the banking industry. Though scarcely addressed by academic authors, many of these instruments and schemes are now in their second or even third generation, e.g. the Guidelines on internal governance of the European Banking Authority (EBA) of 2017, the Joint ESMA and EBA Guidelines from 2017, the report of the Financial Stability Board (April 2017), the Guidelines of the European Central Bank of 2018—and those of similar national supervisory agencies, for example the Swiss FINMA (September 2016) or the German Federal Financial Supervisory Agency (BaFin 2016/2017)—and for the insurance companies the International Association of Insurance Supervisors (November 2015).[7]

## CRD IV, National Bank Supervisory Laws, Legal and Policy Analyses

The concepts and recommendations of the Basel Committee made their way not only into the

http://ssm.com/abstract=1448118. For an explanation as to why bondholders in the bank lack sufficient incentives to address excessive risk-taking, see Bebchuk & Spamann, supra note 33, at 268-71

[7] Joseph E. Stiglitz, Multinational Corporations: Balancing Rights and Responsibilities, 101 AM. Soc'Y OF INT'L L. PROCEEDINGS 3, 45-46 (2007).

principles and guidelines of other international and national supervisory institutions, but also into the bank supervisory law of the Member States of the European Union via the Capital Requirements Directive (CRD IV). Further, via the Solvency II Directive, they entered similarly into the Member States' supervisory law of insurance companies.

Accordingly, as to the academic literature, much of it is just a doctrinal legal presentation and a commentary-like treatment of the actual supervisory law in the various Member States. A significant amount of the literature deals with the European law in the CRD IV—as well as in Solvency II and regarding its implementation for insurance supervision—looking particularly at supervisory boards/boards of directors/CEOs, most of it purely *de lege lata*, but at times based more on functional legal policy considerations. It is true that there are some authors who question the whole approach of the Basel III regulation, but this is due to fundamentally different views towards regulation. In any case, there is criticism of over-regulation as voiced by the industry, and a large number of academic authors rightly join in the latter's complaints. The provisions drafted by legislators, supervisory agencies and international bodies are indeed increasingly detailed; while these provisions are, legally speaking, only persuasive in nature, they are de facto more or less binding. Yet despite often being adopted in the wake of corporate scandals and while frequently tending to overshoot the target, regulation remains both unavoidable and indispensable.[8]

The interplay between stock corporation law, bank supervisory law and insurance supervisory law in corporate governance is considered more rarely. Yet there is a basic agreement on the necessity of taking note of the similarity of supervisory problems in the separate fields as well as of trying to harmonize rules whenever the problems are functionally similar, while maintaining different rules and regulations when the risks and features are different. Cross-sectoral regulation is needed. Some have rightly observed that a European bank corporation law is gradually developing in its own right, and these authors ask what effect the European banking union will have on the governance of credit institutions[9]. Corporate governance of banks may even pave the way to a self-contained law covering financial intermediaries and their corporate governance.

**Shareholder, Stakeholder or Creditor Governance: The Controversies Regarding the**

[8] John Cassidy, An Economist's Invisible Hand, WALL ST. J., Nov. 28, 2009, at W3, available at http://online.wsj.com/article/SB10001424052748704204304574545671352424680.html.

[9] Franklin A. Gevurtz, Getting Real about Corporate Social Responsibility: A Reply to Professor Greenfield, 35 U.C. DAVIS L. REV. 645 (2002)

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**Purpose of Corporations and Banks**

**Shareholder or Stakeholder Governance: The German Experience and the American and European Discussion on the Purpose of Corporations**

The purpose of corporations is an old and controversial topic. The classic approach is the one that prevails in the United States: the purpose of a corporation is to make profit for the shareholders. On the other side of the spectrum stands Germany[10]. There, the board is responsible to promote the interests of all stakeholders, i.e. the shareholders, labor and the public good. While the shareholder-oriented approach had gained some attention also in Germany before the financial crisis, the traditional stakeholder concept is still generally agreed upon. The labor interest is even further consolidated by the mandatory labor co-determination at parity in the supervisory board. Other European states, such as the United Kingdom, follow a middle way with the so-called enlightened shareholder approach, a shareholder orientation that also looks at the interests of other stakeholders in view of preserving a long-term profitability of the firm (Europe). But in the United Kingdom this concept is increasingly criticized as too vague and hardly effective. It is of note that most recently even in the United States there has been a tendency towards having more regard for the full spectrum of stakeholders' interest, as promulgated by the business roundtable statement in 2019. Yet whether this non-binding declaration of many American business leaders will really amount to a change in practice remains to be seen. In any case, in times and terms of financial rescue and insolvency proceedings, it has been recognized that risk together with governance ('ownership') is transferred from the owners to the creditors.[11]

## Towards Creditor or Debtholder Governance for Banks

As regards bank corporations and financial institutions, the case is clearly different. Empirical findings, the experience of the financial crisis, and economic and legal conclusions have produced a change in perspective that amounts to a theory of creditor (i.e. debtholders and depositors) governance. The Basel Committee on Banking Supervision's benchmark guidelines, the Corporate Governance Principles for Banks from July 2015, state at the very beginning: 'The primary objective of corporate governance should be safeguarding stakeholders' interest in

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

[11] This observation is commonly known as the "Berle-Means thesis" after the authors of the classic work which pointed out the phenomenon. See ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

conformity with public interest on a sustainable basis. Among stakeholders, particularly with respect to retail banks, shareholders' interest would be secondary to depositors' interest.' This corresponds to the standing supervisory practice of other national and international banking agencies too.[12]

This position is a clear rejection of the shareholder primacy view, but it differs also from the only slightly tempered view held in Europe, since banks are expected to consider creditor interest not only when this is in the long-term interest of the corporation. Creditor governance is not just a question of the purpose of bank corporations, instead having consequences in many other areas regarding the corporate governance of banks. In particular this view reduces also the relative importance of controlling shareholders, institutional investors and shareholder control in general, as is presently the center of attention in the corporate governance of (non-bank) corporations

## Basics of Corporate Governance

### *Corporations*

Corporations are a group of consensual, contractual relations among several constituencies.[13]

Corporate charter (or Articles of incorporation):

This is an agreement between the "corporation" and "state" in which it is incorporated as to how the corporation will be run; this includes:

- Authorized shares of the corporation.
- Corporation's name.
- Corporation's purpose.
- In return, the corporation pays franchise tax to state based on authorized capital of the company.
- A corporate charter may be amended after they are originally filed by incorporators by the majority or super-majority vote of shareholders.
- For public companies, vote requires:
- Proxy filing with Securities and Exchange Commission (SEC)
- Hiring of proxy solicitor to encourage shareholders to vote their shares

[12] William Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663 (1974).

[13] Martin Lipton, Risk Management and the Board of Directors, HARV. L. SCH. FORUM ON CORPORATE GOVERNANCE AND FIN. REGULATION, Dec. 17, 2009, http://blogs.law.harvard.edu/corpgov/ 2009/12/17/risk-management-and-the-board-of-directors-2/#more-5811 (referring to proposals before Congress to require independent risk committees responsible for the establishment and evaluation of risk management practices to be formed at large financial companies)

***By-laws***

- The main purpose of by-laws is to “Fill the gaps” left by the charter.
- They address board elections and composition, the appointment of officers, timing and conduct of corporate annual meetings, etc.
- By-laws may be amended by the board if permitted by the state of incorporation and charter; otherwise, it is amendable by shareholders.[14]

## Board of directors

- The board of directors are elected by shareholders at the annual stockholders’ meeting.
- Each share is generally entitled to one vote per director unless there is cumulative voting or multiple classes of stock.
- The winner of the voting is decided based on simple majority and hence the director who obtains the most votes wins.
- Directors are expected to maximize the value per share.

***Directors’ Fiduciary Duties***

- Directors have two duties to shareholders under the law:

***Duty of care***

1. Director must act in good faith and strive to exercise ordinary prudential care in making business decisions through processes
2. “Business judgment rule”: the presumption is in the favor of the director’s decision-making even if the expected results of the decision are not realized.
3. “Total fairness standard”: if the director has a conflict of interest, he/she must prove that his/her decision was fair to all parties.[15]

[14] CARL FELSENFELD, BANKING REGULATION IN THE UNITED STATES 77-78 (2d ed., Juris Publishing, Inc. 2006)

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

***Duty of loyalty***

1. A Director must act in the best interests of the corporation and not do things that harm the corporation.
2. The Director cannot compete directly with the corporation unless the other directors have expressly permitted the competing enterprise.
3. Failure to adhere to these two duties may lead to personal liability one part of the director.

**Daily Governance of Corporation**

***Chief executive officer (CEO)***

1. The board recruits and hires the CEO to run the day-to-day operations.
2. The CEO serves as the management's representative to the board and is frequently the same person as chair of the board.
3. The CEO hires a management team (chief financial officer, chief marketing officer, and other "C-level" executives)
4. The board holds the CEO accountable for the corporation's operating performance and the stock price performance.

**Managers have fiduciary duties of care and loyalty that prohibit them from:**

1. Competing with their employer
2. Appropriating business opportunities
3. Misappropriating corporate trade secrets and confidential information

**Consequences for breaching duties to corporation:**

1. Managers may be sued personally.
2. Manager's employment may be terminated.[16]

**Sarbanes-Oxley Act**

1. The management of public companies is responsible for structuring corporation with adequate "internal controls" so that the company has integrity in its financial reporting and other processes.

[16] Citigroup, 964 A.2d at 113 (for example, Citigroup, in a couple major transactions in 2007, acquired billions of dollars worth of subprime loans from financially troubled subprime lenders to package into CDOs).

2. The corporation must report any deficiencies in and status of its internal controls in its public filings with the SEC.
3. This process provides current/prospective shareholders with a view on the perilousness of corporation's internal management systems.

## CONCLUSION

Banks are special, and so is the corporate governance of banks and other financial institutions as compared with the general corporate governance of non-banks. Empirical evidence, mostly gathered after the financial crisis, confirms this. Banks practicing good corporate governance in the traditional, shareholder-oriented style fared less well than banks having less shareholder-prone boards and less shareholder influence. The special governance of banks and other financial institutions is firmly embedded in bank supervisory law and regulation. Starting with the recommendations of the Basel Committee on Banking Supervision, many other supervisory institutions have followed the lead with their own principles and guidelines for good governance of banks. In the European Union, this has led to legislation on bank governance under the so-called CRD IV (Capital Requirements Directive), which has been transformed into the law of the Member States. The legal literature dealing with this is mostly doctrinal and concerned with the national bank supervisory law. But there are also more functional legal as well as economic contributions, these addressing primarily, but not exclusively, systemically important financial institutions. The latter are under a special regime that needs separate treatment.

Most recently there has been intense discussion on the purpose of (non-bank) corporations. Shareholder governance and stakeholder governance have been and still are the two different prevailing regimes in the United States and in Europe, particularly in Germany. Yet for banks this difference has given way to stakeholder and, more particularly, creditor or debtholder governance, certainly in bank supervision and regulation.

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